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MBA (Finance) – III Semester**Paper code: MBFM 3002**

PAPER – XII

Banking and Indian Financial System

Objectives

- To get an insight into the constitutions, structure, objectives and working of the Banking Institutions in India
- To evaluate the performance of Banking Institutions and their contribution to the growth of Indian Corporate Sector and
- To have a Bird's view of the Indian Financial System and in the context of Global Indian Banking System.

Unit - I

Banking Systems – Definitions – Functions – Types – Central Banking – Structure of Banking System- Rural Financing – Banker and Customer Relationship – Deposit Mobilization – Loans and Advances – Assets and Liabilities Management – Secured Advances – Endorsement and Crossing of Cheques – Payment of Cheques – Collection of Cheques.

Unit - II

Central Banking System – Nature- Organization and Management- Functions – Methods of Credit Controls – Objects of Monetary Policy – Autonomy of Central Bank Systems – Indian Money Market – Indian Capital Market – New Issue Market- Banking Legislations in India.

Unit - III

Industrial and Agricultural Banking System – All Indian Development Banks – Investment Institutions- State Level Institutions – Specialized Financial Institutions – International Finance Institutions – IBRD – IFC – IDA – NABARD – NHB – Micro Financing Institutions.

Unit - IV

Financial systems - Overview of Indian Financial System – savings and Financial Intermediation – Financial Markets – Listing Regulations – Primary Markets – Secondary Markets – Mutual Funds – Indian Fiscal Systems.

Unit - V

Foreign Investments – Foreign Capital – Foreign Collaboration – Foreign Direct Investment – foreign Institutional Investors – Offshore Country Funds – Overseas Venture Capital Investments – International Capital Market.

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UNIT - I

If you walk on the streets of any town or city, you could notice signboards on buildings with names - State Bank of India, Punjab National Bank, ICICI Bank, IDBI, City Union Bank, etc. What are these names? Have you tried ever to know about them? Have you entered those buildings? If you go inside these buildings, you can find an office layout wherein a lot of desks (counters) with names like May I Help You, Teller, Deposits, Loans, etc. You can also find

- a) A separate room for manager;
- b) Some kinds of challans being kept in the office
- c) The employees in each counter facilitating the customers who come for their financial services need. If you observe, some customers may be depositing money, some may be withdrawing money. Some may be discussing their financial plan for investing with the branch manager. This office is called a 'Bank'. Let us discuss the meaning, definition, history, functions of banking system, structure of Indian banking system, relationship between banker and customer, cheques and its usage, balance sheet of a bank in this unit.

Unit Structure

Lesson 1.1 - Banking System, its Functions and Types

Lesson 1.2 - Structure of Indian Banking System

Lesson 1.3 - Banker and Customer Relationship

Lesson 1.4 - Deposits, Loans & Advances and Assets & Liabilities
Management of Banks

Lesson 1.5 - Cheques - Crossing, Endorsement, Developments in
Collection and Payment

Lesson 1.1 - Banking System, its Functions and Types

Learning Objectives

- To understand the meaning of 'Bank'
- To trace the history of Modern Banking
- To describe the functions of commercial banks
- To discuss the various types of banks

Introduction

The term 'bank' is derived from the French word '*Banco*' which means a **Bench** or **Money exchange table**. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging.

Banking System – Definitions

Banking systems refer to a structural network of institutions that provide financial in a country. It deals with the ownership of banks, the structure of banking system, functions performed and the nature of business. The elements of the banking system include:

- a) Commercial banks
- b) Investment banks
- c) Central bank. The commercial banks accept deposits and lend loans and advances; the investment banks deal with capital market issues and trading; and the central bank regulates the banking system by setting monetary policies besides many other functions like currency issue.

A banking system also refers a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolios, throughout the day.

What is a Bank?

Oxford Dictionary defines a bank as “an establishment for custody of money, which it pays out on customer’s order.”

According to **Prof. Sayers**, “A bank is an institution whose debts are widely accepted in settlement of other people’s debts to each other.” In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.

According to the Indian **Banking Company Act 1949**, “A banking company means any company which transacts the business of banking. Banking means accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other wise and withdrawable by cheque, draft or otherwise.” This definition throws light on the three major functions of a bank. They are:

- (i) Accepting of deposits and lending loans
- (ii) Issue and pay cheques,
- (iii) Collect cheques on behalf of the customers.

A bank is a financial institution that provides banking and other financial services to their customers. A bank is an institution which provides fundamental banking services such as accepting deposits and lending loans. As financial intermediaries, banks stand between depositors who supply capital and borrowers who demand capital. When banks accept deposits its liabilities increase and it becomes a debtor, but when it makes advances its assets increases and it becomes a creditor.

Banks are a subset of the financial services industry. The banks are the main participants of the financial system in India. All the banks safeguard the money and valuables and provide loans, credit, and payment services, such as money orders, and cheques. The banks also offer investment and insurance products.

Due to the emergence of integration among finance industries, some of the traditional distinctions between banks, insurance companies and securities firms have diminished and they have converted themselves into Universal Banks to offer a variety of services under one umbrella.

Example: IDBI Bank and ICICI. In spite of these changes, banks continue to maintain and perform their primary role—accepting deposits and lending funds from these deposits.

History of Modern Banking in India

Modern Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1770; both are now defunct. The oldest bank still in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955.

In April 1935, the Reserve Bank of India was established. At the time of first phase the progress of banking sector was very sluggish. Between 1913 and 1948 there were around 1100 small banks in India. To reform the working and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.

After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in 1960.

According to the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969, the objective and reasons for bank nationalization are: "The banking system touches the lives of millions and has to be inspired by large social purposes and has to sub-serve national

priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising of employment levels, encouragement of new entrepreneurs and the development of the backward areas. "For this purpose, it is necessary for the Government to take direct responsibility for the extension and diversification of banking services and for the working of the substantial part of the banking system."

On 19th July, 1969, 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. Till the year 1980 approximately 80% of the banking segment in India was under government's ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and hence, the gateways for the new private sector banks were opened.

The following are the major steps taken by the Government of India to Regulate Banking institutions in the country:-

- 1949: Enactment of Banking Regulation Act.
- 1955: Nationalization of State Bank of India.
- 1959: Nationalization of SBI subsidiaries.
- 1961: Insurance cover extended to deposits.
- 1969: Nationalisation of 14 major Banks.
- 1971: Creation of Credit Guarantee Corporation.
- 1975: Creation of Regional Rural Banks.
- 1980: Nationalisation of seven banks with deposits over 200 Crores.

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalisation, licensing a small number of private banks. These came to be known as **New Generation tech-savvy banks**, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank (earlier as UTI Bank), ICICI Bank and HDFC Bank.

Functions of Banks

The following figure clearly shows the functions of banks:

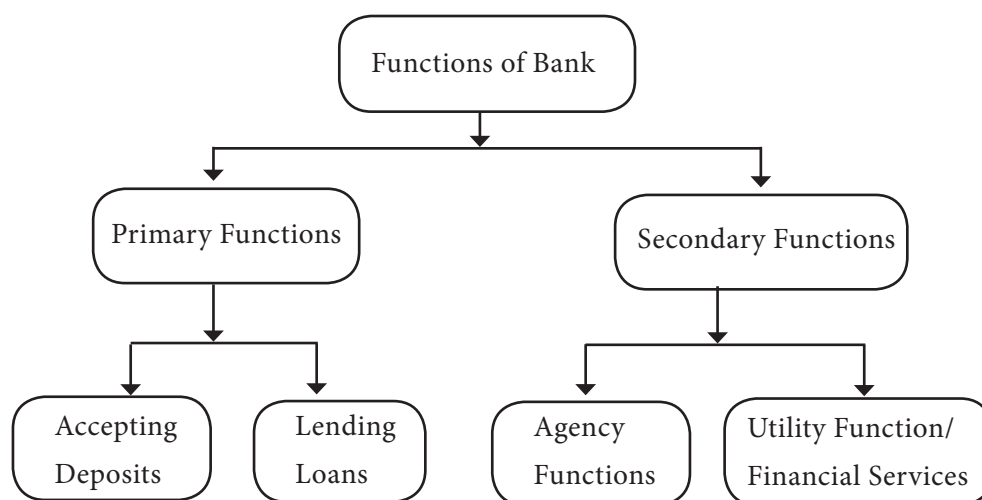


Figure showing the Functions of Bank

The functions of commercial banks can be broadly categorized into

- a) Primary functions
- b) Secondary functions.

Primary Functions

Following are the primary functions rendered by banks.

Accepting of Deposits

The primary function of commercial banks is to accept money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. For these deposits, the banks pay a rate of interest, which is called as interest expenditure. Thus, banks act as a custodian of depositors' funds. The deposits may be of various types such as savings deposits, current deposits, fixed deposits and recurring deposits.

Savings deposits encourage customers to save money and promote banking habit among the public. Savings Bank accounts provide a low rate of interest and they have restrictions on the number of withdrawals by the

customers. The SB accounts can be opened in single or joint names. People who prefer these savings bank accounts include salary and wage earners. Now, all the banks allow customers to open a savings bank account with nil balance.

Current Deposit accounts are opened by business people. These accounts have no restrictions on the number of withdrawals and are subject to service charges. There is no interest payment but current account holders can also avail the benefits such as overdraft and cash credit facilities.

Fixed deposits accounts can be opened by any person who wants to deposit a lump sum funds at one time for a specific time period. These accounts provide higher rate of interest depending on the time period for which it is deposited. These accounts do not allow withdrawal before the expiry of the period.

Recurring deposit accounts are normally opened and operated by persons who get regular income such as salary class and petty shop owners. A specific amount of money is deposited periodically, say, monthly for a specific period, say, one year. These accounts provide higher rate of interest and do not allow withdrawal before the expiry of the period.

Lending Loans and Advances

The second primary function of commerce bank is to lend loans and advances to the corporate sector and households. Normally, the rate of interest levied on these loans and advances is higher than what it pays on deposits. The interest income is the major source of income for commercial banks. The difference in the interest rates (Interest Received and Interest Paid) is called Interest Spread, which contributes to its profitability. Apart from leading, the banks usually keep some portion of funds to meet the demands of depositors and running expenses. The various types of loans and advances include overdraft, cash credit, loans, discounting of bills of exchange.

Over Draft (OD) is a facility extended by banks to the current account holders who maintain their accounts for business purposes. In this facility, the current account holders can withdraw more money from

their accounts than what they maintain as balance. Under this facility, banks honour the cheques drawn by the customers of the current account even if sufficient money is not available in their account. This overdrawing limit will be fixed by the banks for a certain period, based on the credit quality of the current account holders and their history of dealing with the bank. The amount overdrawn will be considered as loan and interest will be charged on the actual amount withdrawn.

Cash Credit (CC) is a facility extended by banks to current account holders and other who do not have account. In this facility, banks sanction a credit limit to a borrower for a certain period (usually for a longer period than overdraft) after verifying the credit worthiness, history of bank dealings and the track record of business. Normally banks expect security of tangible assets (such as stock of inventory) and/or guarantees for sanction cash credit facility. Interest will be charged on the portion of amount withdrawn from the cash credit account but not on the entire amount sanctioned to the borrower.

Loans are normally sanctioned for a short term period (say one year) or medium term (say three to five years). At present, banks lend long term loans also. Repayment of loan will be made in various installments (say monthly, quarterly, semiannually, annually) over a specific period of time or in a lump sum. Banks charge interest on the actual amount of loan sanctioned and rate of interest is somewhat lower than what is charged on OD or CC facility. Regarding the collateral (security), banks expect some tangible assets (like stock of raw materials, finished goods) from the borrower. There are various types of loans such as secured loans, mortgage loans, educational loans, personal loans, etc.

Examples for secured loans include two wheeler loans to the individuals, working capital loans to the business firms, etc. Mortgage loans are given to the borrowers to purchase immovable tangible assets such as land, buildings, homes, etc. with a lien/charge on the asset which will serve as collateral. At present, majority of the banks are granting home loans to the customers. Educational loans for higher studies and professional courses are given by banks to the students at a reasonable rate of interest. Personal Loans (Consumer finance) for individuals are provided on easy terms and conditions to buy consumer durables like TV, refrigerators, etc.

Discounting of Bill of Exchange is another method of granting advances to the traders. The banks can advance funds by purchasing or discounting the bills from traders which arise from trade. Trade bills are those bills which emerge due to credit sale to customers. If the traders require money before the expiry of the bills, they can discount the bills with the banks. The banker will pay an amount to the drawer or beneficiary of the bill (usually trader who sold goods on credit basis to customers) after deducting the discount amount. On maturity of the bill, the banker will receive the amount from the drawee or acceptor of the bill (the customer who bought goods on credit terms).

Secondary Functions

Following are the secondary functions performed by the banks

Besides the primary functions of accepting deposits and lending loans and advances, banks perform various other functions, which are called secondary functions. They include agency functions and utility functions.

Agency Functions

The banks act as agent of their customers and perform a number of agency functions which include transfer of funds, collection of cheques, periodic payment, periodic collections, portfolio management and other agency functions.

Transfer of Funds is made by banks from one branch to another or from one place to another for customers. At present, banks use technology and telecommunication systems to facilitate these transfers. Example: Electronic fund transfers (EFT). For this service, banks collect service charges.

Collection of Cheques is facilitated by banks through clearing section. Thus, the cheques deposited or presented for collection are credited to the customers' account once they collect the same through clearing process. This includes the cheques of the same bank or other banks and within the station and outstation. For providing this service, they charge collection charges which are very nominal.

Periodic Payments such as payment of public utility bills, rent, interest, etc. are made by banks on behalf of the customers based on their standing instructions. A specific example: Payment of housing loan interest from salary account.

Periodic Collections such as receipt of salary, pension, dividend, interest, rent, etc. are made by banks on behalf of the customers based on their standing instructions. A specific example: Receipt of dividend from investments.

Portfolio Management services are offered by banks to guide the customers or clients on their investment decisions to buy or sell the securities (shares and debentures) to achieve optimal portfolio for getting maximum returns.

Other Agency Functions like acting as trustee, administrator, adviser, executor, etc. on behalf of the customer or client are provided by banks.

General Utility Functions/Financial Services

The banks perform general utility functions such as issue of drafts, letter of credits, locker facility, underwriting of shares, dealing in foreign exchange, project counseling, social responsibility programmes and other utility functions.

Issue of Drafts, Traveller Cheques and Letter of Credits are done by banks for facilitating the transfer of money from one place to another and for giving guarantee for import trade. Travellers' cheques are also issued by banks.

Safety Locker Facility is provided to customers for safe keeping their valuables such as documents, gold, silver articles and other values.

Underwriting of Shares and debentures are done by banks in the capacity of merchant banker through their subsidiaries. In the case of client's capital issue fails in the market, the banks assume the risk of under subscription by underwriting the issue. For this, banks receive underwriting commission.

Dealing in Foreign Exchange can be undertaken by banks as they are allowed by RBI. They will act as deal makers or traders depending on their position.

Project Reports are being prepared on behalf of the clients or customers. Many corporate which take up projects and look for financial assistance have to prepare project reports for submitting the same to the Financial Institutions or Banks. This project report preparation requires expertise personnel which the banks possess. Banks collect consultancy charges from their clients or customers.

Social Responsibility Programmes such as public welfare campaigns, adult literacy programmes, maintenance of schools, parts, blood donation camps, etc. are undertaken by banks to showcase their social responsibility.

Other Utility Functions may include any other function the bank may render for customers. Examples include collecting and supplying business information, acting as a referee to a financial standing of customers, etc.

Types of Banks

Banks can be classified into various types based on some criteria like organizational setup, ownership, functions performed by them. The factors which affected the classification include

- a) The regulatory set up prevailing in a country
- b) The impact of LPG (Liberalization, Globalization Privatization) process
- c) The need for various financial services among the customers. With the changing perspectives of trade and commerce, banking and financial system in India has undergone tremendous changes in the recent past. In this section, we will learn as how to classify the banks based on various criteria such as organizational set up, ownership and functions performed by banks.

The following figure explains the various types of banks based on structure, ownership and functions.

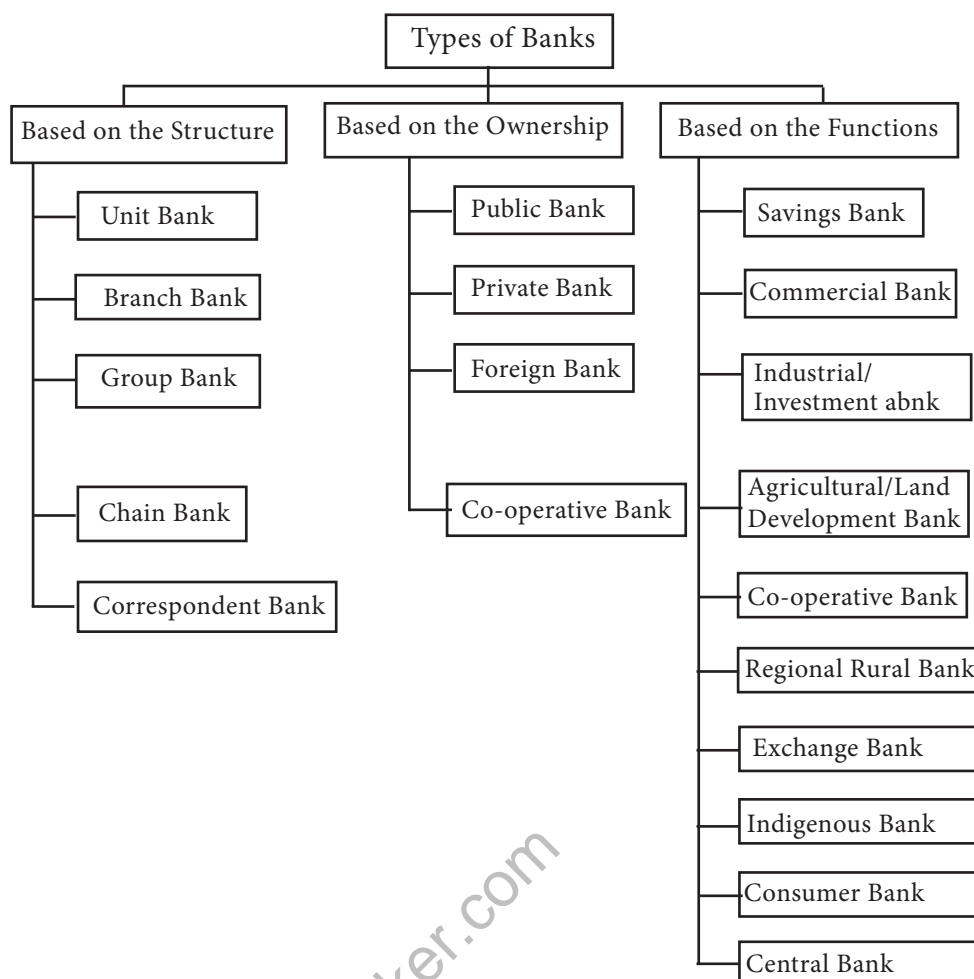


Figure showing the Types of Banks

Let us now discuss the meaning of each one of them.

Based on the Structure or Organizational Setup

Banks can be of five types based on the structure or organizational setup, viz., unit bank, branch bank, group bank, chain bank and correspondent bank.

- 1) **Unit Bank** is a type of bank under which the banking operations are carried by a single branch with a single office and they limit their operations to a limited area. Normally, unit banks may not have any branch or it may have one or two branches. This unit banking system has its origin in United State of America (USA) and

each unit bank has its own shareholders and board of management. In USA, each State may have many unit banks but each unit bank limits its operation within the State or country. There may be many central banks and they control the unit banks operating in their States. Collectively the central banks are called Federal Reserve Banks.

- 2) **Branch Bank** is a type of banking system under which the banking operations are carried with the help of branch network and the branches are controlled by the Head Office of the bank through their zonal or regional offices. Each branch of a bank will be managed by a responsible person called branch manager who will be assisted by the officers, clerks and sub-staff. In England and India, this type of branch banking system is in practice. In India, State Bank of India (SBI) is the biggest public sector bank with a very wide network of 16000 branches.
- 3) **Group Bank** is a system of banking under which there will be holding company controlling the subsidiary companies which carry out banking business. In some cases, both the holding and subsidiary companies may carry out banking business. An apt example in India is SBI which has many subsidiary banks such as State Bank of Mysore, State Bank of Indore, State Bank of Hyderabad, State Bank of Bikaner and Jaipur, State Bank of Patiala and State Bank of Travancore. These subsidiaries carry out banking and other operations such as leasing, merchant banking and so on.
- 4) **Chain Bank** is a system under which different banks come under a common control through common shareholders or by the interlocking of directors. An apt example in India is KarurVysya Bank and Lakshmi Vilas Bank having their head offices located in the same place, viz., Karur and sharing common directors by which they may have common management policy.
- 5) **Correspondent Bank** is a bank which link two banks of different stature or size. Many Indian banks act as correspondent banks for many foreign banks.

Based on the Ownership

Banks can be of four types based on the ownership. They are public sector banks, private sector banks, foreign banks and cooperative banks.

- 1) **Public Sector Banks** are those banks in which majority stake (i.e., more than 50% of the shares) is held by the government of the country. The words such as “The” or “Ltd” will not be found in their names because the ownership of these banks are with the government and the liability is unlimited in nature. Some examples of public sector banks in India include Andhra Bank, Canara Bank, Union Bank of India, Allahabad Bank, Punjab National Bank, Corporation Bank, Indian Bank and so on.
- 2) **Private Sector Banks** are those banks which are owned by group of private shareholders. They elect board of directors which manages the affairs of the banks. Some examples of private banks in India include The Lakshmi Vilas Bank Ltd., The Karur Vysya Bank Ltd., The City Union Bank Ltd., HDFC Bank, Axis Bank and son.
- 3) **Foreign Banks** are those banks which belong to foreign countries and have their incorporated head office in foreign countries and branch offices in other countries. The share capital of the foreign banks will be fully contributed by the foreign investors. Some examples of foreign banks in Indian include ABM Amro bank, Standard Chartered Bank, JP Morgan Chase Bank and so on.
- 4) **Cooperative Banks** are those banks which are run by following cooperative principles of service motive. Their main motive is not profit making but to help the weaker sections of the society. Some examples of cooperative banks in India include Central Cooperative Banks, State Cooperative Banks.

Based on the Functions

Banks can be of various types based on the functions they perform. They include savings banks, commercial banks, industrial banks, agricultural development banks, land mortgage/development banks, cooperative banks, exchange banks, indigenous banks, consumer banks, central banks.

- 1) **Saving Banks** are established to encourage savings habit among the people. There are no separate banks called savings banks but postal department perform the functions of savings bank. People can save even very small amount in these banks and these banks discourage withdrawals by limiting the number of withdrawals during a year. The amount collected from the customers is invested in securities such as bonds, government securities, etc. The main objective of these banks is to promote thrift and savings among the people. People who prefer these banks include salaried people and low income groups. At present, in India all the commercial banks act as savings banks besides providing various other services.
- 2) **Commercial Banks** are established to help the people who carry out trade and commerce, i.e., businessmen. They mobilize deposits from public and lend short-term loans to businessmen in the form of overdrafts, cash credit, etc for their commercial activities. As the commercial activities are of paramount importance to economic development, the commercial banks play a key role in promoting commercial activities in the country. Normally they do not provide long-term loans but provide short to medium term loans to traders for their working capital needs. Apart from lending, they also provide a host of services such as cheque collection, discounting bills of exchange, facilitating money transfer, etc. These commercial banks are subject to Reserve Bank of India's regulation.
- 3) **Industrial Banks / Investment Banks** are those banks which provide long term loans to industries for the purpose of expansion and modernization. They raise capital by issue of shares and debentures and provide long term loans to industries. These banks are also responsible for the development of backward areas for which they promote industries in those places. In India, examples for industrial banks include Industrial Finance Corporation of India (IFCI), earlier Industrial Credit and Investment Corporation of India (ICICI- Now universal bank) and earlier Industrial Development Bank of India (IDBI-now universal bank). Investment bank is a financial and banking organization, which provides both financial as well as advisory banking services to their clients. Besides this, they also deal with research, marketing and sales of a range of financial products like commodities, currency, credit, equities etc. As investment banks, they contribute to share capital and/or take

part in capital issue management for promoting the companies by underwriting their issues and facilitate public to buy those shares. The industrial activities are promoted by these banks and they also mobilize long term deposits. In India, Bank of America, JP Morgan and BNP Paribas are some of the leading investment banks.

- 4) **Agricultural/Land Development Banks** are those banks which are known as Land Mortgage or Agricultural Banks as they provide finance to agricultural sector. They provide long term loan for agriculture for the purposes of purchase of new land, purchase of heavy agricultural machinery such as tractor, repayment of old debt, conservation of soil and reclamation of loans. In India, Government of India has guaranteed the debentures issued by agricultural/land development banks. In Tamil Nadu, we have Tamil Nadu Cooperative Land Development bank. They follow the principles of cooperative banks and help the weaker sections. Commercial banks do not take active part as they view agricultural financing as risky one and hence, Agricultural Development Banks play a key role in this activity.
- 5) **Co-operative Banks** are those banks which are registered under the Cooperative Societies Act 1912. These banks collect share capital from the public and lend to economically weaker sections. They provide financial assistance to farmers, salaried class, small scale industries, etc. They can be found in rural and urban areas and the functions are similar to commercial banks except that they charge less interest for the loans and advances.
- 6) **Regional Rural Banks** are those banks which are established by the Government under the Regional Rural Banks Act of 1976 with a specific purpose to provide credit and other facilities to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in rural areas. Each RRB operates within the specified local areas.
- 7) **Exchange Banks** are also called as foreign exchange banks and they are incorporated outside the country but carry out business in India. They provide foreign exchange subject to the rules and regulations of the country in which they are operating. They also provide finance to exporters and letter of credit/guarantee to

importers. They help in remitting of funds from one country to another country, discount foreign bills, buy and sell gold silver, promote foreign trade. Examples of exchange bank include Bank of America, Hong Kong Bank, etc.

- 8) **Indigenous Banks** refer to money lenders and Sahukars. The money lenders using their own funds and deposits mobilized from public, grant loans to the needy people. They are more popular in villages and small towns. Usually, they act as traders and bankers simultaneously. In India, we have well known Indian communities such as Marwaries, Multani run their indigenous banks.
- 9) **Consumers Banks** operate only in advanced countries like USA and Germany. The primary objective of these banks is to provide loans to customers to purchase consumer durables like Car, TV, Washing Machine, Furniture, etc. The consumers repay the loans in easy installments.
- 10) **Central / Federal / National Bank** is a leader of all the banks in a country. Every country has a central bank. The prime responsibility of a Central Bank is to regulate the banking system and control monetary policy. These banks are called as banker to the bankers as they give financial accommodation to commercial banks. They are non-profit making institutions and they also act as banker to the government, issue currency notes, etc. They maintain foreign exchange reserves of the country and all the government accounts are maintained with them. They help in money circulation in the economy and provide financial accommodation to the government in case of necessity through purchase of treasury bills in the money market. In India, Reserve Bank of India, in USA, Federal Reserve (a group of central banks), in UK, Bank of England are the central banks.

Conclusion

This lesson explained the meaning of bank, history of banking, functions of commercial banks and types of banks. A country's banking system depends on the regulatory regime and India works under the constraints that go with social control and public ownership. The banking system is very important for the development of financial system and in turn economic system. Banking system in India is very strong and it plays a key role in developing Indian economy.

Lesson 1.2 - Structure of Indian Banking System

Learning Objectives

- To understand the structure of Indian Banking System
- To briefly describe the role of central bank
- To describe the role of commercial banks
- To describe the role of cooperative and regional rural banks

Introduction

The structure of banking system varies from country to country depending on the regulatory regime. Nationalization was a structural change in the functioning of commercial banks which resulted in to the emergence of public sector banks. Privatization led to the emergence of private sector banks and globalization facilitated the entry of foreign banks in India. The banking system in India is significantly different from that of other Asian nations because of the country's unique geographic, social, and economic characteristics. India has a large population and land size, a diverse culture, and extreme disparities in income, which are marked among its regions. In this lesson, we will learn the structure of banking system in India.

Structure of Indian Banking System

The Indian Banking System is regulated by the central bank, viz., Reserve Bank of India (RBI). Under the control of RBI, there are scheduled and non-scheduled banks. Scheduled banks consist of commercial and cooperative banks. Scheduled commercial banks consist of public, private, foreign and regional rural banks. Public sector banks consist of SBI and its associates, nationalized banks and other public sector banks.

Private sector banks consist of old generation and new generation banks. Scheduled cooperative banks consist of urban and state cooperative banks. Let us learn the functions of each and every element of Indian

banking system. Non-scheduled banks include local area banks. The following figure exhibits the structure of Indian Banking System.

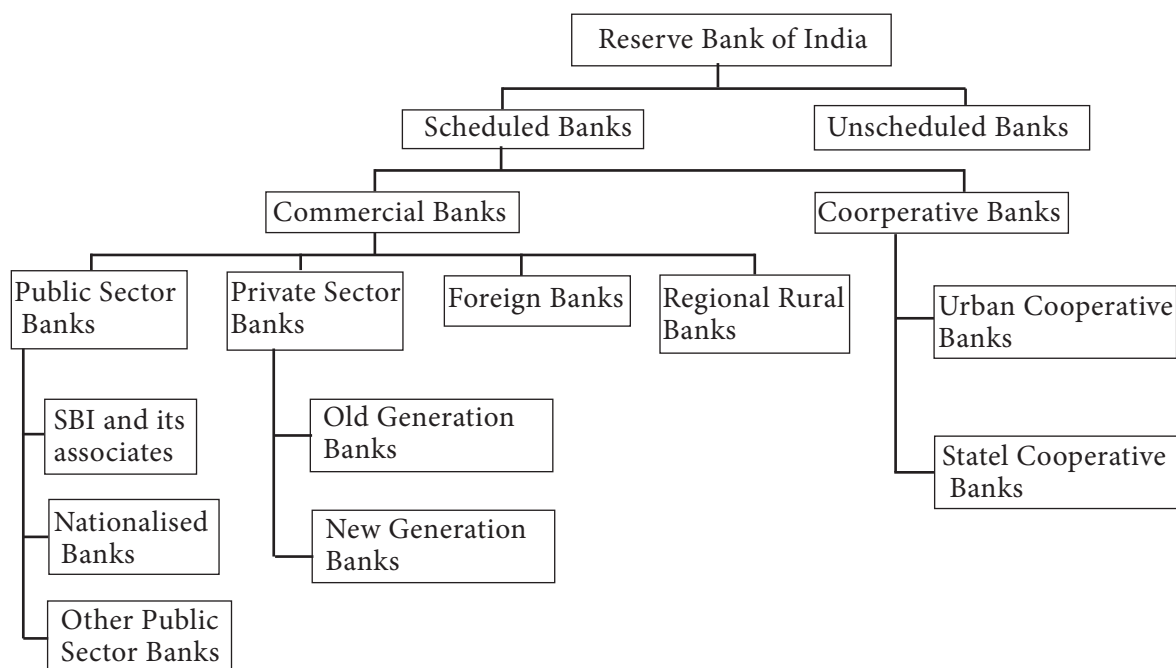


Figure showing the Structure of Indian Banking System

Reserve Bank of India

Reserve Bank of India is the central bank of India. It was established in 1934 and started its operations with effect from April 1, 1935. It is responsible for guiding and regulating the banking system of a country. It does not deal with the general public. It acts as banker to government, issues currency, regulates money circulation in the country, keeps the deposits of commercial banks, and provides financial accommodation to commercial banks.

It guides the commercial banks and hence, is called as bankers' bank. It maintains the government records relating to revenue and expenditure under various heads. It advises the government on monetary and credit policies and decides on the interest rates applicable to bank deposits and loans and advances. We will learn the structure and functions of central bank in the next unit.

Scheduled Banks

Scheduled banks are those banks which are included in the second Schedule of Reserve Bank of India Act 1934. For this inclusion, the banks have to comply with the criteria laid down vide Section 42(6) of the RBI Act. Scheduled banks can be classified into scheduled commercial banks and scheduled cooperative banks. The criteria for scheduled banks include the following:

- (i) Has a paid-up capital and reserves of an aggregate value of not less than five lakhs of rupees;
- (ii) Satisfies the RBI that its affairs are not being conducted in a manner detrimental to the interest of its depositors,
- (iii) Is a State co-operative bank or a company as defined in section 3 of the Companies Act, 1956 (1 of 1956), or an institution notified by the Central Government in this behalf or a corporation or a company incorporated by or under any law in force in any place outside India.

Scheduled banks can be divided into scheduled commercial banks and scheduled cooperative banks.

a) Scheduled Commercial Banks

Scheduled commercial Banks are those banks which accept deposits and lend short-term loans and advances to their customers. After few banks emerged as Universal Banks, they started granting medium and long-term loans as well. They are the bedrock of the Indian financial system and account for three fourths of the financial market. They are present throughout India and their branch network has grown four folds in the last 40 years. The branch network of commercial banks has crossed now 1,00,000 branches.

The scheduled commercial banks are classified into the three types, viz., public sector banks, private sector banks, foreign banks and regional rural banks.

- i) **Public Sector Banks** are those banks in which the majority of the shareholding is held by the Government of India and they are major constituent of Indian Banking System. At present as on 31-1-2013, there are 27 public sector banks functioning in India. They are categorized into SBI and its 6 associates of SBI, 19 nationalized banks and IDBI Bank Ltd.

Public sector banks have assumed the lead role in expansion of branch network all over the country, especially in the rural areas. They account for 69% of branch network of scheduled commercial banks in 2012. The number of branches has increased from 50179 in 2006 to 70314 in 2012. Their presence in the rural areas is remarkable.

State Bank of India and its associates: In 1951, when the First Five Year Plan was launched, the development of rural India was given the highest priority. The commercial banks of the country including the Imperial Bank of India had till then confined their operations to the urban sector and were not equipped to respond to the emergent needs of economic regeneration of the rural areas. In order, therefore, to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank by taking over the Imperial Bank of India, and integrating with it, the former state-owned or state-associate banks.

An act was accordingly passed in Parliament in May 1955 and the State Bank of India was constituted on 1 July 1955. More than a quarter of the resources of the Indian banking system thus passed under the direct control of the State. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959, enabling the State Bank of India to take over eight former State-associated banks as its subsidiaries (later named Associates).

The State Bank of India was thus born with a new sense of social purpose aided by the 480 offices comprising branches, sub offices and three Local Head Offices inherited from the Imperial Bank. The concept of banking as mere repositories of the community's savings and lenders to creditworthy parties was soon to give way to the concept of purposeful banking sub serving the growing and diversified financial needs of planned economic development. The State Bank of India was destined to act as the pacesetter in this respect and lead the Indian banking system into the exciting field of national development.

As of March 31, 2012, the Bank had a network of 20,193 branches, including 5,096 branches of its five associate banks. In addition to banking, the Company, through its various subsidiaries, provides a range of financial services, which include life insurance, merchant banking, mutual funds, credit card, factoring, security trading, pension fund management, custodial services, general insurance (non-life insurance) and primary dealership in the money market.

Its segments include Treasury, which includes investment portfolio and trading in foreign exchange contracts and derivative contracts; Corporate/Wholesale Banking, which comprises lending activities of Corporate Accounts Group, Mid Corporate Accounts Group and Stressed Assets Management Group; Retail Banking, which comprises of branches in National Banking Group, which includes personal banking activities, including lending activities to corporate customers, and Other Banking Business. To make SBI a global power house, the Government has plans to merge SBI associates with SBI in the near future.

Nationalised Banks have contributed a lot for the growth of economy of India and they dominate the Indian Banking System. The major objectives of nationalization of commercial banks were to provide social welfare, control of private monopolies, and expansion of banking, reduction of regional imbalance, provision of priority sector lending and creation of banking habits.

They were established with great purpose to make wide reach of banking activity including rural areas. They are fully committed to offer the best possible service to the rural community. They are recognized for their transparency in service and financial reporting. At present, they have started diversifying their services and cross sell products of other financial intermediaries. For example, Bancassurance is one such product, in which a bank will sell the insurance product of an insurance company.

Industrial Development Bank of India Ltd. (IDBI) is today one of India's largest commercial Banks. For over 40 years, IDBI Bank has played a key nation-building role, first as the apex Development Financial Institution (DFI) (July 1, 1964 to September 30, 2004) in the realm of industry and thereafter as a full-service commercial Bank (October 1, 2004 onwards). As a DFI, the erstwhile IDBI stretched its canvas beyond mere

project financing to cover an array of services that contributed towards balanced geographical spread of industries, development of identified backward areas, emergence of a new spirit of enterprise and evolution of a deep and vibrant capital market.

On October 1, 2004, the erstwhile IDBI converted into a Banking company (as Industrial Development Bank of India Limited) to undertake the entire gamut of Banking activities while continuing to play its secular DFI role. Post the mergers of the erstwhile IDBI Bank with its parent company (IDBI Ltd.) on April 2, 2005 (appointed date: October 1, 2004) and the subsequent merger of the erstwhile United Western Bank Ltd. with IDBI Bank on October 3, 2006, the tech-savvy, new generation Bank with majority Government shareholding today touches the lives of millions of Indians through an array of corporate, retail, SME and Agri products and services. Headquartered in Mumbai, IDBI Bank today rides on the back of a robust business strategy, a highly competent and dedicated workforce and a state-of-the-art information technology platform, to structure and deliver personalized and innovative Banking services and customized financial solutions to its clients across various delivery channels.

As on March 31, 2012, IDBI Bank has a balance sheet of ₹2.91 lakh crore and business size (deposits plus advances) of ₹3.92 lakh crore. As a Universal Bank, IDBI Bank, besides its core banking and project finance domain, has an established presence in associated financial sector businesses like Capital Market, Investment Banking and Mutual Fund Business. Going forward, IDBI Bank is strongly committed to work towards emerging as the 'Bank of choice' and 'the most valued financial conglomerate', besides generating wealth and value to all its stakeholders.

ii) **Private Sector Banks'** are those banks in which the majority of the shareholding is held by private individuals and corporate.

Old Generation Private Banks

When nationalization of banks took place in two periods, viz., 1969 and 1980, not all the private banks were nationalized. The banks which were not nationalized remain private banks and they are named as old generation private sector banks. There are 15 old generation private banks operating in India.

New Generation Private Banks

With the introduction of new economic policies in 1991, the Reserve Bank of India issued guidelines in 1993 and 2001 to give licences to new private banks with a capital introduction of ₹ 300 crore. 10 banks were set up after 1993 and another 2 after the 2001 guidelines. Of these 12 new private banks, four were promoted by development financial institutions, one each by conversion of a co-operative bank and an NBFC (non-banking financial institutions) into commercial banks, five by banking professionals, and one by a media house. However, due to various reasons including lack of financial strength and bad governance, a lot of mergers took place and presently there are only 7 new private banks operating in India. The branch network of private sector banks (both new and old generation banks) has increased from 6834 in 2006 to 13868 in 2012.

The role of private sector banks in Indian economy is commendable and they provide high degree of professional management, create health competition, encourage foreign investment, help to access foreign capital markets and help to develop innovation and achieve expertise. They used technology and led the other banks in various new business lines such as credit card, ATM and computerized operations. Undoubtedly, being tech-savvy and full of expertise, private banks have played a major role in the development of Indian banking industry. They have made banking more efficient and customer friendly. In the process, they have shaken public sector banks out of complacency and compelled them to become more competitive. Now, the RBI wants to liberalize its licensing policy to allow industrial and business houses to float their own banks. The latest Banking Bill envisaged to increase the cap on voting rights for investors in private sector lenders to 26 per cent from 10 per cent and in public sector banks (PSU) banks, the cap on voting rights has been raised to 10 per cent from 1 per cent.

iii) Foreign Banks are those banks which have their registered and incorporated head office in a foreign country but have their branch offices operating in India. RBI permits the foreign banks to operate either through their branches or wholly owned subsidiaries. Corporate segment has been the main business line of most of the foreign banks operating in India. In the recent years, some of the foreign banks have started providing consumer financing such as home loans, automobile

finance, credit cards, household consumer finance. They are subject to all RBI regulations, including priority sector lending norms, which are applicable to domestic banks. The latest bill on banking will allow foreign banks to convert their Indian operations into local subsidiaries or transfer shareholding to a holding company of the bank without paying stamp duty. At present, foreign banks operate through their representative offices and branches in India.

iv) **Regional Rural Banks (RRBs)** are those banks which were established in 1975 under the provisions of the Ordinance promulgated on the 26th September 1975 and the Regional Rural Banks Act, 1976 with a view to develop the rural economy and to create a supplementary channel to the 'Cooperative Credit Structure' with a view to enlarge institutional credit for the rural and agriculture sector. The share capital of RRB is contributed by the Government of India, the concerned State Government and the sponsoring public sector banks in the ratio of 50%, 15% and 35% respectively. The area of operation of the RRBs is limited to notified few districts in a State. The RRBs mobilize deposits primarily from rural/semi-urban areas and provide loans and advances mostly to small and marginal farmers, agricultural labourers, rural artisans and other segments of priority sector. The Government of India initiated a process of structural consolidation of RRBs by amalgamating RRBs sponsored by the same bank within a State, with a view to provide better customer service by having better infrastructure, computerization, experienced work force, common publicity and marketing efforts etc. The amalgamated RRBs also benefit from larger area of operation, enhanced credit exposure limits for high value and diverse banking activities.

RRBs were also permitted to decide the need for conversion of the existing loss making branches into satellite / mobile offices keeping in view the cost-benefit aspect, the likely inconvenience that may be caused to the existing clientele, the effect of the conversion on the performance in the preparation of district credit plan and priority sector lending. With a view to providing better customer service in rural areas, RRBs may also convert their satellite offices into full-fledged branches after obtaining concurrence from their board and necessary licence from the concerned Regional Office of RBI. As a result of the amalgamation, the number of the RRBs has been reduced from 196 to 82 as on 31 March 2011. The number of branches of RRBs increased to 16698 in 2012.

b) Scheduled Cooperative Banks

Scheduled Cooperative Banks are those banks in which individuals that have common interest of carrying out banking business by following the principles of cooperation form a cooperative society under the Cooperative Societies Act. However, the RBI's permission has to be obtained before starting the banking business by the cooperative society. The cooperative banks function under the overall supervision of the Registrar and Cooperative Societies of the State, besides following the guidelines issued by the RBI for banking business. They cater to the financial needs of agriculture, small industry, retail, and trade, self-employed traders in urban, semi-urban and rural areas. They are heterogeneous in nature and their structures differ across urban and rural areas, across states and loan tenures. Due to their widespread geographical penetration, they have the prospect to become an important tool for large scale financial inclusion provided their financial stability is taken care of. RBI and National Bank for Agriculture and Rural Development (NABARD) have taken a lot of reform measures to improve the financial soundness of the cooperative banks. They form the oldest segment of the Indian Banking System. The cooperative banks can be scheduled or non-scheduled. At present, there are 1564 non-scheduled urban cooperative banks operating in India. The scheduled cooperative banks can further be classified in to two types, viz., urban cooperative banks and State Cooperative Banks.

- i) Urban Co-operative Banks** are federation of primary cooperative societies (which are at village or town level) in a particular area. These banks function at the district level. When the memberships of central cooperative banks are restricted to primary cooperative societies, it is called as "banking union". At present, individuals are also permitted to become members of district or central cooperative banks. These banks provide loans to their members (i.e., primary credit societies) and function as a link between the primary credit societies and state co-operative banks. They have on their boards of management, individuals who have business capacity and influence besides being a representative of primary societies. They can borrow money from NABARD for their operations. The source of funds for these banks includes share capital, reserves, deposits, loans from State Cooperative Banks or other banks. At present, there are 51 urban scheduled cooperative banks operating in India.

- ii) **State Co-operative Banks** are the apex (highest level) co-operative banks in all the States of India. They attract deposits from the rich urban classes and channelize among various sectors. Their constitution differs from one bank to the other. Nevertheless, usually, the membership includes the representatives from central cooperative banks and individual shareholders. They provide rediscounting facilities, collect and disseminate useful information regarding cooperative movement. At present 31 state cooperative banks are operating in India.

Non-Scheduled Banks

Non-scheduled bank in India” means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank”. They are not included in the list of scheduled banks. They function as Local Area Banks. They have to adhere to the Cash Reserve Ratio (CRR) condition but are not compelled to deposit these funds with the RBI. They are set up under the scheme announced by the government of India in 1996, for the establishment of new private banks of a local nature; with jurisdiction over a maximum of three contiguous districts. Six LABs were originally licensed, but the license of one of them was cancelled due to irregularities in operations, and the other was amalgamated with Bank of Baroda in 2004 due to its weak financial position. As at end-March 2009 there were only 4 LABs operating in India. They get financial assistance from RBI only under emergency conditions and not for daily operations. They help in the mobilization of funds from rural and semi urban districts. At present, there are no non-scheduled banks exist.

Conclusion

This chapter explained as how the structure of Indian Banking industry is fragmented. To become competitive in the global market, the structure of the Indian banking industry is to be consolidated and the Government of India is taking measures by consolidating few public sector banks into a global power house and by infusing the required capital.

Lesson 1.3 - Banker and Customer Relationship

Learning Objectives

- To define “Banker” and “Customer”
- To understand the various kinds of relationship between banker and customer.
- To understand the duties of a banker.

Introduction

Depending on the activities, products or services provided by the bank to its customers or availed by the customer, the relationship between a banker and a customer emerges. There exist a transactional relationship between a banker and customer. To understand the relationship between them, we must understand the terms, “banker” and “customer” clearly.

Definition of a ‘Banker’

According to Banking Regulations Act, 1949, Section 5(b), Banking is defined as “accepting for the purpose of lending or investments of deposits of money received from the public and repayable on demand and withdrawable by cheque, draft, order or otherwise”. Thus, the term banker is not defined by B R Act but it defines the term “Banking”. This definition highlights two points:

- (1) The primary function of a banker is accepting of deposits for the purpose of lending or investing the same;
- (2) The amount deposited is repayable to the depositor on demand or according to the agreement. The demand for repayment can be made through a cheque, draft or otherwise, and not merely by verbal order. Let us see some definitions of Banker.

According to Dr. Herbert L. Heart, "A Banker is one who in the ordinary course of business honours cheques drawn upon him by any persons from and for whom he receives money on current accounts".

According to **Sec. 3** of the Indian Negotiable Instruments Act 1881, the word "banker includes any person acting as banker and any post office savings bank".

According to **Sec. 2** of the Bill of Exchange Act, 1882, 'banker includes a body of persons, whether incorporated or not who carry on the business of banking.'

From the above definitions, we can derive the meaning of banker as one who

- a) Accepts deposits from public
- b) Grants loans and advances
- c) Issue and pay cheques
- d) Collect cheques for his customers

The word 'public' implies that the banker accepts deposits from anyone who offers money for deposit purpose. For the purpose of receiving deposit, the customer has to open an account with the bank. For both depositing and borrowing funds, customer has to have an account relationship with the bank. The RBI has stipulated "Know Your Customer (KYC) Norms" for opening bank account and the bankers are strictly following the same. Hence, if a customer is not transparent, the banker has the right to reject his/her application.

Definition of a 'Customer'

The term 'Customer' is not defined by any act either in India or in English Statutes. The word 'customer' has its origin from the word 'custom', which means a 'habit or tendency' to-do certain things in a regular or a particular manner. Generally speaking, a customer is one who has an account with the bank or who utilizes the services of the bank.

Account relationship is a contractual relationship. It is generally believed that any individual or an organization, which conducts banking

transactions with a bank, is the customer of bank. However, there are many persons who do utilize services of banks, but do not maintain any account with the bank. Therefore, bank customers can be conveniently classified into four types. They are

- a) Existing customers
- b) Former customers
- c) Customers for services like Demand Draft purchase, cheque encashment, etc.
- d) Potential customers

In the past, the customers have to deposit some amount as initial deposit to open a bank account. Later, as per the directions of RBI, “**No Frill**” accounts were allowed by the banks without any deposit, ie., with nil balance or with meager balance. Now, all the banks are instructed by RBI to open as many bank accounts as possible without any balance, to channelize the benefits of government schemes to the public through Aadhar Card.

In the past, customers can have his transactions only with the branch with which they maintain their account. But, after the implementation of Core Banking Solution (Computerization of branches with interconnectivity), customers can operate their accounts from any branch of the bank and from anywhere. Thus, earlier system of “customer to a branch” is converted into “customer to a bank”. However, for any specific claim or action, the customers have to approach the branch with which they maintain account.

Classification of Banker-Customer Relationship

The relationship between a banker and customers can be broadly classified into

- a) General Relationship
- b) Special Relationship.

As per Sec 5(b) of Banking Regulation Act, the bank’s business is to accept deposits for the purpose of lending. Thus, the relationship emerging out of these two main activities is called as General Relationship. As per

Sec 6 of Banking Regulation Act, the banker undertakes other activities on behalf of the customer and provides lot of services to them. Thus, the relationship emerging out of the provision of these activities and services is called as Special Relationship.

General Relationship

Under general relationship, the banker and customer may have two types of relationships, viz., debtor-creditor relationship and creditor-debtor relationship.

- i) **Debtor-Creditor Relationship:** While opening a bank account, customers fill and sign the account opening form to enter into an agreement/contract with the banker. When the customers deposit money in their account, the relationship between banker and customer becomes that of debtor and creditor. The amount deposited becomes the banks' liability towards the customer and hence, he becomes debtor to the depositor (Customers). The banker can use that amount for any purpose, of course, with the information as to the use of money to the depositors. Normally, banks do not give any security to the depositors. However, when it is demanded by the deposits, the banks have to pay (Joachimson vs. Swiss Bank Corporation). Thus, the banker is completely different from normal debtors who voluntarily repay the debts. The rate of interest on the loan is normally decided by the creditor but in the banker-customer relationship the interest is decided by the banker who as a debtor pays interest once in six months on the deposits. The banks need to pay the deposit amount to the depositors when the demand is made in the proper manner during working days and working hours. But, nowadays, Any Time Machines (Automatic Teller Machines) are used to pay the money. The customers get passbook which carries the account details and all the terms and conditions. Now, websites of the banks are used for transaction purposes also and customers can open their accounts online. When issuing demand draft, telegraphic transfer, bankers become debtors as they own money of the payee or beneficiary.
- ii) **Creditor-Debtor:** When banks grant loans and advances to the customers, the relationship between banker and customer is that of

creditor-debtor relationship. Customers borrow money from bank by executing a contract with terms and conditions and by offering collateral (security). The customers (as debtors) are obliged to repay the loans and advances as per the terms of the contract.

Special Relationship

In addition to opening of a deposit/loan account banks provide variety of services, which makes the relationship more wide and complex. Depending upon the type of services rendered and the nature of transaction, the banker acts as a bailee, trustee, principal, agent, lessor, custodian etc.

- i) **Banker as a Trustee:** As per **Sec. 3** of Indian Trust Act, 1882 ‘A “trust” is an obligation annexed to the ownership of property, and arising out of a confidence reposed in and accepted by the owner, or declared and accepted by him, for the benefit of another, or of another and the owner.’ Thus trustee is the holder of property on behalf of a beneficiary. As per **Sec. 15** of the ‘Indian Trust Act, 1882 ‘A trustee is bound to deal with the trust-property as carefully as a man of ordinary prudence would deal with such property if it were his own; and, in the absence of a contract to the contrary, a trustee so dealing is not responsible for the loss, destruction or deterioration of the trust-property.’ A trustee has the right to reimbursement of expenses (Sec.32 of Indian Trust Act.). In case of trust, banker-customer relationship is a special contract. When a customer entrusts valuable items with bank with an intention that such items would be returned on demand to the customer, the relationship becomes of a trustee and trustier. Customers keep certain valuables or securities with the bank for safekeeping or deposit certain money for a specific purpose (Escrow accounts) the banker in such cases acts as a trustee. Banks charge fee for safekeeping valuables.
- ii) **Banker as a Bailee:** Sec.148 of Indian Contract Act, 1872, defines “Bailment” “bailor” and “bailee”. A “bailment” is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person delivering the goods is called the “bailor”. The person to whom they are delivered is called, the “bailee”. Banks secure customer advances by obtaining tangible securities.

In some cases physical possession of securities goods (Pledge), valuables, bonds etc., are taken. While taking physical possession of securities, the relationship between banker and customer becomes that of bailee and bailor. Banks also keeps articles, valuables, securities etc., of its customers in Safe Custody and acts as a Bailee. As a bailee, the bank is required to take care of the goods bailed.

iii) Banker as a Lessor: Sec.105 of 'Transfer of property Act 1882' defines lease, Lessor, lessee, premium and rent. As per the section "A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms." "The transferor is called the lessor, the transferee is called the lessee, the price is called the premium, and the money, share, service or other thing to be so rendered is called the rent." Providing safe deposit lockers is as an ancillary service provided by banks to customers. While providing Safe Deposit Vault/locker facility to their customers, bank enters into an agreement with the customer. The agreement is known as "Memorandum of letting" and attracts stamp duty. The relationship between the bank and the customer is that of lessor and lessee. Banks lease (let lockers for hire to their customers) their immovable property to the customer and give them the right to enjoy such property during the specified period i.e. during the office/ banking hours and charge rentals. Bank has the right to break-open the locker in case the locker holder defaults in payment of rent. Banks do not assume any liability or responsibility in case of any damage to the contents kept in the locker. Banks do not insure the contents kept in the lockers by customers.

iv) Banker as an Agent: Sec.182 of 'The Indian Contract Act, 1872' defines "an agent" as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called "the Principal". Thus an agent is a person, who acts for and on behalf of the principal and under the latter's express or implied authority and the acts done within such authority are binding on his principal and, the principal is liable to the party for the acts of the agent.

Banks collect cheques, bills, and makes payment to various authorities, viz., rent, telephone bills, insurance premium etc., on behalf of customers.. Banks also abides by the standing instructions given by its customers. In all such cases, bank acts as an agent of its customer, and charges for these services. As per Indian contract Act agent is entitled to charges. No charges are levied in collection of local cheques through clearing house. Charges are levied in only when the cheque is returned in the clearinghouse.

- v) **Banker as a Custodian:** A custodian is a person who acts as a caretaker of something. Banks take legal responsibility for a customer's securities. While opening a DMAT account bank becomes a custodian.
- vi) **Banker as a Guarantor:** Banks give guarantee on behalf of their customers. Guarantee is a contingent contract. As per sec 31, of Indian contract Act guarantee is a "contingent contract". Contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen. It would thus be observed that banker customer relationship is transactional relationship.

Legal Relationship between Banker and Customer

Trust is the basic requirement of bank-customer relationship. The relationship depends on the kind of transaction the customers have with the bank. It is based on contract with certain terms and conditions. It is a fiduciary relationship. The distinctive features of the legal relationship between the banker and the customer may be called as the duties, rights and liabilities of the banker.

Duties of the Banker

The duties of the banker vis-à-vis customer include the following:

- i) **Duty to honour cheques:** As 'banking' means accepting of deposits withdrawable by cheque, draft, order or otherwise, the banker is duty bound to honour cheques issued by the customers on their accounts. Sec. 31 of Negotiable Instruments Act, 1881 specifies the liability of drawee of cheque. As per Sec. 31 "The drawee of a

cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment, must compensate the drawer for any loss or damage caused by such default." Thus, it is the duty of a bank to honour the cheques issued by the account holder if

- a) The cheque has been properly drawn and is in order in all respects i.e. it is properly dated, amount in words and figures have been expressed properly, is neither state nor post-dated nor mutilated and the signature of account holder tallies with the specimen recorded with the bank.
- b) The cheque should be drawn on the branch where the account is maintained. (Due to implementation of technology and core banking solution a customer can present cheques on any branch of a bank. RBI has advised banks to issue **multi city cheques** to account holders.)
- c) There is sufficient balance in the account and the balance is properly applicable for payment of the cheque.
- d) The cheque is presented for payment on a working day and during the business hours of the branch.
- e) Endorsements on the cheque are regular and proper.
- f) The payment of the cheque is not countermanded by the drawer.

However, the **duty of the banker to honour cheques ceases** on receipt of:

- a) Stop payment instructions from the account holder.
- b) Notice about the death of the drawer.
- c) A garnishee order attaching the balance in the account or an income-tax attachment order received by the banker.
- d) Drawer of the cheque becoming insolvent and/or a lunatic at the time of drawing the cheque.

In the following cases, **banker can refuse to honour the cheques:**

- a) There is in sufficient balance in the account to make payment of the cheque.
- b) Cheque issued does not pertain to the account on which it has been drawn.
- c) If the cheque is not in order (post dated, stale, payment countermanded, amount in words and figure differs, etc.)
- d) The balances held in account are earmarked for some specific purpose and the remaining balance is not sufficient to honour the cheque.

ii) Duty to maintain secrecy/confidentiality: It is the duty of the banker not to disclose the state of customer's account to anyone else and maintain secrecy of customers' accounts. Maintaining secrecy is not only a moral duty but bank is legally bound to keep the affairs of the customer secret. The principle behind this duty is that disclosure about the dealings of the customer to any unauthorized person may harm the reputation of customer and the bank may be held liable. The duty of maintaining secrecy does not cease with the closing of account or on the death of the account holder. As per **Sec. 13** of "Banking Companies Acquisition and Transfer of Undertakings Act 1970" - "Every corresponding new bank shall observe, except as otherwise required by law, the practices and usages customary among bankers, and, in particular, it shall not divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in accordance with law or practices and usages customary among bankers, necessary or appropriate for the corresponding new bank to divulge such information." Maintaining secrecy is implied terms of the contract with the customer which bank enters into with the customer at the time of opening an account. Bank has not only to maintain secrecy of transactions, but secrecy is also to be maintained in respect of operations through ATM/ debit cards. Bank has also to maintain secrecy of user ID pins with due care so that it does fall in wrong hands.

Failure to maintain secrecy makes the bank liable to pay damages to the account holder for loss of money and reputation if it fails in its duty to maintain secrecy and discloses information relating to a customer's account or conduct of the account to any unauthorized person.

Circumstances under which banker can disclose information of customer's account include the following

- a) **Under compulsion of law:** Banks disclose information to various authorities who by virtue of powers vested in them under provisions of various acts require banks to furnish information about customer's account. The information is called under Section 4 of Banker's Book Evidence Act, 189; Section 94 (3) of Code of Civil Procedure Act, 1908; Section 45 (B) of Reserve Bank of India Act, 1934; Section 26 of Banking Regulation Act, 1949; Section 36 of Gift Tax Act, 1958; Sections 131, 133 of Income Tax Act, 1961; Section 29 of Industrial Development Bank of India Act, 1964; Section 12 of Foreign Exchange Management Act, (FEMA) 1999; and Section 12 of the Prevention of Money Laundering Act, 2002. Banks are required to furnish only the called for information (no additional information is to be furnished) on receipt of written request of the person who is vested with the authority to call for such information under the said acts. The customer is kept informed about the disclosure of the information.
- b) **Under banking practices:** In order to ascertain financial position and credit worthiness of the person banks obtain information from other banks with which they are maintaining accounts. It is an established practice among bankers and implied consent of the customer is presumed to exist. The opinion is given in strictest confidence and without responsibility on the part of the bank furnishing such information. Credit information is furnished in coded terms to other banks on IBA format and without signatures.
- c) For protecting national interest.
- d) For protecting bank's own interest
- e) Under express or implied consent of the customer

- iii) **Duty to provide proper accounts:** Banks are under duty bound to provide proper accounts to the customer of all the transactions done by him. Bank is required to submit a statement of accounts / passbook to the customer containing all the credits and debits in the account.
- iv) **Duty to carryout standing instructions:** Banks have to carry out the standing instructions given by the customers such as collection of interest, transfer of funds, etc.
- v) **Duty to provide proper services:** The banks have the duty to provide proper services and not to release Articles/items of customers kept with the bank to a third party without due authorization by the customer. In case banker wants to close the account, reasonable notification is to be sent to the customer.

Rights of the Banker

The rights of the banker vis-à-vis customer include the following:

Right of Lien: A lien is the right of a creditor in possession of goods, securities or any other assets belonging to the debtor to retain them until the debt is repaid, provided that there is no contract express or implied, to the contrary. It is a right to retain possession of specific goods or securities or other movables of which the ownership vests in some other person and the possession can be retained till the owner discharges the debt or obligation to the possessor. The creditor (bank) has the right to maintain the security of the debtor but not to sell it. There are two types of lien viz.,

- a) Particular Lien
- b) Right of General Lien

Particular Lien

A 'particular lien' gives the right to retain possession only of those goods in respect of which the dues have arisen. It is also termed as ordinary lien. If the bank has obtained a particular security for a particular debt, then the banker's right gets converted into a particular lien.

Right of General Lien

Banker has a right of general lien against his borrower. General lien confers banks right in respect of all dues and not for a particular due. It is a statutory right of the bank and is available even in absence of an agreement but it does not confer the right to pledge. A 'general lien' gives the right to retain possession of any goods in the legal possession of the creditor until the whole of the debt due from the debtor is paid. Section 171 of Indian Contract Act, 1872 confers the right of general lien to banks. As per the section "Bankers, factors, attorneys of a High Court and policy-brokers may, in the absence of a contract to the contrary, retain, as a security for a general balance of account any goods bailed to them; but no other persons have a right to retain, as a security for such balance, goods bailed to them, unless there is an express contract to the effect." Bank has a right of lien only when goods, securities are received in the capacity as a creditor. While granting advances banks take documents. These documents confer right to convert general lien as an implied pledge. A banker's lien is more than a general lien, it is an implied pledge and he has the right to sell the goods in case of default Bank has a 'Right of Sale' of goods under lien. Banker's right of lien is not barred by the Law of Limitation.

Bank has the right of lien on goods and securities entrusted to him legally and standing in the name of the borrower. Bank can exercise right of lien on the securities in its possession for the dues of the same borrower, even after the loan taken against that particular security has been re-paid. Right of lien can be exercised on bills, cheques, promissory notes, share certificates, bonds, debentures etc.

Bank cannot exercise right of lien on goods received for safe custody, goods held in capacity as a trustee, or as an agent of the customer, or left in bank by mistake.

Right of Set-Off: The banker has the right to set off the accounts of its customer. It is a statutory right available to a bank, to set off a debt owed to him by a creditor from the credit balances held in other accounts of the borrower. The right of set-off can be exercised only if there is no agreement express or implied to the contrary. This right is applicable in respect of dues that are due, are becoming due i.e. certain and not contingent. It is not applicable on future debts. It is applicable in respect of deposits

that are due for payment. The right of set off enables bank to combine all kinds of credit and debit balances of a customer for arriving at a net sum due. The right is also available for deposits kept in other branches of the same bank. The right can be exercised after death, insolvency, and dissolution of a company, after receipt of a garnishee/attachment order. The right is also available for time barred debts. Deposits held in the name of a guarantor cannot be set off to the debit balance in borrowers account until a demand is made to the guarantor and his liability becomes certain. Banks cannot set off the credit balance of customer's personal account for a joint loan account of the customer with another person unless both the joint accountholders are jointly and severally liable. Banks exercise the Right of set off only after serving a notice on the customer informing him that the bank is going to exercise the right of set-off.

Depending on the situation, sometimes the set off takes place automatically without the permission from the customer. In the following events the set off happens automatically i.e., without the permission from the customer:

- a) On the death of the customer;
- b) On customer becoming insolvent;
- c) On receipt of a Garnishee order on customer's account by court;
- d) On receipt of a notice of assignment of credit balance by the customer to the banker
- e) On receipt of notice of second charge on the securities already charged to the bank.

Following are the conditions to be followed while exercising right of Set - Off:

- a) The account should be in the sole name of the customer.
- b) The amount of debts must be certain and measurable.
- c) There should not be any agreement to the contrary
- d) Funds should not be held in trust accounts
- e) The right cannot be exercised in respect of future or contingent debts.
- f) The banker has the right to exercise this right before a garnishee order is received by it.

Right of Appropriation: It is the right of the customers to direct his banker against which debt (when more than one debit outstanding) the payment made by him should be appropriated. In case no such direction is given, the bank can exercise its right of appropriation and apply it in payment of any debt. Section 59,60 and 61 of Indian Contract Act, 1872 lays down the rules of appropriation.**Sec.59.Application of payment where debt to be discharged is indicated:** (i.e.– As per borrowers instructions)Where a debtor, owing several distinct debts to one person, makes a payment to him, either with express intimation, or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly.**Sec.60. Application of payment where debt to be discharged is not indicated:** (i.e. in the absence of express or implied intention of debtor). **Sec.60** of the Indian Contract Act states that if the debtor does not intimate or there is no circumstance of indicating how the payment is to be used, the right of appropriation is vested in the creditor.

According to the Act, “Where the debtor has omitted to intimate and there are no other circumstances, indicating to which debt the payment is to be applied, the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor, whether its recovery is or is not barred by the law in force for the time being as to the limitation of suits.”**Sec.61.Application of payment where neither party appropriates.**

Where neither party makes any appropriation the payment shall be applied in discharge of the debts in order of time, whether they are or are not barred by the law in force for the time being as to the limitation of suits. If the debts are of equal standing, the payment shall be applied in discharge of each proportionally. Unless there is an agreement to the contrary, any payment made by a debtor is applied first towards interest and thereafter towards principal. If a customer has only one account and he deposits and withdraws money from it regularly, the order in which the credit entry will set off the debit entry is in the chronological order, this is known as Clayton's rule.

Rule in Clayton's case: The rule was laid down in famous Devayanas Vs. Noble. The rule applies to running accounts like CC/ OD with debit balance. The rule states that each withdrawal in a debit account is considered as a new loan and each deposit as a repayment in that chronological order.

Right to Charge Interest, Commission, Incidental Charges etc.:

Banker has an implied right to charge for services rendered and sold to a customer. Bank charges interest on amount advanced, processing charges for the advance, charges for non-utilization of credit facilities sanctioned, charges commission, exchange, incidental charges etc. depending on the terms and conditions of advance banks charge interest at monthly, quarterly or semiannually or annually. Banks charge customers if the balance in deposit account falls below the prescribed amount. Usually the bank informs such charges to the customer by various means.

Right to close the account of undesirable customers: Bankers have the right to close the accounts of the customer who is found undesirable in maintaining balance in the account and due to which frequent bouncing or dishonouring of cheques takes place. Due to this, the reputation of the banker is getting affected. Thus, the banker, after giving due notification to the customer can close his account. In case of death, insolvency, lunacy of customers or dissolution of firms or winding up of companies, the account will be closed by the banker.

Liabilities of the Banker

Bankers cannot be held liable when they disclose the customers' account with the consent of the customers. But, while disclosing the account, the banker should do so in a discrete manner without causing any prejudice to the credit worthiness of the customer. No bankers will disclose all the bare facts about the account position of a customer. When a banker discloses the secrecy of the customer's account to a third party and if the third party incurs any loss, he cannot make the banker liable, if banker

- a) Has disclosed bare factors without any intention;
- b) That the banker has disclosed the details of customer's account unintentionally and without any motive to cause injury to third party.

However, a banker can be held liable criminally when he intentionally discloses

- a) Wrongful facts about the customer

- b) To cause damage to third party. If the above facts are proved in a court of law, the banker will be held liable criminally and will undergo penalty as well as imprisonment and the third party can also claim damages from the banker, for the losses suffered by relying on facts which are untrue.

Nomination Facility

Nomination is expression of wish of a person about transfer of his assets after his death to a named person. Nomination is not a will but it serves the purpose of will. In terms of Sections 45ZA to 45ZF of the Banking Regulation Act, 1949, Banking Companies (Nomination) Rules, 1985 have been framed. Nomination facility simplifies the procedure for settlement of claims of deceased depositors and locker holders. In an unfortunate event of the death of a depositor, nomination enables the bank to make payment to the nominee of a deceased depositor, of the amount standing to the credit of the depositor, return the articles left by a deceased person in the bank's safe custody to the nominee without asking for succession certificate or verifying claims of legal heirs. Nomination does not take away the rights of legal heirs on the estate of the deceased. The nominee receives the money from the bank as a trustee of the legal heirs. In the case of a joint deposit account the nominee's right arises only after the death of all the depositors. Nomination facility is intended for individuals and sole proprietary concerns.

Where the nominee is a minor, the depositor making the nomination appoints any person to receive the amount of deposit in the event of his death during the minority of the nominee. A person legally empowered to operate a minor's account can file a nomination on behalf of the minor. Nomination can be made in account opening form itself or on a separate form indicating the name and address of the nominee. The account holders can change the nomination any time. There can be only one Nominee for a deposit account whether held singly or jointly. There can be two nominees for a jointly held locker.

Availability of the Nomination Facility

Nomination facility is available for all types of bank deposits, safe deposit lockers, and safe custody articles. This is also applicable to deposits

having operating instructions “Either or Survivor”. Nomination can be made in favour of one person only. In case of a joint account, nomination is to be made by all depositors jointly. Nomination cannot be made in accounts where deposits are held in a representative capacity, e.g., trust accounts etc. and in accounts of partnership firms, H.U.F., companies, associations, clubs, etc. Nomination can be made in favour of a minor.

However while making the nomination, the nominee has to appoint another person (not a minor), to receive the amount of the deposit on behalf of the nominee in the event of the death of the depositor during the minority of the nominee. Date of birth of minor be obtained and noted. A nomination will continue to be in force even on renewal of term deposit, unless specifically cancelled or changed. Banks obtain separate nomination form for each term deposit receipt. A non-resident can be nominated as a nominee in a resident account. In case of non-resident nominees, the amount entitled to him from the account(s)/ deposits(s) of a deceased person will be credited to his NRO account. The amount so credited cannot be remitted outside India.

Insurance of Bank Deposits

The Deposit Insurance and Credit Guarantee Corporation of India, a public limited company promoted by Reserve Bank of India, insure bank deposits. The authorized capital of the Corporation is ₹50 crore, which is fully issued and subscribed by the Reserve Bank of India (RBI). The management of the Corporation vests in a Board of Directors of which a Deputy Governor, Reserve bank of India, is the Chairman. The Corporation protects the interest of depositors and infuses confidence by providing deposit insurance on account of failure of banks. All commercial banks including the branches of foreign banks functioning in India, local area banks, regional rural banks, and all eligible co-operative banks are covered under the Deposit Insurance Scheme. The insurance covers the loss of all or part of their deposits in all branches of a bank to a maximum of ₹1,00,000.

It insures all deposits such as savings, fixed, current, recurring, etc except the following types of deposits such as Deposits of foreign Governments, Deposits of Central/State Governments, Inter-bank deposits, Deposits of the State Land Development Banks with the State

co-operative bank, any amount due on account of and deposit received outside India, and any amount, which has been specifically exempted by the corporation with the previous approval of Reserve Bank of India. The Corporation charges insurance premium from banks on deposits @10 paisa per ₹100 of assessable deposits per annum. The premium is charged twice a year on the assessable deposits as at 31st March and 30th September. Though the premium is charged on the full amount of deposit kept by depositors in a bank is insured up to a maximum of ₹1,00,000 (Rupees One Lakh) only for both principal and interest amount.

The corporation pays to each depositor through the liquidator, the amount of his deposit up to Rupees one lakh within two months from the date of receipt of claim list from the liquidator. If a bank is reconstructed or amalgamated / merged with another bank, it pays the bank concerned, the difference between the full amount of deposit or the limit of insurance cover in force at the time, whichever is less and the amount received by him under the reconstruction / amalgamation scheme within two months from the date of receipt of claim list from the transferee bank / Chief Executive Officer of the insured bank/transferee bank as the case may be.

In the second report of Narasimham Committee (April 1998) on "Banking Sector Reforms" recommendations have been made for reforming scheme of Deposit insurance. The committee has recommended that instead of "flat" rate premium, it should be 'risk based' or 'variable rate' premium.

Know Your Customer (KYC) Norms

As per 'Know Your Customer' guidelines issued by Reserve Bank of India, customer has been defined as:

- a) A person or entity that maintains an account and/or has a business relationship with the bank;
- b) One on whose behalf the account is maintained (i.e. the beneficial owner);
- c) Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and

- d) Any person or entity connected with a financial transaction, which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

KYC Norms and Cash Transactions

The objective of KYC guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures enable banks to know/understand their customers and their financial dealings better, which in turn help them, manage their risks prudently. Necessary checks before opening a new account ensures that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organizations etc. and that no account is opened in anonymous or fictitious/ benami name(s).

Banks are supposed to adopt due diligence and appropriate KYC norms at the time of opening of accounts. The objectives of the KYC are to ensure appropriate customer identification and to monitor transactions of a suspicious nature. While opening an account a bank is supposed to obtain all information necessary for establishing the identity/legal existence of each new customer by taking and verifying the introductory reference from an existing account holder/a person known to the bank or on the basis of documents provided by the customer. The means of establishing identity can be passport, driving license etc. In respect of existing customers banks are required to complete customer identification at the earliest.

Ceiling and Monitoring of Cash Transactions

As per RBI guidelines issued under Section 35 (A) of the Banking Regulation Act, 1949:

- i) Banks are required to issue travelers cheques, demand drafts, mail transfers, and telegraphic transfers for ₹50,000 and above only by debit to customers' accounts or against cheques and not against cash. While purchasing travelers cheques, demand drafts, mail transfers, and telegraphic transfers for ₹50,000 and above purchaser has to mention his Permanent Income Tax Account Number (PAN) on the application.

- ii) The banks are required to keep a close watch of cash withdrawals and deposits for ₹10 lakhs and above in deposit, cash credit or overdraft accounts and keep record of details of these large cash transactions in a separate register. Branches of banks are required to report all cash deposits and withdrawals of ₹10 lakhs and above as well as transactions of suspicious nature with full details in fortnightly statements to their controlling offices.

Bankers' Fair Practice Code

Indian Banks' Association has prepared a code, which sets standards of fair banking practices. This document is a broad framework under which the rights of common depositors are recognized. It is a voluntary Code that promotes competition and encourages market forces to achieve higher operating standards for the benefit of customers. The Code applies to current, savings and all other deposit accounts, collection and remittance services offered by the banks, loans and overdrafts, foreign-exchange services, card products and third party products offered by banks.

Termination of Relationship Between a Banker and a Customer

The relationship between a bank and a customer ceases on:

- a) The death, insolvency, lunacy of the customer.
- b) The customer closing the account i.e. Voluntary termination.
- c) Liquidation of the company.
- d) The closing of the account by the bank after giving due notice.
- e) The completion of the contract or the specific transaction.

Conclusion

The relationship developed between a banker and customer involves some duties on the part of both. Bank's business depends much on the strong bondage with the customer. "Trust" plays an important role in building healthy relationship between a banker and customer.

Lesson 1.4 - Deposits, Loans & Advances and Assets & Liabilities Management of Banks

Learning Objectives

- To understand the various types of deposits and loans & advances.
- To understand the balance sheet of a bank.
- To understand the management of assets and liabilities of banks

Introduction

Financial intermediation by commercial banks has played a key role in India in supporting the economic growth process. An efficient financial intermediation process has two components: effective mobilization of savings and their allocation to the most productive uses. In this lesson, let us discuss both the aspects besides knowing the balance sheet of a commercial bank and bank's financial management, viz., assets liabilities management (ALM).

Deposit Mobilization

When banks mobilize savings, they do it in the form of deposits, which are the money accepted by banks from customers to be held under stipulated terms and conditions. Deposits are thus an instrument of savings. Since the first episode of bank nationalization in 1969, banks have been at the core of the financial intermediation process in India. They have mobilized a sizeable share of savings of the household sector, the major surplus sector of the economy.

This in turn has raised the financial savings of the household sector and hence the overall savings rate. Notwithstanding the liberalization of the financial sector and increased competition from various other saving instruments, bank deposits continue to be the dominant instrument of savings in India. The gross domestic savings of the Indian economy have been growing over the years and the household sector has been the most significant contributor to savings. Household sector saves in two major

ways, viz. financial assets and physical assets. Within the financial savings of the household sector, bank deposits are the most prominent instrument, accounting for nearly half of total financial savings of the household sector.

Bank Deposits

One of the most important functions of any commercial bank is to accept deposits from the public, basically for the purpose of lending. Deposits from the public are the principal sources of funds for banks and the public sector banks continue to dominate the Indian banking industry. However, the share of the new private sector banks has been raising at the expense of the public sector banks, particularly in the last few years.

Safety of Bank Deposits

At the time of depositing money with the bank, a depositor would want to be certain that his/her money is safe with the bank and at the same time, wants to earn a reasonable return. The safety of depositors' funds, therefore, forms a key area of the regulatory framework for banking. In India, this aspect is taken care of in the Banking Regulation Act, 1949 (BR Act). The RBI is empowered to issue directives/advice on several aspects regarding the conduct of deposit accounts from time to time. Further, the establishment of the Deposit Insurance Corporation in 1962 (against the backdrop of failure of banks) offered protection to bank depositors, particularly small-account holders.

Rates of Interest

The process of deregulation of interest rates started in April 1992. Until then, all interest rates were regulated; that is, they were fixed by the RBI. In other words, banks had no freedom to fix interest rates on their deposits. With liberalization in the financial system, nearly all the interest rates have now been deregulated. Now, banks have the freedom to fix their own deposit rates with only a very few exceptions. The RBI prescribes interest rates only in respect of savings deposits and NRI deposits, leaving others for individual banks to determine.

Deposit Policy

The Board of Directors of a bank, along with its top management, formulates policies relating to the types of deposit the bank should have, rates of interest payable on each type, special deposit schemes to be introduced, types of customers to be targeted by the bank, etc. Of course, depending on the changing economic environment, the policy of a bank towards deposit mobilization undergoes changes.

Types of Deposit Accounts

The bank deposits can also be classified into (i) demand deposits and (b) time deposits.

- (i) **Demand deposits** are defined as deposits payable on demand through cheque or otherwise. Demand deposits serve as a medium of exchange, for their ownership can be transferred from one person to another through cheques and clearing arrangements provided by banks. They have no fixed term to maturity.
- (ii) **Time deposits** are defined as those deposits which are not payable on demand and on which cheques cannot be drawn. They have a fixed term to maturity.

Demand and time deposits are two broad categories of deposits. There are several deposit accounts offered by banks in India; but they can be classified into three main categories:

- 1) Savings bank account
- 2) Current account
- 3) Term deposit account

Current account deposits fall entirely under the demand-deposit category and term deposit account falls entirely under time deposit. Savings bank accounts have both demand-deposit and time-deposit components. In other words, some parts of savings deposits are considered demand deposits and the rest as time deposits.

Savings Bank Deposit

Savings deposits are a form of demand deposits, which is subject to restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period. Further, minimum balances may be prescribed in order to offset the cost of maintaining and servicing such deposits. Savings deposits are deposits that accrue interest at a fixed rate set by RBI. Savings bank accounts are used by a large segment of small depositors as they can deposit their regular incomes into these accounts, withdraw the money on demand and also earn interest on the balance left in the account. The savings bank accounts cannot be opened by big trading or business firms. Similarly, institutions such as government departments and bodies, local authorities, etc. cannot open savings bank accounts.

Current Account Deposit

A current account is a form of demand-deposit, as the banker is obliged to repay these liabilities on demands from the customer. Withdrawals from current accounts are allowed any number of times depending upon the balance in the account or up to a particular agreed amount. Current deposits are non-interest bearing. A current account is basically a running and actively operated account with very little restriction on the number and amount of drawings. The primary objective of a current account is to provide convenient operation facility to the customer, via continuous liquidity. On account of the high cost of maintaining such accounts, banks do not pay any interest on such deposits. In addition, many banks insist on customers maintaining minimum balances to offset the transaction costs involved. If minimum balances are not maintained, these banks charge the customers a certain amount. Current accounts can be opened by rich individuals/ partnership firms/ private and limited companies/ Hindu Undivided Families (HUFs)/ societies/ trusts, etc.

Savings account deposits together with current account deposits are called CASA deposits.

Term Deposit

A "Term deposit" is a deposit received by the Bank for a fixed period, after which it can be withdrawn. Term deposits include deposits

such as Fixed Deposits / Reinvestment deposits/Recurring Deposits etc. The term deposits account for the largest share of total deposits in the recent years. Interest is paid on term-deposits, either on maturity or at stipulated intervals depending upon the deposit scheme under which the money is placed. Also, a customer can earn interest on a term-deposit for a minimum period of 7 days. Interest rates on term-deposits are usually higher than on savings deposits. Term deposits include:

- Fixed deposits on which a fixed rate of interest is paid at fixed, regular intervals;
- Re-investment deposits, under which the interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. Some banks have introduced “flexi” deposits under which, the amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits; and
- Recurring deposits, under which a fixed amount is deposited at regular intervals for a fixed term and the repayment of principal and accumulated interest is made at the end of the term. These deposits are usually targeted at persons who are salaried or receive other regular income. A Recurring Deposit can usually be opened for any period from 6 months to 120 months.

Deposit Mobilization Strategies

To maximize their profits, commercial banks always attempt to mobilize savings at the lowest cost possible. While mobilizing deposits, banks have to comply with various directives issued by the RBI, the Indian Bank Association (IBA), Government of India and other statutory authorities/agencies. At the same time, since banks operate in a very competitive environment, they have to reach out to a wide spectrum of customers and also offer deposit products that lead to higher customer satisfaction. Banks devise various strategies to expand the customer base and reducing the cost of raising deposits. This is done by identifying target markets, designing the products as per the requirements for customers, taking measures for marketing and promoting the deposit products. It is essential not only to expand the customer base but also to retain it. This is done by providing counseling, after-sales information and also through prompt handling of customer complaints. While the strategies for

mobilizing bank deposits vary from bank to bank, one common feature is to maximize the share of CASA deposits. The other common features generally observed are as follows:

- Staff members posted at branches are adequately trained to offer efficient and courteous service to the customers and to educate them about their rights and obligations.
- A bank often offers personalized banking relationship for its high-value customers by appointing Customer Relationship Managers (CRMs).
- Senior citizens/pensioners have become an important category of customers to be targeted by a bank. Products are developed by banks to meet the specific requirements of this group.
- While banks endeavour to provide services to the satisfaction of customers, they put in place an expeditious mechanism to redress the complaints of the customers.

Common Guidelines for Opening and Operating Deposit Accounts

To open and operate a bank account, the following guidelines need to be followed:

Due Diligence Process

Before opening any deposit account, the bank has to carry out due diligence as required under “Know Your Customer” (KYC) guidelines issued by RBI and or such other norms or procedures adopted by the bank. The ‘due diligence’ process, while opening a deposit account, involves the bank having adequate knowledge of the person’s identity, occupation, sources of income, and location. Obtaining an introduction of the prospective depositor from a person acceptable to the bank, obtaining recent photographs of people opening/operating the account are part of the due diligence process. For customers providing proof of identification and address, there is no need for personal introduction to the bank for opening of a new savings bank account. To promote financial inclusion in rural areas / tribal areas, KYC norms have been relaxed for below the poverty line (BPL) families.

Minimum Balance

For deposit products like a savings bank account or a current account, banks normally stipulate certain minimum balances to be maintained as part of terms and conditions governing operation of such accounts. But for people below the poverty line, banks encourage the opening of 'No-frills Accounts', typically a special savings bank account where no minimum balance requirement is required. For a savings bank account, the bank may also place restrictions on number of transactions, cash withdrawals, etc., during a given period.

Transparency

Failure to maintain minimum balance in the accounts, where applicable, will attract levy of charges as specified by the bank from time to time. Similarly, the bank may specify charges for issue of cheques books, additional statement of accounts, duplicate pass book, folio charges, etc. All such details regarding terms and conditions for operation of the accounts and schedule of charges for various services provided should be communicated to the prospective depositor while opening the account for the sake of transparency.

Eligibility

A savings bank account can be opened by eligible person(s) and certain organizations/agencies, as advised by the RBI from time to time. But current accounts can be opened by individuals, partnership firms, private and public limited companies, Hindu Undivided Families (HUFs), specified associates, society trusts, etc. Eligibility criteria for a savings account and a current account are largely similar, but there are important differences too. While both the accounts can be opened by individuals, the savings account cannot be opened by a firm. Term Deposit Accounts can be opened by all categories of account holders.

Requirement of PAN

In addition to the due diligence requirements, under KYC norms, banks are required by law to obtain a Permanent Account Number (PAN) from the prospective account holder or alternate declarations as specified under the Income Tax Act.

Operation of Joint Account

Deposit accounts can be opened by an individual in his own name or by more than one individual in their own names (known as a 'joint account'). A joint account can be operated by a single individual or by more than one individual jointly. The mandate for who can operate the account can be modified with the consent of all account holders. Joint accounts opened by minors with their parents or guardians can be only operated by the latter. Account holders of a joint account can give mandates on the operation of the account, and the disposal of balances in the event of the demise of one or more of the holders. Banks classify these mandates as 'Either or Survivor', and 'Any one or Survivor(s)', etc.

Power of Attorney

At the request of the depositor, the bank can register mandate/power of attorney given by him authorizing another person to operate the account on his behalf.

Closure/Renewal of Deposits

Term-deposit account holders at the time of placing their deposits can give instructions with regard to closure of deposit account or renewal of deposit for further period on the date of maturity. In absence of such mandate, the bank will usually seek instructions from the depositor(s) as to the renewal of the deposit or otherwise by sending intimation before say, 15 days of the maturity date of the term deposit. If no mandate is given or received by the bank before the date of maturity of term deposit, the bank will be at liberty to roll over the deposit on due date.

Nomination

A depositor is permitted to officially authorize someone, who would receive the money of his account when the depositor passes away. This is called the nomination process. Nomination facility is available on all deposit accounts opened by individuals. Nomination is also available to a sole proprietary concern account. Nomination can be made in favour of one individual only. Nomination so made can be cancelled or changed by the account holder/s anytime. Nomination can be made in favour of a minor too.

Deposit Related Services

As per the RBI guidelines, banks are required to provide some services to the depositors and to recognize the rights of depositors. The ultimate objective of the banking industry should be to provide a customer different services they are rightfully entitled to receive without demand.

Following are the deposit related services provided by banks:

Customer Information

Customer information collected from the customers should not be used for cross-selling of services or products by the bank, its subsidiaries and affiliates. If the bank proposes to use such information, it should be strictly with the 'express consent' of the account-holder.

Banks are not expected to disclose details/particulars of the customer's account to a third person or party without the expressed or implied consent from the customer. However, there are some exceptions, such as disclosure of information under compulsion of law or where there is a duty to public for the bank to disclose.

Interest Payment

Interest is paid on savings bank deposit account at the rate specified by RBI from time to time. In case of savings bank accounts, till recently, banks paid interest on the minimum balance between the 11th and the last day of the month. With effect from April 1, 2010, banks have been advised to calculate interest on savings bank deposit by considering daily product, which would benefit the holders of savings bank accounts.

Term-deposit interest rates are decided by individual banks with in these general guidelines. In terms of RBI directives, interest is calculated at quarterly intervals on term deposits and paid at the rate decided by the bank depending upon the period of deposits. The interest on term deposits is calculated by the bank in accordance with the formulae and conventions advised by Indian Bank Association.

Tax Deducted at Source (TDS)

The bank has statutory obligation to deduct tax at source if the total interest paid/payable on all term deposits held by a person exceeds the amount specified under the Income Tax Act and rules there under. The Bank will issue a tax deduction certificate (TDS Certificate) for the amount of tax deducted. The depositor, if entitled to exemption from TDS, can submit a declaration to the bank in the prescribed format at the beginning of every financial year.

Premature Withdrawal of Term Deposit

The bank on request from the depositor, at its discretion, may allow withdrawal of term-deposit before completion of the period of the deposit agreed upon at the time of placing the deposit. Banks usually charge a penalty for premature withdrawal of deposits. The bank shall declare their penal interest rates policy for premature withdrawal of term deposit, if any, at the time of opening of the account.

Premature Renewal of Term Deposit

In case the depositor desires to renew the deposit by seeking premature closure of an existing term deposit account, the bank will permit the renewal at the applicable rate on the date of renewal, provided the deposit is renewed for a period longer than the balance period of the original deposit. While prematurely closing a deposit for the purpose of renewal, interest on the deposit for the period it has remained with the bank will be paid at the rate applicable to the period for which the deposit remained with the bank and not at the contracted rate.

Advances Against Deposit

The Bank may consider requests of the depositor(s) for loan/ overdraft facility against term deposits duly discharged by the depositor(s) on execution of necessary security documents. The bank may also consider giving an advance against a deposit standing in the name of minor. However, a suitable declaration stating that the loan is for the benefit of the minor, is to be furnished by the depositor-applicant.

Settlement of Dues in Deceased Deposit Account

- a) If the depositor has registered nomination with the bank; the balance outstanding in the account of the deceased depositor will be transferred/ paid to the nominee after the bank is satisfied about the identity of the nominee, etc.
- b) The above procedure will be followed even in respect of a joint account where nomination is registered with the bank.
- c) In case of joint deposit accounts where joint account holders do not give any mandate for disposal, when one of the joint account holders dies, the bank is required to make payment jointly to the legal heirs of the deceased person and the surviving depositor(s). In these cases, delays may ensue in the production of legal papers by the heirs of the deceased. However, if the joint account holders had given mandate for disposal of the balance in the account in the forms such as 'either or survivor', 'former/latter or survivor', 'anyone of survivors or survivor'; etc., the payment will be made as per the mandate. In such cases, there is no delay in production of legal papers by the heirs of the deceased.
- d) In the absence of nomination, the bank will pay the amount outstanding to all legal heirs against joint application and on receipt of the necessary documents, including court order.

Stop Payment Facility

The Bank will accept 'stop payment' instructions from the depositors in respect of cheques issued by them. Charges, as specified, will be recovered.

Dormant Accounts

Accounts which are not operated for a considerable period of time (usually 12/24 months for savings bank accounts and 6/12 months for current accounts), will be transferred to a separate dormant/inoperative account status in the interest of the depositor as well as the bank. The depositor will be informed if there are charges that the bank would levy on dormant/inoperative accounts. Such accounts can be used again on an activation request to the bank. Such a practice is in the interest of the

depositor since it avoids the possibility of frauds on the account. It is also in the interest of the bank as it reduces the servicing costs that the bank would have had to incur if the account were to remain active.

Safe Deposit Locker

This facility is not offered through all bank branches and wherever the facility is offered, allotment of safe deposit vault will be subject to availability and compliance with other terms and conditions attached to the service. Safe deposit lockers may be hired by an individual (not a minor) singly or jointly with another individual(s), HUFs, firms, limited companies, associates, societies, trusts etc. Nomination facility is available to individual(s) holding the lockers singly or jointly. In the absence of nomination or mandate for disposal of contents of lockers, with a view to avoid hardship to common persons, the bank will release the contents of locker to the legal heirs against indemnity on the lines as applicable to deposit accounts.

Redress of Complaints and Grievance

Depositors having any complaint/grievance with regard to services rendered by the bank have a right to approach the authorities designated by the bank for handling customer complaints/grievances. In case the depositor does not get a response from the bank within one month after the bank receives his representation /complaint or he is not satisfied with the response received from the bank, he has a right to approach the Banking Ombudsman appointed by RBI.

Deposit Services Offered to Non-Resident Indians

Banks actively seek banking business from Non-Resident Indians (NRIs) by offering different types of deposit accounts (and related services) in accordance with RBI guidelines, including:

- Non-resident ordinary account;
- Non-resident (external) Rupee account; and
- Foreign currency non-resident account (Banks)

Definition of Non-Resident Indian (NRI)

As per the Foreign Exchange Management Act (FEMA), 1999, an NRI means: on-Resident Indian National (i.e. Non-resident Indian holding Indian passport), and Persons of Indian Origin (i.e., Non-residents holding foreign passports).

Non-Resident Indian Nationals Include

- (i) Indian citizens who proceed abroad for employment or for any business or vocation in circumstances indicating an indefinite period of stay outside India; NRI is defined differently under different acts. For the purpose of bank accounts, FEMA definition holds.
- (ii) Indian citizens working abroad on assignments with foreign governments, international/multinational agencies such as the United Nations, the International Monetary Fund, the World Bank etc.
- (iii) Officials of Central and State Governments and Public Sector Undertakings (PSUs) deputed abroad on assignments with foreign governments, multilateral agencies or Indian diplomatic missions abroad.

PIO (Persons of Indian Origin) is defined as a citizen of any country other than Bangladesh or Pakistan, if

- He has at any time held an Indian passport; or
- He or either of his parents or any of his grandparents was a citizen of India; or
- The person is a spouse of an Indian citizen or a person referred to in sub-clause (a) or (b).

In general, NRI is thus a person of Indian nationality or origin, who is resident abroad for business or employment or vocation, or with the intension of seeking employment or vocation and the period of stay abroad is uncertain.

Non Resident Ordinary Accounts (NRO)

These are Rupee accounts and can be opened by any person resident outside India. Typically, when a resident becomes non-resident, his domestic Rupee account gets converted into an NRO account. In other words, it is basically a domestic account of an NRI which help him get credits which accrue in India, such as rent from property or income from other investments. New accounts can be opened by sending fresh remittances from abroad. NRO accounts can be opened only as savings account, current account, recurring deposits and term-deposit accounts. Regulations on interest rates, tenors etc. are similar to those of domestic accounts. While the principal of NRO deposits is non-repatriable, current income such as interest earnings on NRO deposits are repatriable. Further, NRI/PIO may remit an amount, not exceeding US\$1millionper financial year, for permissible transactions from these accounts.

Non-Resident (External) Rupee Account

The Non-Resident (External) Rupee Account NR(E)RA scheme, also known as the NRE scheme, was introduced in 1970. This is a rupee account. Any NRI can open an NRE account with funds remitted to India through a bank abroad.

An NRE rupee account may be opened as current, savings, and recurring or term deposit account. Since this account is maintained in Rupees, the depositor is exposed to exchange risk. Thus, a student going abroad for studies or a tourist going abroad for brief visit is not an NRI. This is a repatriable account (for both interest and principal) and transfer from/to another NRE account or FCNR (B) account (see below) is also permitted. Local payments can also be freely made from NRE accounts. NRIs / PIOs have the option to credit the current income to their NRE accounts, provided income tax has been deducted / provided for. Interest rates on NRE accounts are determined by the RBI, for both savings and term deposits.

Foreign Currency Non Resident Account (Banks)

The Foreign Currency Non-Resident Account (Banks) or FCNR(B) accounts scheme was introduced with effect from May 15, 1993 to replace the then prevailing FCNR(A) scheme introduced in 1975.

- These are foreign currency accounts, which can be opened by NRIs in only designated currencies: Pound Sterling, US Dollar, Canadian Dollar, Australian Dollar, EURO and Japanese Yen.
- Repatriation of principal amount and interest is permitted.
- These deposits can be opened only in the form of term deposits.
- Deposits are in foreign currency and are repaid in the currency of issue. Hence, there is no exchange risk for the account holder.
- Transfer of funds from existing NRE accounts to FCNR (B) accounts and vice- versa, of the same account holder, is permissible without the prior approval of RBI.

A bank should obtain the prior approval of its Board of Directors for the interest rates that it will offer on deposits of various maturities, within the ceiling prescribed by RBI.

Deposit Insurance

Deposit insurance helps sustain public confidence in the banking system through the protection of depositors, especially small depositors, against loss of deposit to a significant extent. In India, bank deposits are covered under the insurance scheme offered by Deposit Insurance and Credit Guarantee Corporation of India (DICGC), which was established with funding from the Reserve Bank of India. The scheme is subject to certain limits and conditions. DICGC is a wholly-owned subsidiary of the RBI. All commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks are insured by the DICGC. Further, all State, Central and Primary cooperative banks functioning in States/Union Territories which have amended the local Cooperative Societies Act empowering RBI suitably are insured by the DICGC. Primary cooperative societies are not insured by the DICGC.

In the event of a bank failure, DICGC protects bank deposits that are payable in India. DICGC is liable to pay if A bank goes into liquidation If a bank is amalgamated/ merged with another bank. There are two methods of protecting depositors' interest when an insured bank fails:

- (i) By transferring business of the failed bank to another sound bank (in case of merger or amalgamation) and

- (ii) Where the DICGC pays insurance proceeds to depositors (insurance pay-out method). Each depositor in a bank is insured up to a maximum of ₹1,00,000 for both principal and interest amount held by him in the same capacity and same right. Deposit insurance premium is borne entirely by the insured bank. Banks are required to pay the insurance premium for the eligible amount to the DICGC on a semi-annual basis. The cost of the insurance premium cannot be passed on to the customer. The deposit insurance scheme is compulsory and no bank can withdraw from it. The DICGC, on the other hand, can withdraw the deposit insurance cover for a bank if it fails to pay the premium for three consecutive half year periods. In the event of the DICGC withdrawing its cover from any bank for default in the payment of premium, the public will be notified through the newspapers.

Loans and Advances

Banks extend credit to different categories of borrowers for a wide variety of purposes. For many borrowers, bank credit is the easiest to access at reasonable interest rates. Bank credit is provided to households, retail traders, small and medium enterprises (SMEs), corporate, the Government undertakings etc. in the economy. Retail banking loans are accessed by consumers of goods and services for financing the purchase of consumer durables, housing or even for day-to-day consumption. In contrast, the need for capital investment, and day-to-day operations of private corporate and the Government undertakings are met through wholesale lending. Loans for capital expenditure are usually extended with medium and long-term maturities, while day-to-day finance requirements are provided through short-term credit (working capital loans). Meeting the financing needs of the agriculture sector is also an important role that Indian banks play.

Principles of Lending

To lend, banks depend largely on deposits from the public. Banks act as custodian of public deposits. Since the depositors require safety and security of their deposits, want to withdraw deposits whenever they need and also adequate return, bank lending must necessarily be based on principles that reflect these concerns of the depositors. These principles include: safety, liquidity, profitability, and risk diversion.

Safety

Banks need to ensure that advances are safe and money lent out by them will come back. Since the repayment of loans depends on the borrowers' capacity to pay, the banker must be satisfied before lending that the business for which money is sought is a sound one. In addition, bankers many times insist on security against the loan, which they fall back on if things go wrong for the business. The security must be adequate, readily marketable and free of encumbrances.

Liquidity

To maintain liquidity, banks have to ensure that money lent out by them is not locked up for long time by designing the loan maturity period appropriately. Further, money must come back as per the repayment schedule. If loans become excessively illiquid, it may not be possible for bankers to meet their obligations vis-à-vis depositors.

Profitability

To remain viable, a bank must earn adequate profit on its investment. This calls for adequate margin between deposit rates and lending rates. In this respect, appropriate fixing of interest rates on both advances and deposits is critical. Unless interest rates are competitively fixed and margins are adequate, banks may lose customers to their competitors and become unprofitable.

Risk Diversification

To mitigate risk, banks should lend to a diversified customer base. Diversification should be in terms of geographic location, nature of business etc. If, for example, all the borrowers of a bank are concentrated in one region and that region gets affected by a natural disaster, the bank's profitability can be seriously affected.

Loan Policy

Based on the general principles of lending stated above, the Credit Policy Committee (CPC) of individual banks prepares the basic credit policy

of the Bank, which has to be approved by the Bank's Board of Directors. The loan policy outlines lending guidelines and establishes operating procedures in all aspects of credit management including standards for presentation of credit proposals, financial covenants, rating standards and benchmarks, delegation of credit approving powers, prudential limits on large credit exposures, asset concentrations, portfolio management, loan review mechanism, risk monitoring and evaluation, pricing of loans, provisioning for bad debts, regulatory/ legal compliance etc. The lending guidelines reflect the specific bank's lending strategy (both at the macro level and individual borrower level) and have to be in conformity with RBI guidelines. The loan policy typically lays down lending guidelines in the following areas such as level of credit-deposit ratio, targeted portfolio mix, hurdle ratings, loan pricing, collateral security.

Credit Deposit (CD) Ratio

A bank can lend out only a certain proportion of its deposits, since some part of deposits have to be statutorily maintained as Cash Reserve Ratio (CRR) deposits, and an additional part has to be used for making investment in prescribed securities (Statutory Liquidity Ratio or SLR requirement). It may be noted that these are minimum requirements. Banks have the option of having more cash reserves than CRR requirement and invest more in SLR securities than they are required to. Further, banks also have the option to invest in non-SLR securities. Therefore, the CPC has to lay down the quantum of credit that can be granted by the bank as a percentage of deposits available. Currently, the average CD ratio of the entire banking industry is around 70 percent, though it differs across banks. It is rarely observed that banks lend out of their borrowings.

Targeted Portfolio Mix

The CPC aims at a targeted portfolio mix keeping in view both risk and return. Toward this end, it lays down guidelines on choosing the preferred areas of lending (such as sunrise sectors and profitable sectors) as well as the sectors to avoid. Banks typically monitor all major sectors of the economy. They target a portfolio mix in the light of forecasts for growth and profitability for each sector. If a bank perceives economic weakness in a sector, it would restrict new exposures to that segment and similarly, growing and profitable sectors of the economy prompt banks to increase

new exposures to those sectors. This entails active portfolio management. Further, the bank also has to decide which sectors to avoid.

Hurdle Ratings

There are a number of diverse risk factors associated with borrowers. Banks should have a comprehensive risk rating system that serves as a single point indicator of diverse risk factors of a borrower. This helps taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardization is required in ratings across borrowers. The risk rating system should be so designed as to reveal the overall risk of lending. For new borrowers, a bank usually lays down guidelines regarding minimum rating to be achieved by the borrower to become eligible for the loan. This is also known as the 'hurdle rating' criterion to be achieved by a new borrower.

Pricing of Loans

Risk-return trade-off is a fundamental aspect of risk management. Borrowers with weak financial position and, hence, placed in higher risk category are provided credit facilities at a higher price (that is, at higher interest). The higher the credit risk of a borrower the higher would be his cost of borrowing. To price credit risks, banks devise appropriate systems, which usually allow flexibility for revising the price (risk premium) due to changes in rating. In other words, if the risk rating of a borrower deteriorates, his cost of borrowing should rise and vice versa. At the macro level, loan pricing for a bank is dependent upon a number of its cost factors such as cost of raising resources, cost of administration and overheads, cost of reserve assets like CRR and SLR, cost of maintaining capital, percentage of bad debt, etc. Loan pricing is also dependent upon competition.

Collateral Security

As part of a prudent lending policy, banks usually advance loans against some security. The loan policy provides guidelines for this. In the case of term loans and working capital assets, banks take as 'primary security' the property or goods against which loans are granted. In addition to this, banks often ask for additional security or 'collateral security' in the

form of both physical and financial assets to further bind the borrower. This reduces the risk for the bank. Sometimes, loans are extended as 'clean loans' for which only personal guarantee of the borrower is taken.

Compliance with RBI Guidelines

The credit policy of a bank should be conformant with RBI guidelines; some of the important guidelines of the RBI relating to bank credit are discussed below.

Directed Credit Stipulation

The RBI lays down guidelines regarding minimum advances to be made for priority sector advances, export credit finance, etc. These guidelines need to be kept in mind while formulating credit policies for the Bank.

Capital Adequacy

If a bank creates assets-loans or investment-they are required to be backed up by bank capital; the amount of capital they have to be backed up by depends on the risk of individual assets that the bank acquires. The riskier the asset, the larger would be the capital it has to be backed up by. This is so, because bank capital provides a cushion against unexpected losses of banks and riskier assets would require larger amounts of capital to act as cushion. The Basel Committee for Bank Supervision (BCBS) has prescribed a set of norms for the capital requirement for the banks for all countries to follow. These norms ensure that capital should be adequate to absorb unexpected losses. In addition, all countries, including India, establish their own guidelines for risk based capital framework known as Capital Adequacy Norms.

These norms have to be at least as stringent as the norms set by the Basel committee. A key norm of the Basel committee is the Capital Adequacy Ratio (CAR), also known as Capital Risk Weighted Assets Ratio, is a simple measure of the soundness of a bank. The ratio is the capital with the bank as a percentage of its risk-weighted assets. Given the level of capital available with an individual bank, this ratio determines the maximum extent to which the bank can lend. The Basel committee

specifies a CAR of at least 8% the bank's risk weighted assets for banks. In India, the RBI has specified a minimum of 9%, which is more stringent than the international norm. In fact, the actual ratio of all scheduled commercial banks (SCBs) in India stood at 13.2% in March 2009. The RBI also provides guidelines about how much risk weights banks should assign to different classes of assets (such as loans).

Credit Exposure Limits

As a prudential measure aimed at better risk management and avoidance of concentration of credit risks, the Reserve Bank has fixed limits on bank exposure to the capital market as well as to individual and group borrowers with reference to a bank's capital. Limits on inter-bank exposures have also been placed. Banks are further encouraged to place internal caps on their sectoral exposures, their exposure to commercial real estate and to unsecured exposures.

These exposures are closely monitored by the Reserve Bank. Prudential norms on banks' exposures to NBFCs and to related entities are also in place. RBI has given guidelines on exposure norms for commercial banks in India. Further, a Bank may fix its own credit exposure limits for mitigating credit risk. The bank may, for example, set upper caps on exposures to sensitive sectors like commodity sector, real estate sector and capital markets. Banks also may lay down guidelines regarding exposure limits to unsecured loans.

Lending Rates

Banks are free to determine their own lending rates on all kinds of advances except a few such as export finance; interest rates on these exceptional categories of advances are regulated by the RBI. It may be noted that the Section 21A of the BR Act provides that the rate of interest charged by a bank shall not be reopened by any court on the ground that the rate of interest charged is excessive. The concept of benchmark prime lending rate (BPLR) was however introduced in November 2003 for pricing of loans by commercial banks with the objective of enhancing transparency in the pricing of their loan products. Each bank must declare its benchmark prime lending rate (BPLR) as approved by its Board of Directors. A bank's BPLR is the interest rate to be charged to its best clients; that is, clients with

the lowest credit risk. Each bank is also required to indicate the maximum spread over the BPLR for various credit exposures. However, BPLR lost its relevance over time as a meaningful reference rate, as the bulk of loans were advanced below BPLR. According to RBI guidelines, the 'Base Rate system' will replace the BPLR system with effect from July 01, 2010. All categories of loans should henceforth be priced only with reference to the Base Rate. Each bank will decide its own Base Rate.

The actual lending rates charged to borrowers would be the Base Rate plus borrower-specific charges, which will include product-specific operating costs, credit risk premium and tenor premium. Since transparency in the pricing of loans is a key objective, banks are required to exhibit the information on their Base Rate at all branches and also on their websites. Changes in the Base Rate should also be conveyed to the general public from time to time through appropriate channels. Apart from transparency, banks should ensure that interest rates charged to customers in the above arrangement are non-discriminatory in nature.

Guidelines on Fair Practices Code for Lender

RBI has been encouraging banks to introduce a fair practices code for bank loans. Loan application forms in respect of all categories of loans irrespective of the amount of loan sought by the borrower should be comprehensive. It should include information about the fees/ charges, if any, payable for processing the loan, the amount of such fees refundable in the case of non-acceptance of application, prepayment options and any other matter which affects the interest of the borrower, so that a meaningful comparison with the fees charged by other banks can be made and informed decision can be taken by the borrower. Further, the banks must inform 'all-in-cost' to the customer to enable him to compare the rates charged with other sources of finance.

Regulations Relating to Providing Loans

The provisions of the Banking Regulation Act, 1949 (BR Act) govern the making of loans by banks in India. RBI issues directions covering the loan activities of banks. Some of the major guidelines of RBI, which are now in effect, are as follows:

Advances Against Banks Own Shares

A bank cannot grant any loans and advances against the security of its own shares.

Advances to Bank's Directors

The BR Act lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.

Restrictions on Holding Shares in Companies

In terms of Section 19(2) of the BR Act, banks should not hold shares in any company except as provided in sub-section (1) whether as pledge, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

Basics of Loan Appraisal, Credit Decision-Making and Review***Credit Approval Authorities***

The Bank's Board of Directors also has to approve the delegation structure of the various credit approval authorities. Banks establish multi-tier credit approval authorities for corporate banking activities, small enterprises, retail credit, agricultural credit, etc.

Concurrently, each bank should set up a Credit Risk Management Department (CMRD), being independent of the CPC. The CRMD should enforce and monitor compliance of the risk parameters and prudential limits set up by the CPC.

Credit Appraisal and Credit Decision-Making

When a loan proposal comes to the bank, the banker has to decide how much funds the proposal really requires for it to be a viable project and what are the credentials of those who are seeking the project. In checking the credentials of the potential borrowers, Credit Information Bureaus play an important role. Credit information bureaus are thus repositories

of information, which contains the credit history of commercial and individual borrowers. They provide this information to their Members in the form of credit information reports. To get a complete picture of the payment history of a credit applicant, credit grantors must be able to gain access to the applicant's complete credit record that may be spread over different institutions. Credit information bureaus collect commercial and consumer credit-related data and collate such data to create credit reports, which they distribute to their Members. A Credit Information Report (CIR) is a factual record of a borrower's credit payment history compiled from information received from different credit grantors. Its purpose is to help credit grantors make informed lending decisions - quickly and objectively. As of today, bureaus provide history of credit card holders and SMEs.

Monitoring and Review of Loan Portfolio

It is not only important for banks to follow due processes at the time of sanctioning and disbursing loans, it is equally important to monitor the loan portfolio on a continuous basis. Banks need to constantly keep a check on the overall quality of the portfolio. They have to ensure that the borrower utilizes the funds for the purpose for which it is sanctioned and complies with the terms and conditions of sanction. Further, they monitor individual borrows accounts and check to see whether borrowers in different industrial sectors are facing difficulty in making loan repayment. Information technology has become an important tool for efficient handling of the above functions including decision support systems and data bases.

Such a surveillance and monitoring approach helps to mitigate credit risk of the portfolio. Banks have set up Loan Review Departments or Credit Audit Departments in order to ensure compliance with extant sanction and post-sanction processes and procedures laid down by the Bank from time to time. This is especially applicable for the larger advances. The Loan Review Department helps a bank to improve the quality of the credit portfolio by detecting early warning signals, suggesting remedial measures and providing the top management with information on credit administration, including the credit sanction process, risk evaluation and post-sanction follow up.

Types of Loans & Advances

Advances can be broadly classified into: fund-based lending and non-fund based lending. **Fund based lending:** This is a direct form of lending in which a loan with an actual cash outflow is given to the borrower by the Bank. In most cases, such a loan is backed by primary and/or collateral security. The loan can be to provide for financing capital goods and/or working capital requirements. Let us discuss some important types of fund-based lending.

Working Capital Finance

Working capital finance is utilized for operating purposes, resulting in creation of current assets (such as inventories and receivables). This is in contrast to term loans which are utilized for establishing or expanding a manufacturing unit by the acquisition of fixed assets. Banks carry out a detailed analysis of borrowers' working capital requirements. Credit limits are established in accordance with the process approved by the board of directors. The limits on Working capital facilities are primarily secured by inventories and receivables (chargeable current assets). Working capital finance consists mainly of cash credit facilities, short term loan and bill discounting. Under the cash credit facility, a line of credit is provided up to a pre-established amount based on the borrower's projected level of sales inventories, receivables and cash deficits. Up to this pre-established amount, disbursements are made based on the actual level of inventories and receivables. Here the borrower is expected to buy inventory on payments and, thereafter, seek reimbursement from the Bank. In reality, this may not happen. The facility is generally given for a period of up to 12 months and is extended after a review of the credit limit.

Project Finance

Project finance business consists mainly of extending medium-term and long-term rupee and foreign currency loans to the manufacturing and infrastructure sectors. Banks also provide financing by way of investment in marketable instruments such as fixed rate and floating rate debentures. Lending banks usually insist on having a first charge on the fixed assets of the borrower. During the recent years, the larger banks are increasingly becoming involved in financing large projects, including infrastructure

projects. Given the large amounts of financing involved, banks need to have a strong framework for project appraisal. The adopted framework will need to emphasize proper identification of projects, optimal allocation and mitigation of risks. The project finance approval process entails a detailed evaluation of technical, commercial, financial and management factors and the project sponsor's financial strength and experience. As part of the appraisal process, a risk matrix is generated, which identifies each of the project risks, mitigating factors and risk allocation.

Loans to Small and Medium Enterprises

A substantial quantum of loans is granted by banks to small and medium enterprises (SMEs). While granting credit facilities to smaller units, banks often use a cluster-based approach, which encourages financing of small enterprises that have a homogeneous profile such as leather manufacturing units, chemical units, or even export oriented units. For assessing the credit risk of individual units, banks use the credit scoring models. As per RBI guidelines, banks should use simplified credit appraisal methods for assessment of bank finance for the smaller units. Further, banks have also been advised that they should not insist on collateral security for loans up to ₹10 lakh for the micro enterprises.

Rural and Agricultural Loan: The rural and agricultural loan portfolio of banks comprises loans to farmers, small and medium enterprises in rural areas, dealers and vendors linked to these entities and even corporate. For farmers, banks extend term loans for equipments used in farming, including tractors, pump sets, etc. Banks also extend crop loan facility to farmers. In agricultural financing, banks prefer an 'area based' approach; for example, by financing farmers in an adopted village. The regional rural banks (RRBs) have a special place in ensuring adequate credit flow to agriculture and the rural sector.

Directed Lending

The RBI requires banks to deploy a certain minimum amount of their credit in certain identified sectors of the economy. This is called directed lending. Such directed lending comprises priority sector lending and export credit.

- a) Priority sector lending:** The objective of priority sector lending program is to ensure that adequate credit flows into some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability. These sectors include agriculture, small scale enterprises, retail trade, etc. Small housing loans, loans to individuals for pursuing education, loans to weaker sections of the society etc also qualify as priority sector loans. To ensure banks channelize a part of their credit to these sectors, the RBI has set guidelines defining targets for lending to priority sector as whole and in certain cases, sub-targets for lending to individual priority sectors. The RBI guidelines require banks to lend at least 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure (CEOBSE), whichever is higher. In case of foreign banks, the target for priority sector advances is 32% of ANBC or CEOBSE, whichever is higher. In addition to these limits for overall priority sector lending, the RBI sets sub-limits for certain sub-sectors within the priority sector such as agriculture. Banks are required to comply with the priority sector lending requirements at the end of each financial year. A bank having shortfall in lending to priority sector lending target or sub-target shall be required to make contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD or funds with other financial institutions as specified by the RBI.
- b) Export Credit:** As part of directed lending, RBI requires banks to make loans to exporters at concessional rates of interest. Export credit is provided for pre-shipment and post-shipment requirements of exporter borrowers in rupees and foreign currencies. At the end of any fiscal year, 12.0% of a bank's credit is required to be in the form of export credit. This requirement is in addition to the priority sector lending requirement but credits extended to exporters that are small scale industries or small businesses may also meet part of the priority sector lending requirement.

Retail Loan

Banks, today, offer a range of retail asset products, including home loans, automobile loans, personal loans (for marriage, medical expenses etc), credit cards, consumer loans (such as TV sets, personal computers

etc) and, loans against time deposits and loans against shares. Banks also may fund dealers who sell automobiles, two wheelers, consumer durables and commercial vehicles. Customers for retail loans are typically middle and high-income, salaried or self-employed individuals, and, in some cases, proprietorship and partnership firms. Except for personal loans and credit through credit cards, banks stipulate that

- (a) A certain percentage of the cost of the asset (such as a home or a TV set) sought to be financed by the loan, to be borne by the borrower and
- (b) That the loans are secured by the asset financed. In making credit decisions, banks draw upon reports from agencies such as the Credit Information Bureau (India) Limited (CIBIL) about borrowers. Some private sector banks use direct marketing associates as well as their own branch network and employees for marketing retail credit products. However, credit approval authority lies only with the bank's credit officers. Two important categories of retail loans are home finance and personal loans.

Home Finance: Banks extend home finance loans, either directly or through home finance subsidiaries. Such long term housing loans are provided to individuals and corporations and also given as construction finance to builders. The loans are secured by a mortgage of the property financed. These loans are extended for maturities generally ranging from five to fifteen years and a large proportion of these loans are at floating rates of interest. This reduces the interest rate risk that banks assume, since a bank's sources of finance are generally of shorter maturity. However, fixed rate loans may also be provided; usually with banks keeping a higher margin over benchmark rates in order to compensate for higher interest rate risk. Equated monthly installments are fixed for repayment of loans depending upon the income and age of the borrower(s).

Personal Loans: These are often unsecured loans provided to customers who use these funds for various purposes such as higher education, medical expenses, social events and holidays. Sometimes collateral security in the form of physical and financial assets may be available for securing the personal loan. Portfolio of personal loans also includes micro-banking loans, which are relatively small value loans extended to lower income customers in urban and rural areas.

International Loans Extended by Banks

Indian corporate raise foreign currency loans from banks based in India as well as abroad as per guidelines issued by RBI/ Government of India. Banks raise funds abroad for on-lending to Indian corporate. Further, banks based in India have an access to deposits placed by Non-Resident Indians (NRIs) in the form of FCNR (B) deposits, which can be used by banks in India for on-lending to Indian customers.

Non-Fund Based Lending

In this type of facility, the Bank makes no funds outlay. However, such arrangements may be converted to fund-based advances if the client fails to fulfill the terms of his contract with the counterparty. Such facilities are known as contingent liabilities of the bank. Facilities such as 'letters of credit' and 'guarantees' fall under the category of non-fund based credit.

Management of Non Performing Assets

An asset of a bank (such as a loan given by the bank) turns into a non-performing asset (NPA) when it ceases to generate regular income such as interest etc for the bank. In other words, when a bank which lends a loan does not get back its principal and interest on time, the loan is said to have turned into an NPA. While NPAs are a natural fall-out of undertaking banking business and hence cannot be completely avoided, high levels of NPAs can severely erode the bank's profits, its capital and ultimately its ability to lend further funds to potential borrowers. Similarly, at the macro level, a high level of non-performing assets means choking off credit to potential borrowers, thus lowering capital formation and economic activity. So the challenge is to keep the growth of NPAs under control. Clearly, it is important to have a robust appraisal of loans, which can reduce the chances of loan turning into an NPA. Also, once a loan starts facing difficulties, it is important for the bank to take remedial action.

According to the RBI guidelines, banks must classify their assets on an on-going basis into the following four categories such as standard assets, sub-standard assets, doubtful assets and loss assets.

Once a borrower faces difficulty in repaying loans or paying interest, the bank should initially address the problem by trying to verify whether the financed company is viable in the long run. If the company/project is viable, then rehabilitation is possible by restructuring the credit facilities. In a restructuring exercise, the bank can change the repayment or interest payment schedule to improve the chances of recovery or even make some sacrifices in terms of waiving interest etc. RBI has separate guidelines for restructured loans. To create an institutional mechanism for the restructuring of corporate debt, RBI has devised a Corporate Debt Restructuring (CDR) system. The objective of this framework is to ensure a timely and transparent mechanism for the restructuring of corporate debts of viable entities facing problems.

Banks utilize the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) as an effective tool for NPA recovery. It is possible where non-performing assets are backed by securities charged to the Bank by way of hypothecation or mortgage or assignment. Upon loan default, banks can seize the securities (except agricultural land) without intervention of the court. SARFAESI is effective only for secured loans where bank can enforce the underlying security e.g. hypothecation, pledge and mortgages. In such cases, court intervention is not necessary, unless the security is invalid or fraudulent. However, if the asset in question is an unsecured asset, the bank would have to move the court to file civil case against the defaulters.

The SARFAESI Act, 2002 gives powers of “seize and desist” to banks. Banks can give a notice in writing to the defaulting borrower requiring it to discharge its liabilities within 60 days. If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures: Take possession of the security for the loan; Sale or lease or assign the right over the security; and manage the same or appoint any person to manage the same. The SARFAESI Act also provides for the establishment of asset reconstruction companies regulated by RBI to acquire assets from banks and financial institutions. The Act provides for sale of financial assets by banks and financial institutions to asset reconstruction companies (ARCs). RBI has issued guidelines to banks on the process to be followed for sales of financial assets to ARCs.

Balance Sheet of a Bank

Banks are a key intermediary in the financial sector. Being companies, they are covered by the Companies Act, 1956. The Act, through Schedule VI has specified a format for financial statements of companies. The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) formulates accounting standards, with a view to harmonize the accounting policies and practices. The Schedule VI was revised by Ministry of Corporate Affairs on March 3, 2011. The revised Schedule VI has been framed as per the existing non-converged Indian Accounting Standards notified under the Companies (Accounting Standards), Rules, 2006 and has no connection with the converged Indian Accounting Standards. Important changes in the revised Schedule VI include

- a) Only vertical form is allowed;
- b) Unit of measurement should be uniform;
- c) “sources of funds” has been replaced with “Equity & Liabilities”; Liabilities will be classified as current and non-current liabilities; Schedules are eliminated and additional information are to be provided in the Notes to Accounts.

RBI, on its part, wishes to align Indian banking system with global standards. Further, since banking companies are different from normal manufacturing companies, direct application of the ICAI standards to banking companies created issues. With a view to eliminating gaps in compliance with accounting standards by banks, a Working Group was created. The recommendations of the Working Group were accepted by RBI. Accordingly, RBI has issued guidelines to be followed by banks.

Balance Sheet of a Bank

Balance sheet of a bank brings out its financial operations for that particular period and one can find out the extent of operating profits earned by a bank compared to its previous year. In addition to this, the balance sheet also depicts the financial soundness of the bank. This can be found from the funds that are owned and borrowed by the bank and the way they are developed.

The liability side of the balance sheet has *owned funds* in the form of *capital and reserves*, followed by *borrowed funds*, consisting of *deposits and other borrowings*. The asset side of the balance sheet is on the basis of *descending order of liquidity and ascending order of profitability*. That is, cash being highly liquid asset, finds its first place followed by money at call and short notice, investments and advances. From the point of view of profitability, we find that cash comes as the last item on the ascending order as cash on hand does not bring any return to the bank.

The following summarized balance sheet of a bank gives an idea of the nature of items that feature in a bank's balance sheet.

Balance Sheet of Bank as on March 31, 2013	
Equity and Liabilities	₹
Equity	xxx
Reserves and Surplus	xxx
Deposits	xxx
Borrowings	xxx
Other Liabilities and Provisions	xxx
Total	xxx
Assets	
Cash and Balances with Reserve Bank of India	xxx
Balances with banks and Money at call and short notice	xxx
Investments	xxx
Advances	xxx
Fixed Assets	xxx
Other Assets	xxx
Total	Xxx

Contingent Liabilities

Now, let us analyze the items of balance sheet.

Capital and Liabilities

Capital: Every bank will have an authorized capital. This is the maximum capital that a bank is allowed to raise by issue of shares. In the case of public sector banks, this may be completely contributed by the

government. But in the case of private sector banks, different types of shareholders contribute this. As per the Banking Regulation Act, issued capital should not be less than 50% of authorized capital and the subscribed capital should not be less than 50% of the issued capital.

Paid up capital should not be less than 50% of subscribed capital. This shows that from the authorized capital, a bank should issue shares with a minimum of not less than 50%, which is called issued capital. Subscribed capital is that which the public have agreed to subscribe and this should not be less than 50% of the issued capital. Paid up capital is what actually paid by the shareholders which should not be less than 50% of subscribed capital. For example, if an amount of ₹ 10 crores is authorized capital, ₹ 5 crores will be issued capital. ₹ 2.5 crores, which is 50% of issued capital, will be subscribed capital. ₹ 1.25 crores will be the paid up capital. These are all the minimum requirements as per the law; it can be more than this also. As per the International Banking Convention (**BASLE**), every bank must have core capital, which should be minimum 4% of its deposits and another 4% of capital based on risk-weighted asset structure.

Reserves and Surplus: As per Section 17 of the Banking Regulation Act, every bank must compulsorily allocate 20% of its profit towards reserve fund. A bank cannot declare any dividend until it has built-up reserve fund, equivalent to its paid-up capital. Hence, all the banks will allocate entire profit towards reserve fund until it become equivalent to 'paid up capital'. Surplus here represents the surplus earning left over after distributing dividends and other statutory provisions. Share premiums will also come under surplus.

Deposits: This is the biggest utility of any bank. It is based on the confidence created by the bank on public minds, banks mobilize deposits. The deposits so mobilized can be broadly classified into- Demand deposit and Time deposit.

Borrowings: A bank borrows from RBI to meet its current requirements, as the interest rate charged by RBI called the *Bank rate* will be less than market rate. In addition to this, banks will also go for inter bank borrowings to meet the customers' obligations. There will also be borrowings by commercial banks from foreign banks in terms of foreign exchange. Thus, bank borrowings will be from within India as well as

outside India. Banks also discount their first class bills when they happened to be *Scheduled banks*. In order to meet short term requirements, they borrow from money market. There is also money market mutual funds promoted by banks for the purpose of raising short-term loans.

Other Liabilities and Provisions: Bills payable will form part of other liabilities. Drafts, telegraphic transfers, mail transfers, electronic clearance etc., will form a part of this. Interest due on deposits and borrowings will also be included in this. Outstanding charges like rent, conveyance, tax deducted at source, etc., will be included in this schedule.

Assets

Cash and Balance with RBI: Every bank should maintain certain amount of deposits as cash on hand to meet the demands of customers. This includes apart from domestic currency, foreign currencies also. The factors which decide the balance include statutory requirements, business conditions, banking habit of the people, well Developed Banking System, clearing house facilities, and seasonal stringency

Balance with banks and money at call and short notice: Next to cash on hand, the *most liquid asset* is the balance with other banks and *money at call and short notice*. Banks maintain balances with other commercial banks towards inter-bank loans. These loans are called *Call loans* as they can be obtained within 24 hours notice from other banks. During the busy season, banks will go for inter-bank loans, as they are not only cheaper but also safe. A bank instead of keeping cash idle would like to lend to its counterparts (i.e. the other banks) for some nominal interest. *Money at call and short notice* represents loan given by banks to either bill market brokers or to stock market brokers for a very short period. These loans can be called back even within 24 hours notice. But in India, money at call and short notice represents inter-bank call loans.

Investment: A bank has a moral responsibility towards its depositors in not only providing proper interest but also safeguarding their *interests*. A bank has a commercial obligation towards its shareholders and has to provide them attractive dividend. As a compromise, to protect the interest of both-the *depositors and shareholders*, a bank will have to go in for such an investment, which will provide better returns while maintaining the

safety and security of the assets at the same time. The investment policy of a bank consists of three basic principles of *safety, liquidity and profitability*. In addition to this, national interest and statutory requirements have to be fulfilled also.

Advances: Loans and advances form a part of bank asset. Loans are different from advances. In loans, the banker will insist on security and based on its market value, the loan amount will be decided. The purpose of the loan will not be the concern of the bank. Thus, *pledge, mortgage, assignment* are some of the loans granted by banks. In advances, the bank will give advances for a specific purpose and such an amount cannot be spent for any other purpose other than specified one. Examples for advances are *working capital* or *fixed capital*.

Fixed assets: Land, building, furniture and fittings etc., will come under this category. The bank will provide necessary depreciation.

Other assets: This represents non-banking assets acquired by banks by way of claims from the customers. The assets might have been given as security for loans and due to default the bank will recover the asset as a part of claim.

Contingent liabilities: Here, the bank will show guarantees given in India and outside India for loans extended to customers. There may also be outstanding rent, electricity, telephone charges, etc., which will be shown under this item.

Bills for Collection: Customers hand over to the bank, both domestic and foreign bills for collection. For this, the bank will charge service charges. With the help of its branches, these bills are collected and credited to the respective customers' account.

CAMELS Framework

'CAMELS' is a framework for composite evaluation of banks (and financial intermediaries, in general). The acronym stands for:

Capital Adequacy: This is a measure of financial strength, in particular its ability to cushion operational and abnormal losses. It is calculated based on the asset structure of the bank, and the risk weights that have been assigned by the regulator for each asset class.

Asset Quality: This depends on factors such as concentration of loans in the portfolio, related party exposure and provisions made for loan loss.

Management: Management of the bank obviously influences the other parameters. Operating cost per unit of money lent and earnings per employee are parameters used.

Earnings: This can be measured through ratios like return on assets, return on equity and interest spread.

Liquidity: In order to meet obligations as they come, the bank needs an effective asset-liability management system that balances gaps in the maturity profile of assets and liabilities. However, if the bank provides too much liquidity, then it will suffer in terms of profitability. This can be measured by the Loans to Deposit ratio, separately for short term, medium term and long term.

Sensitivity to Market Risk: Longer the maturity of debt investments, more prone it is to valuation losses, if interest rates go up. More sensitive the portfolio is to market risk, the more risky the bank is.

Assets and Liabilities Management of Bank

Banks are always aiming at maximizing profitability at the same time trying to ensure sufficient liquidity to repose confidence in the minds of the depositors on their ability in servicing the deposits by making timely payment of interest/returning them on due dates and meeting all other liability commitments as agreed upon. To achieve these objectives, it is essential that banks have to monitor, maintain and manage their assets and liabilities portfolios in a systematic manner taking into account the various risks involved in these areas. This concept has gained importance in Indian conditions in the wake of the ongoing financial sector reforms, particularly reforms relating to interest rate deregulation. The technique

of managing both assets and liabilities together has come into being as a strategic response of banks to inflationary pressure, volatility in interest rates and severe recessionary trends which marked the global economy in the seventies and eighties.

Assets and Liabilities Management (ALM) is a dynamic process of planning, organizing, coordinating and controlling the assets and liabilities – their mixes, volumes, maturities, yields and costs in order to achieve a specified Net Interest Income (NII). The NII is the difference between interest income and interest expenses and the basic source of banks profitability. The easing of controls on interest rates has led to higher interest rate volatility in India. Hence, there is a need to measure and monitor the interest rate exposure of Indian banks. ALM is a system of matching cash inflows and outflows, and thus of liquidity management. The ALM system rests on three pillars, i.e.,

- a) ALM Information system (MIS)
- b) ALM organization (Structure and responsibilities)
- c) ALM Process (Risk parameters, identifying, measuring, managing risks and setting risk policies and tolerance levels).

Adopting an asset/liability management philosophy is an important first step in drafting ALM policy. The philosophy should set out the broad goals and objectives of the bank's asset/liability portfolio, as established by the board of directors, who represent the membership at large. The ALM philosophy should always address the following principles:

- The bank will manage its asset cash flows in relation to its liability cash flows in a manner that contributes adequately to earnings and limits the risk to the financial margin.
- Product terms, pricing and balance sheet mix must balance product demands with the need to protect the equity of the bank.
- Financial derivatives instruments must only be used to limit interest rate risk and must never be used for speculative or investment purposes.

Balance Sheet Risk

Balance sheet risk can be categorized into two major types of significant risks, which are liquidity risk and interest rate risk. Interest rate risk is the risk to earnings or capital arising from movement of interest rates. It arises from differences between the timing of rate changes and the timing of cash flows (re-pricing risk); from changing rate relationships among yield curves that affect bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-rate-related options embedded in bank products (option risk). The value of a bank's assets, liabilities, and interest-rate-related, off-balance-sheet contracts is affected by a change in rates because the present value of future cash flows, and in some cases the cash flows themselves, is changed. For measuring interest rate risk, banks use a variety of method such as gap analysis, the duration gap method, the basis point value (BPV) method, and simulation methods.

Matching Maturities

Policy should require that, as much as possible, liability maturities and cash flows correlate to asset maturities and cash flows. "Matching" refers to the process of structuring the balance sheet so that maturities of interest rate sensitive assets correspond closely to the maturities of interest rate sensitive liabilities. If the balance sheet is well-matched, a change in interest rates will have little or no impact on margin, because assets and liabilities re-price at the same time. The periodic measurement of interest rate risk exposure will quantify the extent of balance sheet mismatch. Balance sheet mismatches can be corrected through the use of traditional portfolio manipulation techniques. Alternatively, financial derivative instruments can be put into place to hedge against cash flow mismatches.

Conclusion

The commercial banks have emerged as one of the major financial intermediaries in the country to mobilize the community's financial savings. Sustained efforts have been made by commercial banks to induce people to keep a part of their savings as bank deposits. Deposits mobilized by the banks are utilized for:

- (i) Loans and advances,
- (ii) Investments in government and other approved securities in fulfillment of the liquidity stipulations,
- (iii) Investment in commercial papers, shares, debentures, etc. up to a stipulated ceiling. Reserve Bank of India has instructed the banks to adopt the realized system of accounting and not the accrued system. It means that when a loan is sanctioned, it has to be repaid in time along with interest. In case of failure, it becomes a non performing asset (NPA) and the bank will have to make provisions from out of its profit for such NPAs. Since the balance sheet is based on realized system, banks cannot resort to *window dressing of their balance sheet*. Thus, we find that the new format of balance sheet has changed the attitude of banks towards their asset portfolio.

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Lesson 1.5 - Cheques - Crossing, Endorsement, Developments in Collection and Payment

Learning Objectives

- To understand meaning, essential characteristics and types of negotiable instruments
- To understand the various types of crossing cheques
- To understand the various methods of endorsing cheques
- To understand the developments in collection and payment - Cheque Truncation System

Introduction

A negotiable instrument is used as a medium of payment in all business transactions. The Negotiable Instruments Act was enacted, in India, in 1881. Prior to its enactment, the provision of the English Negotiable Instrument Act were applicable in India, and the present Act is also based on the English Act with certain modifications. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934. Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorized by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to be payable on demand or after a certain time. Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are:

- a) A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.
- b) A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.

- c) But a cheque {though a bill of exchange} payable to bearer or demand can be drawn on a person's account with a banker.

Meaning of Negotiable Instruments

According to Section 13 (a) of the Act, "Negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or "bearer" appear on the instrument or not." In the words of Justice, Willis, "A negotiable instrument is one, the property in which is acquired by anyone who takes it bona fide and for value notwithstanding any defects of the title in the person from whom he took it". Thus, the term, negotiable instrument means a written document which creates a right in favour of some person and which is freely transferable. Although the Act mentions only these three instruments

(Such as a promissory note, a bill of exchange and cheque), it does not exclude the possibility of adding any other instrument which satisfies the following two conditions of negotiability:

- a) The instrument should be freely transferable (by delivery or by endorsement and delivery) by the custom of the trade; and
- b) The person who obtains it in good faith and for value should get it free from all defects, and be entitled to recover the money of the instrument in his own name.

As such, documents like share warrants payable to bearer, debentures payable to bearer and dividend warrants are negotiable instruments. But the money orders and postal orders, deposit receipts, share certificates, bill of lading, dock warrant, etc. are not negotiable instruments. Although they are transferable by delivery and endorsements, yet they are not able to give better title to the bona fide transferee for value than what the transferor has.

Features of a Negotiable Instrument

A negotiable instrument has the following characteristics:

- 1) **Property:** The possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument does not merely give possession of the instrument but right to property also. The property in a negotiable instrument can be transferred without any formality. In the case of bearer instrument, the property passes by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transfer of property.
2. **Title:** The transferee of a negotiable instrument is known as 'holder in due course'. A bona fide transferee for value is not affected by any defect of title on the part of the transferor or of any of the previous holders of the instrument.
3. **Rights:** The transferee of the negotiable instrument can sue in his own name, in case of dishonour. A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party who is liable to pay on that instrument.
4. **Presumptions:** Certain presumptions apply to all negotiable instruments e.g., a presumption that consideration has been paid under it. It is not necessary to write in a promissory note the words 'for value received' or similar expressions because the payment of consideration is presumed. The words are usually included to create additional evidence of consideration.
5. **Prompt payment:** A negotiable instrument enables the holder to expect prompt payment because a dishonour means the ruin of the credit of all persons who are parties to the instrument.

Presumptions as to Negotiable Instrument

Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes in regard to negotiable instruments. In other words, these presumptions need not be proved as they are presumed to exist in every negotiable instrument. Until the

contrary is proved the following presumptions shall be made in case of all negotiable instruments:

1. **Consideration:** It shall be presumed that every negotiable instrument was made drawn, accepted or endorsed for consideration. It is presumed that, consideration is present in every negotiable instrument until the contrary is presumed. The presumption of consideration, however may be rebutted by proof that the instrument had been obtained from, its lawful owner by means of fraud or undue influence.
2. **Date:** Where a negotiable instrument is dated, the presumption is that it has been made or drawn on such date, unless the contrary is proved.
3. **Time of acceptance:** Unless the contrary is proved, every accepted bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity. This presumption only applies when the acceptance is not dated; if the acceptance bears a date, it will prima facie be taken as evidence of the date on which it was made.
4. **Time of transfer:** Unless the contrary is proved it shall be presumed that every transfer of a negotiable instrument was made before its maturity.
5. **Order of endorsement:** Until the contrary is proved it shall be presumed that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.
6. **Stamp:** Unless the contrary is proved, it shall be presumed that a lost promissory note, bill of exchange or cheque was duly stamped.
7. **Holder in due course:** Until the contrary is proved, it shall be presumed that the holder of a negotiable instrument is the holder in due course. Every holder of a negotiable instrument is presumed to have paid consideration for it and to have taken it in good faith. But if the instrument was obtained from its lawful owner by means of an offence or fraud, the holder has to prove that he is a holder in due course.
8. **Proof of protest:** Section 119 lays down that in a suit upon an instrument which has been dishonoured, the court shall on proof

of the protest, presume the fact of dishonour, unless and until such fact is disproved.

Types of Negotiable Instrument

Section 13, of the 'Negotiable Instruments Act' states that a negotiable instrument is a promissory note, bill of exchange or a cheque payable either to order or to bearer.

Negotiable instruments recognized by statute are:

- a. Promissory notes
- b. Bills of exchange
- c. Cheques

Negotiable instruments recognized by usage or custom are Hundis, Bankers draft, Share warrants, Dividend warrants, Circular notes, Bearer debentures, Debentures of Bombay Port Trust, Railway receipts and Delivery orders.

This list of negotiable instrument is not a closed chapter. With the growth of commerce, new kinds of securities may claim recognition as negotiable instruments. Let us see the meaning of promissory note, bill of exchange, cheque and hundi.

- 1. Promissory notes:** Section 4 of the Act defines, "A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments." The essential elements of promissory notes include

- a) It must be in writing;
- b) It must contain an express promise or clear understanding to pay;
- c) Promise to pay must be unconditional;
- d) It should be signed by the maker;
- e) The maker must be certain;

- f) The payee must be certain;
- g) The promise should be to pay money and money only;
- h) The amount should be certain; and
- i) Other formalities regarding number, place, date, consideration etc. though usually found given in the promissory notes but are not essential in law.

2. Bill of exchange: Section 5 of the Act defines, “A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument”. A bill of exchange, therefore, is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. There are usually three parties to a bill of exchange drawer, acceptor or drawee and payee. Drawer himself may be the payee. For example: If A sells goods to B on credit basis for ₹ 1000 and draws a bill on B. If B accepts the bill, then it becomes the liability for B to pay the agreed sum within the stipulated time. The essential conditions of a bill of exchange include

- a) It must be in writing;
- b) It must be signed by the drawer;
- c) The drawer, drawee and payee must be certain;
- d) The sum payable must also be certain;
- e) It should be properly stamped;
- f) It must contain an express order to pay money and money alone;
- g) The order must be unconditional.

3. Cheques: Section 6 of the Act defines “A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand”. A cheque is bill of exchange with two more qualifications, namely, (i) it is always drawn on a specified banker, and (ii) it is always payable on demand. Consequently, all cheques are bill of exchange, but all bills are not cheque. A cheque must satisfy all the requirements of a bill of exchange; that is, it must be signed by the drawer, and must contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a certain person or to the bearer of the cheque. It does not require acceptance.

4. **Hundis:** A “Hundi” is a negotiable instrument written in an oriental language. The term hundi includes all indigenous negotiable instrument whether they be in the form of notes or bills. The word ‘hundi’ is said to be derived from the Sanskrit word ‘hundi’, which means “to collect”. They are quite popular among the Indian merchants from very old days. They are used to finance trade and commerce and served as easy and sound medium of currency and credit. Hundis are governed by the custom and usage of the locality in which they are intended to be used and not by the provision of the Negotiable Instruments Act. In case there is no customary rule known as to a certain point, the court may apply the provisions of the Negotiable Instruments Act. It is also open to the parties to expressly exclude the applicability of any custom relating to hundis by agreement.
5. **Bankers draft:** A draft payable by a bank in cash on presentation.
6. **Share warrant:** A certificate, usually issued along with a bond or preferred stock, entitling the holder to buy a specific amount of securities at a specific price, usually above the current market price at the time of issuance, for an extended period, anywhere from a few years to forever. In the case that the price of the security rises to above that of the warrant’s exercise price, then the investor can buy the security at the warrant’s exercise price and resell it for a profit. Otherwise, the warrant will simply expire or remain unused.
7. **Dividend warrant:** A cheque which makes payment of a dividend.
8. **Circular notes:** Similar instruments to “letters of credit.” They are drawn by resident bankers upon their foreign correspondents, in favor of persons traveling abroad. The correspondents must be satisfied of the identity of the applicant, before payment; and the requisite proof of such identity is usually furnished, upon the applicant’s producing a letter with his signature, by a comparison of the signatures.
9. **Bearer debentures:** Bearer debentures do not show the name of the owner on the debenture. The holders of the bearer debenture are entitled to receive interest payment on the due dates.

Cheque

According to Section 6 of the Negotiable Instruments Act, a cheque is defined (see the definition given in the last section). A cheque is a negotiable instrument which is supplied by a banker to the customer who opens a savings or current account in a bank.

Parties to a Cheque: The customer who draws the cheque on the bank is called capital drawer. The bank on whom the cheque is drawn is called the drawee. The person who receives payment on the cheque is called the payee. Thus, there are three parties to a cheque.

1. **Drawer.** He is the person who draws the cheque, i.e., the depositor of money in the bank.
2. **Drawee.** It is the drawer's banker on whom the cheque has been drawn.
3. **Payee.** He is the person who is entitled to receive the payment of the cheque.

A savings account holder may have an account with cheque or without cheque facility. But all the current account holders will be provided a cheque book. A cheque is a printed leaf supplied by the banker and it consists of a book of 10 or 20 printed leaves. In the modern days, in all the metropolitan cities the cheques supplied by the bank to the customer are called MICR Cheques i.e., Magnetic Ink Character Recognition.

This means that cheque contains a white patch at the bottom in which numbers are given in magnetic form which represents not only the number of the cheque but also the code number of branch and bank. To facilitate mechanical sorting the code line contains the following numbers:

- The first 6 numbers signify the cheque number.
- The second 3 numbers signify the city code.
- The third 3 numbers signify the bank code.
- The fourth 3 numbers signify the branch code of the bank.

Features of a Cheque

Following are the features of a cheque:

1. It is an instrument in writing.
2. A cheque is to be drawn only on the branch in which the customer is maintaining an account.
3. Before drawing a cheque, the customer must have sufficient funds in his account or else, the cheque will be dishonoured.
4. A cheque is an order by the customer on the bank and so the cheque must be very clear in the instructions given to the banker.
5. As the cheque is meant for payment of money, the amount mentioned in the cheque should be specific and it should be written both in words and figures. If there is any difference in the amount written in words and figures, the cheque will be dishonoured.
6. A cheque is payable to a specific person. This may be an individual or a firm or a body corporate that have an account in the bank. At the same time, to receive payment on cheque, an individual on whom the cheque is drawn need not have an account. But when the cheque is given to an individual is crossed, he must have an account in the bank or else he cannot receive payment.
7. A cheque is payable either to order or bearer. An order cheque is one which is payable only to a specific person or to whom so ever he orders. An order cheque is one which is drawn in the following manner:

Specimen of a Cheque

X Bank of India Chennai	
Pay to Y or Bearer Rupees S. B. A/c No.	<div style="border: 1px solid black; width: 60px; height: 40px; margin: 0 auto; display: flex; align-items: center; justify-content: center;"> ₹ </div>
"202460" 6000530 17: 10	

In the above cheque format the word *or bearer* will be struck in the case of an order cheque. For example, 'Pay to Y' or *bearer*, when the word *or bearer* is struck, it becomes an order cheque payable only to Y or whom so ever he orders. When Y wants to transfer, he will have to endorse the cheque by signing on the back side of the cheque and deliver it to the transferee. But when it is a bearer cheque, Y can simply hand over the cheque to any party to whom he wants to transfer. In the case of a bearer cheque, the word *or bearer* will not be cancelled.

Whether a cheque is a *bearer cheque* or *order cheque*, it depends on the intention of the drawer of a cheque. If it is a bearer cheque, it will remain a bearer cheque once for all. On the other hand, when a cheque is converted into order cheque by cancelling the order or bearer, the cheque will permanently remain as an *order cheque*. Here again once an order cheque will remain an order cheque forever.

8. *Signature* is an important aspect in a cheque. A cheque should be signed by the customer and the signature in the cheque should be as per the specimen signature given by the account holder at the time of opening the account. In case, a customer adopts a different style of signature, he must furnish to the bank, a set of fresh specimen signatures and cancel the old specimen signature.
9. *Date* appearing on the cheque is a date on which the cheque is said to have been issued. A banker will make payment on a cheque either on the date of the cheque or subsequently but not before the date. A post-dated cheque will never be honoured by the bank. Date also decides the valid period of the cheque, which is normally six months.
10. The number appearing on the cheque at the bottom represents the cheque number and code number of the bank. When the cheque is presented in the clearing house the computer decodes the cheque and by this the name of the bank, the branch and the cheque number with the amount is available which will be prepared in a statement, when banks take the cheque to the clearing house for realization.
11. Endorsements are done when an order cheque is transferred and the endorsements appearing on the cheque mention clearly the manner in which the cheque is transferred from one person to another.

According to Sections 118 and 119 of the Negotiable Instruments Act, endorsement should appear in the same sequence in which the cheque is transferred from one person to another. This enables the banker to find out as to who is liable in case of dishonour.

Crossing of a Cheque

Definition of Crossing

Section 123 to 131 (A) of the Negotiable Instruments Act deal about crossing of a cheque. There are two types of crossing. They are (1) General crossing and (2) Special crossing. Section 123 defines general crossing of cheque while Section 124 defines special crossing.

General Crossing: According to Section 123 “where a cheque bears across its face an addition of the words ‘And Company’ or any abbreviation thereof, between two parallel transverse lines, or two parallel transverse lines simply, either with or without the words “Not Negotiable” that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally”.

Special Crossing: According to Section 124 “where a cheque bears across in face an addition of the name of the banker, either with or without the words ‘Not Negotiable’, that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially and to be crossed to that banker”.

Introduction of Crossing

Crossing of cheques is introduced in the beginning of 20th century as banks in England were experiencing pilferage of cheques when they were being taken in coaches to the Central Bank for clearance. To prevent such pilferage, cheques were crossed after which the missing cheques could be easily traced as the crossed cheques could be encashed only through an account. Thus, the introduction of crossing had not only prevented stealing of cheques but had also enabled the bank to find out which account holder had received the cheque and received a payment.

Who can Cross a Cheque?

A cheque can be crossed by four persons:

1. *Drawer*: When a drawer issues a cheque to a party, he will cross the cheque either generally or specially.
2. *Holder*: When a cheque is given to the holder by the drawer without crossing, the holder can cross the cheque. But, if the cheque is already crossed and crossed generally, the holder can convert it into special crossing. But, a cheque crossed specially cannot be converted into general crossing.
3. *Holder in due course*: A holder in due course can also cross the cheque provided the cheque is not crossed or crossed generally. When a holder in due course receives an open cheque, he can cross the cheque generally, it can be converted into special crossing. But he cannot convert special crossing onto general crossing.
4. *Banker*: A banker can cross a cheque when he receives it for collection. A collecting banker normally accepts a crossed cheque on behalf of the customer for the purpose of collection. But when the collecting banker receives an open cheque without any crossing, the banker himself will cross the cheque before sending it for collection.

What Constitutes Crossing of a Cheque?

When a cheque is crossed across the face with two transverse parallel lines, it is said to be crossed. In between the two parallel lines, the cheque will contain words such as 'And Company' or an abbreviation as '& Co.', such cheque is said to be crossed generally.

When a cheque is crossed it implies two things:

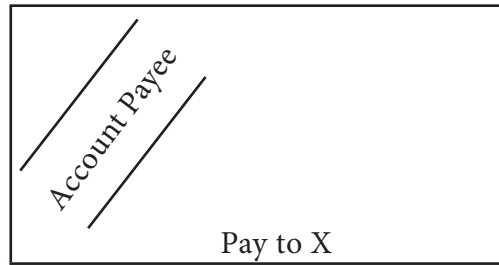
- (1) Payment will not be made across the counter by a bank when a crossed cheque is presented.
- (2) The crossed cheque will have to be presented in an account through a pay-in-slip.

If a banker makes the payment of a crossed cheque across the counter, it is a gross violation of payment in due course. When a cheque goes to an account, it will be credited and the amount can be withdrawn only by a separate cheque. In General crossing, the cheque will bear across the two parallel transverse lines, 2 types of words. These are:

- (1) Not Negotiable
- (2) Account Payee.

(1) **Not Negotiable crossing:** When a cheque bears across its face two transverse parallel lines with the words *not negotiable*, it is a clear indication to the banker that the bank has to be very careful while making the payment on the cheque. Not negotiable takes away the character of negotiability on a cheque. It means that if there is any defect in the cheque, it will affect the transferee, even if the transferee is a holder in due course. Thus, not negotiable crossing is a forewarning given to all the transferees of the cheque that they should be careful while receiving the cheque even if they happened to be a holder in due course. In real life we come across 'Not Negotiable' crossing when companies are sending dividend warrants to their shareholders. When lakhs of shareholders are receiving cheques, it can be altered, or the payees' names can be changed without the knowledge of the bank. If a banker, overlooking this alteration, credits the account of the customer, it is the bank that will be liable and not the drawer company. Hence, a 'Not Negotiable' crossing gives caution to the banker and the bank has to take utmost precaution while making payment on the cheque containing *not negotiable* crossing. Otherwise, the banker will be held liable for negligence. A bank cannot claim protection even as a holder in due course.

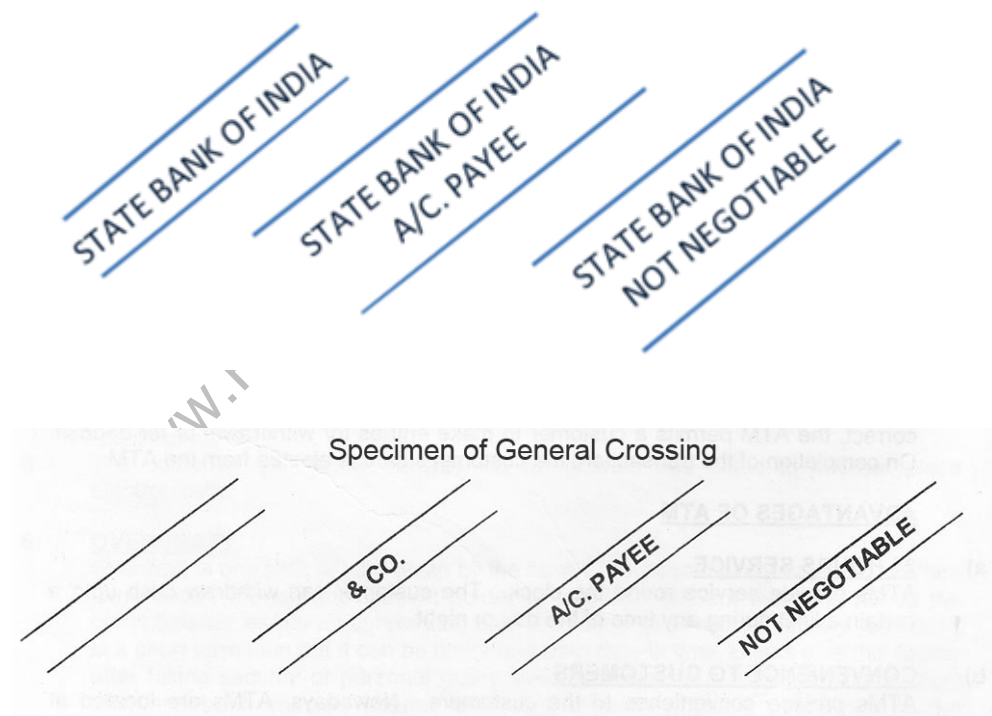
(2) **Account Payee crossing:** Though *Not Negotiable* crossing is mentioned nowhere in the Section 130 of the Negotiable Instruments Act, *account payee* crossing is mentioned. This means that account payee crossing is not legally permitted under the Negotiable Instruments Act. The reason is that when a cheque is crossed *account payee only*, payment should be credited by the bank only to the account of the payee. An example is given below:



This means that the bank has to credit the account of X only and the cheque is not transferable to any other person. This goes against the principle of negotiability and transferability. Hence, the Negotiable Instruments Act has not recognized the account payee crossing but by custom a banker allows the *account payee* crossing and so the courts have agreed such crossing by *custom* and not by *statute*.

The following diagrams show general crossing and special crossing

Specimen Of Special Crossing



Special Crossing: Section 124 defines special crossing wherein the cheque will contain the name of another bank in the crossing. Special crossing does not require two parallel transverse lines. It may or may not exist.

<div style="border: 1px solid black; padding: 5px; transform: rotate(-45deg); display: inline-block;"> Account Payee </div>	State Bank of India Chennai
Pay to Y or Bearer Rupees S. B. A/c No.	<div style="border: 1px solid black; width: 60px; height: 30px; display: flex; align-items: center; justify-content: center; margin: 0 auto;"> ₹ </div>
“202460” 6000530 17: 10	

This cheque is said to be crossed specially. In this cheque, State Bank of India is the paying banker and Indian Bank is the collecting banker. When the cheque is presented in the clearing house, State Bank of India should pay on this cheque only to Indian Bank which presents it. If any other bank presents this cheque, State Bank of India should not pay. Thus, a clear instruction is given by the drawer of the cheque or any other holder that payment should be made through Indian Bank.

The above cheque can also be drawn with the name of Indian Bank appearing along with words *Account Payee* only. In such a case, State Bank of India will pay to the Indian Bank which will be crediting account of the payee in whose name the cheque is drawn. The cheque is not transferable to any other person. Similarly, along with the Indian Bank name in the special crossing, there may be words such as ‘*not negotiable*’. This again is an indication that the paying banker State Bank of India should be careful so also the collecting banker, Indian Bank. It should take more precautions while crediting the account of the customer. Unless the customer presenting the cheque is a genuine person, the cheque with the words not negotiable cannot be credited.

Double Special Crossing or Double Crossing: Normally in a special crossing, the paying banker will pay only to that bank whose name is appearing in that crossing. But sometimes, the bank whose name is appearing in the crossing may not find a branch in the place where the payee is to present the cheque. For example, a cheque belonging to Indian Bank with a crossing of Bank of Tamil Nadu is sent to a person in Punjab. Since, the Bank of Tamil Nadu does not have a branch in Punjab, Indian Bank at Punjab will find it difficult to pay on the cheque. Hence, Bank of Tamil Nadu will appoint Punjab National Bank as its agent for collection. Now the crossing will appear as below:

Bank of Tamil Nadu

to

Punjab National Bank
as agent for collection

If in this crossing, the word as agent for collection is not there, Indian Bank which is a paying banker will refuse to pay on the cheque according to Section 127 of the Negotiable Instruments Act. Thus, a paying banker will have to be careful and the collecting banker also must write the words as *agent for collection*, failing which he cannot receive payment of the cheque.

Liability of a Paying Banker on a Crossed Cheque

A paying banker has to be careful while making payment on a crossed cheque. Especially, when the crossing contains certain special instructions such as *account payee* or *not negotiable*. Under Section 126 of the Negotiable Instruments Act, the paying banker has to pay only to that banker whose name is appearing in the crossing of the cheque. Otherwise, the paying banker will be liable. According to Section 124, the paying banker has to strictly observe the crossing on the cheque as per the instructions given in the crossing. A paying banker is liable to two parties when he fails to observe the crossing.

- (1) **Liable to true owner:** When a cheque is drawn in the name of X and crossed *account payee only*, it is the duty of the paying banker to pay or credit the account of X failing which the owner of the cheque can sue the paying banker. The paying banker should also be careful when the cheque contains crossing as *not negotiable*. If due care is not taken, the paying banker commits the mistake of negligence. Now the paying banker will be liable to the true owner not only for the amount of the cheque but also for any damages for refusal to pay.
- (2) **To the Drawer:** The paying banker is liable to the drawer for not complying with instruction as given in the cheque. It is not only making payment to an account but payment as per the instructions in the crossing is also a must. So, when there is a violation and when the paying banker has not observed the instruction given in the

crossing, the drawer will make the paying banker liable and can also claim damages. The paying banker also loses statutory protection.

Lifting of crossing or Opening of Crossing: A cheque containing a crossing is called a *crossed cheque*. But when the crossing in the cheque is cancelled by the drawer by himself with his full signature at the place of cancellation in the cheque, then the cheque becomes an open cheque, in which case, the banker can make payment across the counter. Other than drawer, no other person is authorized to lift the crossing.

Obliterating of crossing: When the crossing in the cheque is erased deliberately by persons other than the drawer to defraud the drawer or the drawee, and the banker without looking at such erasing of crossing makes payments on the cheque, the banker is set to have committed the mistake of violating Section 10 *i.e.*, payment in due course. The paying banker can claim protection in the case of obliterating of crossing provided he has made payment but strictly adhering to payment in due course. In other words, the banker could not find out the obliterating of crossing even after a careful scrutiny of the cheque.

Endorsement of Cheque

Transfer of negotiable instruments: Negotiable instruments are those which can be transferred from one person to another either by mere delivery, if it is a bearer instrument or by endorsement and delivery if it is an order instrument. By such a transfer, the transferee becomes the owner of the instrument according to Section 14 of the negotiable instrument act. In the normal day to day life, we normally do not come across endorsement, as most of us have only savings account.

Endorsement is applicable only to an order instrument and is accepted only in current account. In savings account, only cheques drawn in the name of the account holder are accepted and no third party cheques will be accepted by the bank. Whereas in the current account, third party cheques are accepted and an order cheque drawn in the name of a third party can be deposited when the third party endorses the cheque in favor of the account holder and delivers the same.

An order cheque is written by cancelling the words “or bearer” in the cheque by the drawer at the time of issuing it. If a cheque is drawn in the name of Mr. X, and as an order cheque, Mr. X will have to endorse if he wants to transfer it to Y. This means X will have to sign on the reverse side of the cheque and handover the same to Y. This is called *blank endorsement*. Mr. X can also write on the reverse side as ‘Pay to Y’ and sign. This is *full endorsement*. Mr. X, who endorses the cheque, is called the *endorser* and Mr. Y to whom the cheque is endorsed is the *endorsee*. Thus, there are two parties to an endorsement – endorser and endorsee. Endorser is the one who transfers. Endorsee is the transferee.

Thus, an endorsement is a process by which an order instrument is transferred. An endorsement is said to be complete only when the instrument is delivered by the endorser to the endorsee. The transfer may be physical or constructive. When an endorser after endorsing the negotiable instrument, hands over to the endorsee, it is called *physical transfer*. If the endorser after endorsing the instrument, informs the endorsee either by phone or through any person and asks the endorsee to collect the instrument it is called *constructive delivery*.

Endorsement is defined under Section 15 of the Negotiable Instrument Act as “When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called the endorser”.

Legal Effects of the Transfer by Endorsement

- (a) Transfer of ownership:** When a negotiable instrument is endorsed and delivered, the endorsee not only becomes absolute owner but also has the right to further transfer the instrument by endorsement. Even if the legal relationship existing prior to endorsement gets terminated, it will not affect the transfer of ownership under endorsement. If the relationship between a principal and agent gets terminated after the principal endorsing the instrument to the agent, the effects of endorsement remain, by the agent becoming the owner of the instrument. The termination of legal relationship

will not affect the transfer and so the drawee of the instrument is liable to the agent and cannot escape the liability. If the principal dies, the agent will have the right on the instrument and the agent can further endorse the instrument or encash the instrument by presenting it on the due date with the drawee.

- (b) Presumption under Section 118:** The order or sequence in which the instrument is transferred, in the same order, the endorsement should appear on the reverse side of the instrument. Thus, when the instrument is dishonoured by the drawee it is easy for the endorsee to know his previous endorser and can fix the liability. Section 118 presumes that the instrument is transferred in the same order in which the endorsement is appearing on the instrument.
- (c) Joint endorsement:** When an instrument is held jointly, all the joint owners have to endorse the instrument. Similarly, when an instrument is endorsed in favour of more than one person, all the endorsees will sign when they further endorse the instrument.
- (d) Endorsement for full amount:** When an instrument is endorsed in favour of an endorsee, the entire amount in the instrument is transferred in the favour of the endorsee. Part endorsement in favour of different parties is not allowed. The legal effect of endorsement completely transfers the ownership in favour of endorsee and not partly in favour of endorsee.
- (e) Endorsement within stipulate time:** The endorsement of a negotiable instrument must be done and received by the endorsee within the time limit or maturity of the instrument. A cheque must be endorsed and delivered within six months from the date of the cheque or else the endorsement will become ineffective.
- (f) Endorsement to be followed by delivery:** An endorsement is said to be complete only when it is followed by delivery. The endorser after the endorsement may physically deliver the instrument to the endorsee or he may inform the endorsee to collect the instrument endorsed in his favour, which is constructive delivery. If an endorser after the endorsement and before delivery dies, the endorsement is not complete and the endorsee cannot claim the ownership. Even the legal heirs of the deceased cannot deliver in favour of the endorsee.

Rules Pertaining to Endorsement

(1) Allonge: When an instrument is endorsed, if there is no more space for further endorsement, a paper will be attached with the instrument for further endorsement. This paper is called *allonge*. When an allonge is attached, the last endorsement appearing on the instrument will once again appear as the first endorsement in the allonge. This procedure is adopted for avoiding any mix up of allonges with various other instruments.

(2) Signature: An endorsement is complete only when it is endorsed by the owner of the instrument or any of his authorized agents, who is allowed to endorse on his behalf. If there are more than one person owning, all of them have to endorse and only then the endorsement is said to be complete.

(3) Correct initial and Name: The endorser should sign the instrument in the same spelling and initial and then give the correct name and initial. For example, if a cheque is endorsed for Ramoo and then given below his correct spelling as Ramu. The same applies to wrong initial also.

(4) Endorsement by

(a) Married Woman: When a cheque is drawn in favour of Mrs. Kannan. Now when M^{rs}. Kannan endorses, she will have to sign as Lata Kannan and the endorsement will appear as

Sindhu Ramesh
(Wife of Mr. Ramesh)

That is, the christened name will appear first followed by her husband's name.

In the case of unmarried woman, if a cheque is drawn in favour of Miss. Raman, she will endorse in her christened name followed by her father's name.

Gayathri Sarvesh
(daughter of Mr. Sarvesh)

- (b) **Illiterate person:** When a cheque is drawn in favour of illiterate person, and when he wants to endorse, his thumb impression will have to be affixed and it should be followed by the signature and address of the witness.
- (c) **Partnership firm:** When a partnership firm is endorsing a cheque, it should be signed by the partner who is authorized by the firm to endorse.

M/s. Hanshika Sarvesh & Sons

Sadhanaa

Partner

- (d) **Company:** When a company is endorsing a cheque, it should be done by persons who are authorized to do so as per the resolutions of the board of directors of the company. The endorsements will appear as

For HANSHIKA COMPANY LIMITED

SARVESH

(Director)

- (e) **Institution:** In the case of institution, the endorsement will appear as

For AKSHAJ TECHNOLOGICAL RESEARCH INSTITUTE

RISHIK

(Chairman)

- (f) **Liquidator:** When a company is in the process of winding up, a liquidator will be appointed and he alone has the power to endorse the cheques belonging to the company. The endorsement will appear as

For JAIPUR COMPANY LIMITED in liquidation

KARUN

(Liquidator)

- (g) **Executor or Administrator:** An executor is one who is appointed by a will and on the death of the person who has written the will, the executor has to implement the will. For this purpose the executor will have to probate the will through

the court. After this, any cheque belonging to the deceased will be endorsed as

ANBU

(Executor of Late Ranganathan)

Administrator is one who is appointed by the court in the absence of executor and he will endorse as

DAMAL SINGH

(Administrator of Late Sitalakshmi)

(h) Trustee: When a cheque is endorsed by a trustee, he will sign as

HIMESH

(Trustee of Krishna Temple)

(i) Power of Attorney: This is like an agent and when the power of attorney endorses a cheque drawn in the name of his principal, he will endorse as

For (or on behalf of or perpro) Prabhakar

Mukesh

(Power of Attorney)

(5) Prefix and Suffix: A cheque may be drawn with a prefix Mr. or Mrs. And may also have suffix with qualifications. *Example:* Pay to Mr. Raja, M.Com., B.Ed., Mr is a prefix and M.Com., B.Ed. is suffix and when endorsement is made by Raja, only his name alone should be there without any prefix and suffix.

(6) Defence personnel: When cheques are drawn in the name of persons working in army, navy or air force, the cheque will be drawn along with their rank. *Example:* Pay to Major Vijay. Now this cheque will be endorsed by Major Vijay as

Vijay

Maj.

Kinds of Endorsements

- (1) **Blank endorsement:** When an endorsement is made on the reverse side of the instrument with a mere signature of the endorser without any name or any other remark, it is called *blank endorsement*.
- (2) **Full endorsement:** When the endorser writes the name of the endorsee on the reverse side of the instrument such as: Pay to Raju or order *(Sd) Krish. Here, the endorser is Krish and the endorsee is Raju. Thus, the full endorsement is complete in all respects.
- (3) **Conditional Endorsement:** Where an endorsement is made with a specific condition to be fulfilled by the endorsee for acquiring the ownership right on the instrument, it is conditional endorsement. Example: Pay to Raju on delivery of bill of lading. (Sd) Krish. Raju will be given instrument or the amount on the instrument only when he delivers bill of lading.
- (4) **Restrictive endorsement:** Here, the endorser takes away the right of the endorsee for further endorsement of the instrument. Example: Pay to Raju only. (Sd) Krishnan. Now this type of endorsement restricts further transfer of the instrument. This takes away the fundamental character of negotiable instrument, which is one of transferability.
- (5) **Sans-recourse endorsement:** When the endorser informs the endorsee that in case of the dishonour of the instrument, the endorsee cannot make the endorser liable, the endorsee can only catch hold of any other party on the instrument but not the endorser. Example: Pay to Raju Sans-recourse. (Sd) Krishnan. Here, in case of dishonour of the instrument, Krish cannot be held liable as he has endorsed the instrument Sans-recourse is stop taking action.
- (6) **Sans-frais endorsement:** When the endorser informs the endorsee that any expenses incurred in receiving payment on the instrument should not be debited to the account of the endorser.
- (7) **Facultative endorsement:** When the endorser excuses the endorsee from performing any duty in the case of dishonour. *Example:* Pay to Raju. Notice of dishonour waived. (Sd) Krishnan. From this endorsement, the endorser does not escape his liability in case of dishonour of the instrument.

Developments in Collection and Payment of Cheques - Cheque Truncation System (CTS)

Cheque Truncation

Truncation is the process of stopping the flow of the physical cheque issued by a drawer to the drawee branch. The physical instrument will be truncated at some point en-route to the drawee branch and an electronic image of the cheque would be sent to the drawee branch along with the relevant information like the MICR fields, date of presentation, presenting banks etc. Thus, with the implementation of cheque truncation, the need to move the physical instruments across branches would not be required, except in exceptional circumstances. This would effectively reduce the time required for payment of cheques, the associated cost of transit and delay in processing, etc., thus speeding up the process of collection or realization of the cheques.

Need for Cheque Truncation in India

Cheque Truncation speeds up collection of cheques and therefore enhances customer service, reduces the scope for clearing related frauds, minimizes cost of collection of cheques, reduces reconciliation problems, eliminates logistics problems etc. With the other major product offering in the form of RTGS, the Reserve Bank created the capability to enable inter-bank payments online real time and facilitate corporate customer payments. The other product, National Electronic Funds Transfer, is an electronic credit transfer system.

However, to wish away cheques is simply not possible and that is the reason why the Bank decided to focus on improving the efficiency of the Cheque Clearing Cycle. Cheque Truncation is the alternative. Moreover contrary to perceptions, Cheque Truncation is a more secure system than the current exchange of physical documents in which the cheque moves from one point to another, thus, not only creating delays but inconvenience to the customer in case the instrument is lost in transit or manipulated during the clearing cycle. In addition to operational efficiency, Cheque Truncation has several benefits to the banks and customers which includes introduction of new products, re-engineering the total receipts and payments mechanism of the customers, human resource rationalization,

cost effectiveness, etc. Cheque Truncation, thus, is an important efficiency enhancement initiative in the Payments Systems area, undertaken by RBI.

Uniqueness of the Cheque to be Imparted to the Image

The images captured at the presenting bank level would be transmitted to the Clearing House and then to the drawee branches with digital signatures of the presenting bank. Thus, each image would carry the digital signature, apart from the physical endorsement of the presenting bank, in a prescribed manner. In order to ensure only images of requisite quality reach the drawee branches, there will be a quality check process at the level of the Capture Systems and the Clearing House Interface. This would ensure only images of requisite quality secured with the digital signatures of the presenting banks reach the drawee branches. In addition, drawers could consider using holograms, barcoding or such other features, which would add to the uniqueness of the images.

Implementation of Cheque Truncation Method Proposed by RBI

Reserve Bank of India (RBI) is proposing to implement the project on a PILOT basis in the National Capital Region (NCR), New Delhi. Based on the experienced gathered, it would consider extending the coverage to other centres. In the process of implementation, banks have been given the freedom to decide the point of truncation. RBI would be installing an interface with its system (Clearing House Interface - CHI) at the service branches of banks, who are members of New-Delhi Bankers Clearing House. Banks have to decide the point of truncation and have to ensure that the images are digitally signed after their capture. It would flow thereafter to the interface (CHI) provided by RBI, from where the images would flow to the clearing House with the digital signatures of the banks. These digitally signed images would reach the service branches of the drawee branches clearing house interface. The service branches have to ensure that these images are moved across their branches to ensure their processing.

Support from RBI to Facilitate Cheque Truncation

RBI's services include system development and installation at the clearing house, interfaces at the bank's end, network, handholding, awareness propagation and training.

Entire Process Flow Envisaged in the CTS

The CTS project envisages a safe, secured, faster and effective system for clearing of the cheques. In the CTS, the presenting bank will capture the data & images of the cheques using their Capture System which is internal to them. They have to meet the specifications and standards prescribed for data and images. To ensure security, safety and non-repudiation the PKI (Public Key Infrastructure) is being implemented across the system. The banks will send the captured images and data to the central clearing house for onward transmission to the payee/drawee banks. For that purpose RBI will be providing the banks software called the Clearing House Interface (CHI) that will enable them to connect and transmit data in a secure way and with non-repudiation to the Clearing House (CH). The Clearing House will process the data and arrive at the settlement figure for the banks and send the required data to payee/drawee banks for processing at their end. The drawee/payee banks will use the same CHI mentioned earlier for receiving the data and images from the Clearing House. It will be the responsibility of the drawee bank Capture System to process the inward data and images and generate the return file for unpaid instruments.

Participants in the Cheque Truncation System

The criteria for banks participating in the Cheque truncation system are:

- (a) Membership of the clearing house in the NCR.
- (b) Membership of the Indian Financial Network (INFINET)

Participation by Non-INFINET Member Banks

In respect of banks who are not members of the INFINET, the following alternatives are available.

- (a) They may become the sub-members of the direct members
- (b) Such banks may use the infrastructure of the other banks having INFINET membership without being the INFINET members themselves and their clearing settlement can be done either directly or through the member through whom they are participating.

Infrastructure Requirements for Banks

The infrastructure required for CTS from bank's end are connectivity from the bank gateway to the clearing house, hardware and software for the CTS applications. RBI shall be providing member banks with the CHI and the banks have to procure other hardware and system software for the CHI and the application software for their capture systems on their own. The hardware requirement is based on the volume of the cheques processed by the banks. Based on the volume the CHI is categorized into four types and the hardware requirement is different for each category. The band width requirement for each bank is calculated based a number of factors like the peak inward and outward volume of the bank, average size of an image, efficiency factor of the network etc. In addition to that, future requirement have been taken into consideration for calculating the band with requirement.

Image Specifications in the CTS

Imaging of cheques can be based on various technology options. The cheque images can be black and white, Grey Scale or coloured. Black and White images do not reveal all the subtle features that are there in the cheques. Coloured Images increase storage and network bandwidth requirements. So it was decided that the electronic images of truncated cheques will be in gray scale technology. There will be three images of the cheques i.e. front grey, front black & white and back black & white which will be made available to member banks.

Ensuring Quality of the Images

As the payments will be made on the basis of the images, it is essential to ensure the quality of the images. For that purpose the solution proposes Image Quality Audit (IQA) at different level. RBI will be specifying the image standards to the member banks. The presenting bank is required to perform the quality audit during the capture itself. Further quality audit will be done at the gateway before onward transmission to clearing house. Further, the drawee bank can ask for the physical instrument if it is not satisfied that the image quality is not good enough for payment processing.

Security of Image and Data Transmitted Over the Network

The security, integrity, non-repudiation and authenticity of the data and image transmitted from the paying bank to payee bank will be ensured using the Public Key Infrastructure (PKI). The CTS is compliant to the requirement of the IT Act, 2000. It has been made mandatory for the presenting bank to sign the image & data from the point of origin itself. The image and data are secured using the PKI throughout the entire cycle covering capture system, the presenting bank, the clearing house and the drawee bank. The PKI standards used are in accordance with the appropriate Indian acts and practices of IDRBT which is the certifying authority for banks & financial institutions in India.

Type of Cheques that can be Presented in the CTS

All the local cheques can be presented in the CTS. Banks may also present cheques on banks situated outside the NCR, but such banks have branches in the NCR region. The CTS also supports the intercity clearing and specialized clearing like high value clearing etc.

Precautions Required to be Taken by the Bank Customers to Avoid Frauds

Bank customers should use image friendly cheques. They should preferably use dark coloured ink while drawing the instruments. Care should be exercised in the use of rubber stamp, so that it would not interfere with the material portions of the cheque. The date of the cheque, payees name, amount and signature are the basic features which are essential in a cheque. The use of rubber stamps, etc, should not overshadow the clear appearance of these basic features in image. In order to ensure that all essential elements of a cheque are captured in an image during the scanning process, bank customers have to exercise appropriate care in this regard.

Change in the Process for the Customers

There will be no change in the clearing process. Customers would continue to use cheques as at present, except in the use of image friendly coloured ink for making the instruments. Of course, such of those

customers, who used to receive the paid instruments, like Government Departments, would only receive cheque images instead of the physical instruments. This will also facilitate in better processing at their end, as they will be able to access online images in addition to the data.

As the images are going to be moved across, the time taken for the receipt of paid instruments at their end could be reduced so that better and timely control could be exercised over payments. This will also give an early opportunity to the drawers or issuers of cheques to detect frauds or alterations in their cheques. It is also possible for cheque issuers to consider newer techniques such as embedded verifiable features such as bar-codes or logos or watermarks, encrypted codes, holograms, etc., which would facilitate early interception of altered/forged instruments.

Benefit of Cheque Truncation to Customers of Banks

Before we answer this question, we have to understand the present system of cheque clearance. The cheques presented by customers, today, are sent to the clearing house at the drawee centres by the beneficiaries' bank. The cheques at the bigger cities, in view of the large volume of paper instruments, are subjected encoding and then to mechanical sorting and thereafter reach the drawee branches.

As per the existing banking practice, these instruments received at the counters of the drawee branches are paid or returned by them. The returned instruments are passed on to the presenting customers through the process of a return clearing. Only after the return clearing process gets over, banks release the credit to the customers. The beneficiaries' account gets credited on the same day on which the drawees' account gets debited; however, the beneficiary is permitted to use the proceeds only after the return clearing process. With the introduction of the imaging and truncation, the physical movement of instruments would be stopped and the electronic movement of images of cheques would speed up the process of settlements and ultimately alter the clearing cycles. The clearing cycle could be shortened and it would be possible for customers to realize the proceeds of cheques early. Thus, cheque truncation would reduce effectively the time of float, i.e. time from the point of issue of cheque to the point of time the actual debit takes place. In case such clearing is introduced across the cities, it would ensure the realization of inter-city

instruments faster thus ensuring early availability of funds to beneficiaries. Thus the benefits could be summarized as:

- a) Faster clearing cycle;
- b) Better reconciliation/verification process
- c) Better Customer Service and Enhanced Customer Window
- d) T+0 for Local Clearing and T + 1 for inter-city clearing.
- e) Elimination of Float and Incentive to shift to Credit Push payments.
- f) The jurisdiction of Clearing House can be extended to the entire country.
- h) No Geographical Dependence
- g) Operational Efficiency will benefit the bottom lines of banks and Local Clearing activity is a high cost no revenue activity.
- h) Minimizes Transaction Costs.
- i) Reduces operational risk by securing the transmission route.

What is an Image Replacement Document (IRD)?

Under CTS, after the capture of the image, the physical cheque would be warehoused with the presenting bank. In case the beneficiary or any other connected persons require the instrument, the payee bank could issue a copy of the image, under its authentication, which is called Image Replacement document. It is a legally recognized replacement of the original cheque for re-presentment. The provisions of Negotiable Instruments Act [Section 81(3) of the NI Act as amended] also permit the usage of such IRD. The physical instruments are required to be stored for a statutory period. It would be obligatory for presenting bank to warehouse the physical instruments for that statutory period. In case a customer desires to get a paper instrument back, the instrument can be sourced from the presenting bank through the drawee bank.

Conclusion

Cheque is a negotiable instrument used as a medium of payment in all business transactions. There is lot of developments that took place in the banking services due to the advances in telecommunication and information technology. Cheque truncation service is one such example.

Self Assessment Questions

1. Define Bank. What are the characteristic features of bank?
2. Trace the history of modern banking in India.
3. Explain the functions of commercial banks.
4. Enumerate the agency and utility functions performed by commercial banks in India.
5. What are the primary functions of commercial banks?
6. What factors affected the Indian banking system?
7. Classify the banks on various bases.
8. Explain the various types of banks based on ownership.
9. Explain the various types of banks based on organizational structure.
10. Explain the various types of banks based on the function
11. Explain the structure of Indian banking system.
12. Discuss the evolution of SBI and its associates.
13. Explain the objectives of nationalization of banks.
14. Elucidate the role of public sector banks in economic development.
15. What are scheduled banks and non-scheduled banks?
16. Classify the scheduled banks?
17. Classify the role of private sector banks in India.
18. Explain the role of regional rural banks in India.
19. Explain the role of cooperative banks in India.
20. Explain the role of foreign banks in India.
21. Define Banker and Customer.
22. Explain the various types of relationship between banker and customer.
23. Discuss the duties of banker vis-à-vis customer.
24. Discuss the rights of banker vis-à-vis customer.
25. What is right of lien? How does banker use this right?
26. Explain the liabilities of banker.
27. What are the principles of KYC norms? How are cash transactions monitored under KYC?
28. What is nomination facility? Who can avail the same?

29. Can bank deposits be insured? Explain.
30. What are the circumstances under which the banker-customer relationship terminates?
31. Describe the various types of Deposits accounts.
32. Discuss the strategies adopted by banks for deposit mobilization.
33. Explain the common guidelines for opening and operating deposit account.
34. Explain the deposit related services provided by banks to the customers.
35. Describe the deposit services offered by banks to NRIs.
36. What is deposit insurance? Substantiate the role of DICGC.
37. What are principles of good lending?
38. Explain the role of CPC in framing loan policy.
39. Describe the various types of loans and advances.
40. Explain the items in the Balance Sheet and Profit and Loss Account of a Bank.
41. Describe CAMELS Framework for evaluating banks.
42. What is Asset Liability Management? How does it work?
43. Define negotiable instruments. Explain the features of NI?
44. What are the types of negotiable instruments?
45. Define Cheque. Explain its features.
46. Define crossing of cheque. Explain the various types of crossing of cheque.
47. Define endorsement of cheque. Explain the various types of endorsement of cheque.
48. What are the legal effects of transfer by endorsement?
49. Explain the rules pertaining to endorsement of cheque.
50. What is Cheque Truncation System? What are its features?
51. Explain the advantages of CTS.
52. Substantiate the need for CTS in India.

CASE STUDY

Customer Relationship Management (CRM) in Banking: A Case Study of ICICI Bank

ICICI Bank has to manage more than 13 million customers. The bank has over 550 branches, a network of 2025 ATMs, multiple call centres, Internet banking and mobile banking. Its customers often use multiple channels, and they are increasingly turning to electronic banking options. ICICI Bank has distinguished itself from other banks through its relationship with customers. The Teradata solution focuses on a Customer Relationship Management (CRM) platform. The Benefits of CRM include Customers' usage pattern, new product development, and Central data management.

Some Noteworthy CRM Initiatives of ICICI Bank include:

Mobile ATMs: These ATMs are kept in vans and parked at locations that have a high traffic of bank customers such as the commercial areas in a city or upmarket residential areas. ICICI Bank now provides standard ATM facilities through ATM vans.

Bulk Deposits: The ICICI Bank's Bulk Deposit ATMs enable customers to deposit large amounts at one time. The Bulk Deposit ATM is available in Mumbai's Vashi sector branch office of ICICI. ICICI Bank issues a special card called the 'Deposit Only Card' to facilitate this service.

ATMs for the visually challenged: ICICI Bank has launched ATMs with special voice-guided systems, which guide a visually challenged person to access ATMs without any help. The jack on the terminal enables headphones to be connected to it and voice commands enable the customer to transact business.

Other Services through ATMs: These include: Prepaid mobile recharge, Making donations for Tirupati Tirumala Devasthanams, Nathdwara temple and Shri Mata Vaishnodevi shrine, Mutual fund transactions, and Bill payments.

Mobile phone as a Virtual Wallet: The mobile phone has been transformed into a virtual wallet – a new innovation in mobile commerce. On September 19, 2005, Airtel, ICICI Bank and VISA announced the launch of mChq – a revolutionary new service – which is a credit card using the mobile phone. This is the first mobile-to-mobile payment option which enables Airtel customers and ICICI Bank Visa cardholders to pay for their purchases with their Airtel Mobile phones. The service has eliminated the need for carrying physical cash for making a purchase and also the problems associated with the point of sale (POS) terminal since the mobile phone services as a secure POS and a payment mechanism.

Social Events: ICICI Bank organized the largest domestic invitational amateur golf event for HN1 (high-net-worth individuals) customers. This nation-wide golf tournament had over one lakh high-net-worth clients of ICICI Bank's private banking division participating in the event.

Mobile Banking Benefits: Mobile banking enables the customer to avail of many facilities by just sending an SMS. These facilities, which are currently offered free of cost, are : Locating ATM, Locating branch, Locating drop box, Alert facilities like salary credit, account debit/credit, cheque bounce, etc., and Queries on banking, cards and demat account.

Questions

1. Explain the initiatives take by ICICI Bank to promote Customer Relationship Management (CRM).
2. Discuss the benefits of the initiatives taken by ICICI Bank to promote Customer Relationship Management (CRM).

UNIT - II

Have you seen information released by Reserve Bank of India in the financial dailies? Reserve Bank of India is our central bank and it is responsible for framing monetary policy and regulating the financial system of our country. In this unit, let us understand the evolution of central bank in India, its organization, management, autonomy & functions, methods of credit controls used by RBI, objectives of monetary policy, Indian money and capital market and banking legislations in India.

Unit Structure

Lesson 2.1 - Central Banking System – Evolution, Organization, Management, Structure & Functions

Lesson 2.2 - Objectives of Monetary Policy, Methods of Credit Control and Autonomy of Central Banks

Lesson 2.3 - Indian Money Market, Capital Market and Banking Legislations

Lesson 2.1 - Central Banking System – Evolution, Organization, Management, Structure & Functions

Learning Objectives

- To trace the evolution of central banking system
- To understand the nature, organization and management of central bank in India
- To understand the functions of RBI.

Evolution of Central Banking System

Global Evolution of Central Banking

Evolution of central banking is essentially a twentieth century phenomenon as there were only about a dozen central banks in the world at the turn of the twentieth century. In contrast, at present there are nearly 160 central banks. This is not surprising since the need for central banks obviously emerged, as banking became more complex, while becoming an increasingly important part of the economy over time. Many problems experienced by banks and their depositors inevitably led to cries for their regulation. Second, central banks are essentially a nation's phenomenon. Third, it is useful to recall some of the reasons for the origin of central banks: to issue currency; to be a banker and lender to the government; to regulate and supervise the banks and financial entities; and to serve as a lender-of-last-resort.

The new objective function assigned to the central bank is to focus on price stability, with financial stability as an additional objective in some cases. Two pertinent questions recently being raised relating to the independence of the central bank include: First, why is it so obvious that central banks should abandon their 'parents', the sovereign government? One quick explanation could be that the central banks have 'come-of-age' in recent years. But then, some instances like the case of two currencies in Iraq in the 1990s and that of the Bank of Japan in recent years provide a contrary view to the 'come-of-age' hypothesis. Second, is it really the case that supervision and regulation of banks by the central bank leads to conflict of interest? In consideration of this conflict, the Financial Services Authority was established in the UK in 2000, and a number of countries have followed suit. In India, we have Financial Stability and Development Council.

The Genesis of Central Banking in India

In 1926, the Royal Commission on Indian Currency and Finance (Hilton Young Commission) recommended that dichotomy of functions and division of responsibilities for control of currency and credit should be ended. The Commission suggested the establishment of a central bank to be called the Reserve Bank of India, whose separate existence was considered necessary for augmenting banking facilities throughout the country. The

Bill to establish the Reserve Bank of India (RBI) was introduced in January 1927 in the Legislative Assembly, but it was dropped due to differences in views regarding ownership, constitution and composition of its Board of Directors. The White Paper on Indian Constitutional Reforms (1933) proposed the setting up of the RBI free from political influences. The Indian Central Banking Enquiry Committee (1931) had also strongly recommended the establishment of a Reserve Bank. These events led to the introduction of a fresh Bill in 1933. The Bill was passed in 1934 and the RBI Act came into force on January 1, 1935. The Reserve Bank was inaugurated on April 1, 1935.

Central banks occupy a pivotal position in the institutional fabric of an economy. The functions of a modern central bank are vastly different from what was expected from the early central banks founded in Europe in the seventeenth century. The evolution of central banking in the Indian context has its own specificity. The RBI, while discharging its statutory responsibilities, has played a crucial role in the nation building process, particularly in the development of the financial sector. In fact, institution building constitutes a distinguishing feature of central banking in India. This following section describes the evolution of central banking in India over the period of seventy years since the inception of the Reserve Bank in 1935. For analytical convenience, the entire period 1935-2005 is sub-divided into three broad phases: foundation phase (1935-1950), development phase (1951-1990) and reform phase (1991 onwards).

- a) Foundation Phase (1935-50):** During most of the formation phase it was a private bank, though formed under a statute and overseen by the then colonial government. The functions of the Bank during this phase were confined essentially to traditional central banking, *i.e.*, note issue authority and banker to the Government. During the war and post war years, its major preoccupation was facilitation of war finance, repatriation of sterling debt and planning and administration of exchange control. Upon the nationalization of the Bank in 1949 in terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 and the enactment of the Banking Regulation Act, 1949, regulation and supervision of banks received the focus. On the initiative of the Reserve Bank, the Government appointed the Rural Banking Enquiry Committee in 1949 to consider important policy issues relating to the extension of banking facilities in the country.

- b) *Development Phase (1951-1990):*** With the launching of five-year plans, the Bank's functions became more diversified in terms of Plan financing and establishment of specialized institutions to promote savings and investment in the Indian economy and meet the credit requirements of the priority sectors. Two important events during the 1960s – the devaluation of the rupee in June 1966 and nationalization of 14 private commercial banks in July 1969 – greatly influenced the functions of the Reserve Bank in the subsequent years. Externally, the uncertainties in the global economy following the breakdown of the Bretton Woods system of stable exchange rates and the emergence of the floating regimes exacerbated by the oil shock of 1973-74 presented serious challenges for exchange rate management and gave rise to balance of payments difficulties in India as in many other developing countries. The Government re-focused on the Foreign Exchange Regulation Act (FERA), 1947 for conserving foreign exchange rather than regulating the entry of foreign capital. The FERA, 1973 was drafted incorporating the changes necessary for effective implementation of the Government policy and removing the difficulties in the working of the existing legislation. The major responsibilities devolving on the Reserve Bank during the 1970s related to regulation and management of the country's scarce foreign exchange reserves and expansion in the volume and scope of its refinance facilities for agriculture and rural development. During the 1980s, monetary policy assumed a new focus. On the whole, the development phase was characterized by a plethora of controls and regulations in the Indian economy.
- c) *Reform Phase (1991 Onwards):*** The process of liberalization and globalization the Indian economy initiated since 1991 added several new dimensions to the responsibilities of the Reserve Bank. Along with financial sector reforms, the monetary policy framework has been fine-tuned and the conventional central banking functions including those of currency management and payment and settlement systems have been revamped in tandem with the global trends and domestic expediency. The reform measures in the financial sector and the initiatives taken by the Reserve Bank for developing financial markets to ensure efficient transmission of monetary policy impulses, constituted the hallmark of this phase. The first phase of reforms, guided by the recommendations of the

Committee on Financial System (Narasimham Committee I), aimed at enhancing the operational flexibility and functional autonomy of the financial sector with a view to fostering efficiency, productivity and profitability. The second phase, based on the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II), focused on strengthening the foundations of the banking system and bringing about structural improvements.

Organization, Management and Structure of RBI

The RBI is wholly owned by the Government of India. The Central Board of Directors oversees the Reserve Bank's business.

About the Central Board: The Central Board has primary authority for the oversight of the Reserve Bank. It delegates specific functions to its committees and sub-committees.

Central Board of Directors by the Numbers

Official Directors: a) 1 Governor and b) 4 Deputy Governors, at a maximum.

Non-Official Directors: a) 4 directors—nominated by the Central Government to represent each local board; b) 10 directors nominated by the Central Government with expertise in various segments of the economy; and c) 1 representative of the Central Government.

Number of Meetings: a) 6 meetings—at a minimum—each year; and b) 1 meeting—at a minimum—each quarter.

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

- **Central Board:** Includes the Governor, Deputy Governors and the nominated Directors and a government nominee-Director.
- **Committee of Central Board:** Oversees the current business of the central bank and typically meets every week, on Wednesdays. The agenda focuses on current business, including approval of

the weekly statement of accounts related to the Issue and Banking Departments.

- **Board for Financial Supervision:** Regulates and supervises commercial banks, Non-Banking Finance Companies (NBFCs), development finance institutions, urban co-operative banks and primary dealers.
- **Board for Payment and Settlement Systems:** Regulates and supervises the payment and settlement systems.
- **Sub-committees of the Central Board:** Includes those on Inspection and Audit; Staff; and Building. Focus of each sub-committee is on specific areas of operations.
- **Local Boards:** In Chennai, Kolkata, Mumbai and New Delhi, representing the country's four regions. Local board members, appointed by the Central Government for four-year terms, represent regional and economic interests and the interests of co-operative and indigenous banks.

Management and Structure of RBI

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

The RBI is made up of

1. **26 Departments:** These focus on policy issues in the Reserve Bank's functional areas and internal operations.
2. **26 Regional Offices and Branches:** These are the Reserve Bank's operational arms and customer interfaces, headed by Regional Directors. Smaller branches / sub-offices are headed by a General Manager / Deputy General Manager.
3. **Training Centres:** The Reserve Bank Staff College at Chennai addresses the training needs of RBI officers; the College of Agricultural Banking at Pune trains staff of co-operative and commercial banks, including regional rural banks. The Zonal

Training Centres, located at regional offices, train non-executive staff.

4. **Research institutes:** RBI-funded institutions to advance training and research on banking issues, economic growth and banking technology, such as, National Institute of Bank Management (NIBM) at Pune, Indira Gandhi Institute of Development Research (IGIDR) at Mumbai, and Institute for Development and Research in Banking Technology (IDRBT) at Hyderabad.
5. **Subsidiaries:** Fully-owned subsidiaries include National Housing Bank (NHB), Deposit Insurance and Credit Guarantee Corporation (DICGC), Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL). The Reserve Bank also has a majority stake in the National Bank for Agriculture and Rural Development (NABARD).

Functions of RBI

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

- 1) Monetary Authority
- 2) Issuer of Currency
- 3) Banker and Debt Manager to Government
- 4) Banker to Banks
- 5) Regulator of the Banking System
- 6) Manager of Foreign Exchange
- 7) Regulator and Supervisor of the Payment and Settlement Systems
- 8) Developmental Role

1) Monetary Authority

Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit. The goal of monetary policy is to achieve specific economic objectives such as low and stable inflation and promoting growth. *The main objectives of monetary policy in India are:*

- a) Maintaining price stability;
- b) Ensuring adequate flow of credit to the productive sectors of the economy to support economic growth
- c) Financial stability.

The relative emphasis among the objectives varies from time to time, depending on evolving macro economic developments. The operating framework is based on a multiple indicator approach. This means that RBI monitors and analyses the movement of a number of indicators including interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows and fiscal position, along with trends in output as it develops its policy perspectives.

The Reserve Bank's Monetary Policy Department (MPD) formulates monetary policy. The Financial Markets Department (FMD) handles day-to-day liquidity management operations. There are several direct and indirect instruments that are used in the formulation and implementation of monetary policy.

Direct Instruments

- a) Cash Reserve Ratio (CRR):** CRR is the share of net demand and time liabilities that banks must maintain as cash balance with the Reserve Bank. This to ensure that banks have sufficient cash to cover customer withdrawals. This ratio will be adjusted on occasion, as an instrument of monetary policy, depending on prevailing conditions. RBI's centralized and computerized system allows for efficient and accurate monitoring of the balances maintained by banks with it.
- b) Statutory Liquidity Ratio (SLR):** The share of net demand and time liabilities that banks must maintain in safe and liquid assets, such as, government securities, cash and gold.
- c) Refinance facilities:** Sector-specific refinance facilities (e.g., against lending to export sector) provided to banks.

Indirect Instruments

- **Liquidity Adjustment Facility (LAF):** Consists of daily infusion or absorption of liquidity on purchase basis, through repo

(liquidity injection) and reverse repo (liquidity absorption) auction operations, using government securities as collateral.

- **Open Market Operations (OMO):** Outright sales/purchases of government securities, in addition to LAF, as a tool to determine the level of liquidity over the medium term.
- **Market Stabilization Scheme (MSS):** This instrument for monetary management was introduced in 2004. Liquidity of a more enduring nature arising from large capital flows is absorbed through sale of short-dated government securities and treasury bills. The mobilized cash is held in a separate government account with the Reserve Bank.
- **Repo/reverse repo rate:** These rates under the Liquidity Adjustment Facility (LAF) determine the corridor for short-term money market interest rates. In turn, this is expected to trigger movement in other segments of the financial market and the real economy.
- **Bank rate:** It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. It also signals the medium-term stance of monetary policy.

Open and Transparent Monetary Policy-Making

The Reserve Bank explains the relative importance of its objectives in a given context in a transparent manner, emphasizes a consultative approach in policy formulation as well as autonomy in policy operations and harmony with other elements of macroeconomic policies. The monetary policy formulation is aided by advice and input from:

- Technical Advisory Committee on Monetary Policy
- Pre-policy consultations with bankers, economists, market participants, chambers of commerce and industry and other stakeholders
- Regular discussions with credit heads of banks
- Feedback from banks and financial institutions
- Internal analysis

The RBI's Annual Policy Statements, announced in April, are followed by three quarterly reviews, in July, October and January. A detailed background report — *Review of Macro Economic and Monetary*

Developments — is released the day before the policy review. Faced with multiple tasks and a complex mandate, the RBI emphasizes clear and structured communication for effective functioning. Improving transparency in decisions and actions is a constant endeavor of RBI. The RBI looks at both short term and longer term issues related to liquidity management. In the longer term, RBI monitor the developments in global financial markets, capital flows, the government's fiscal position and inflationary pressures, with an eye toward encouraging strong and sustainable economic growth.

2) Issuer of Currency

The RBI is the nation's sole note issuing authority. Along with the Government of India, RBI is responsible for the design and production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. The Reserve Bank also makes sure there is an adequate supply of coins, produced by the government. In consultation with the government, RBI routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery.

The Department of Currency Management in Mumbai, in cooperation with the Issue Departments in the Reserve Bank's regional offices, oversees the production and manages the distribution of currency. Currency chests at more than 4,000 bank branches—typically commercial banks—contain adequate quantity of notes and coins so that currency is accessible to the public in all parts of the country. The Reserve Bank has the authority to issue notes up to value of Rupees Ten Thousand.

Four printing presses actively print notes: Dewas in Madhya Pradesh, Nasik in Maharashtra, Mysore in Karnataka, and Salboni in West Bengal. The presses in Madhya Pradesh and Maharashtra are owned by the Security Printing and Minting Corporation of India (SPMCIL), a wholly owned company of the Government of India. The presses in Karnataka and West Bengal are set up by BRBNMPL, a wholly owned subsidiary of the Reserve Bank. Coins are minted by the Government of India. RBI is the agent of the Government for distribution, issue and handling of coins. Four mints are in operation: Mumbai, Noida in Uttar Pradesh, Kolkata, and Hyderabad.

RBI's Anti-counterfeiting Measures

- Continual upgrades of bank note security features.
- Public awareness campaigns to educate citizens to help prevent circulation of forged or counterfeit notes.
- Installation of note sorting machines.

RBI's Clean Note Policy

- Education campaign on preferred way to handle notes: no stapling, writing, excessive folding and the like.
- Timely removal of soiled notes: use of currency verification and processing systems and sorting machines.
- Exchange facility for torn, mutilated or defective notes: at currency chests of commercial banks and in Reserve Bank issue offices.

Focus continues on ensuring availability of clean notes and on strengthening the security features of bank notes. Given the volumes involved and costs incurred in the printing, transport, storage and removal of unfit/soiled notes, the RBI is evaluating ways to extend the life of bank notes—particularly in the lower denominations.

For example, RBI is considering issues of ₹10 banknotes in polymer.

3) Banker and Debt Manager to Government

Managing the government's banking transactions is a key RBI role. Like individuals, businesses and banks, governments need a banker to carry out their financial transactions in an efficient and effective manner, including the raising of resources from the public. As a banker to the central government, the Reserve Bank maintains its accounts, receives money into and makes payments out of these accounts and facilitates the transfer of government funds. RBI also acts as the banker to those state governments that have entered into an agreement with it.

The role as banker and debt manager to government includes several distinct functions:

- Undertaking banking transactions for the central and state

governments to facilitate receipts and payments and maintaining their accounts.

- Managing the governments' domestic debt with the objective of raising the required amount of public debt in a cost-effective and timely manner.
- Developing the market for government securities to enable the government to raise debt at a reasonable cost, provide benchmarks for raising resources by other entities and facilitate transmission of monetary policy actions.

At the end of each day, our electronic system automatically consolidates all of the government's transactions to determine the net final position. If the balance in the government's account shows a negative position, RBI extends a short-term, interest-bearing advance, called a Ways and Means Advance - WMA – the limit or amount for which is set at the beginning of each financial year in April.

The RBI's Government Finance Operating Structure

The RBI's Department of Government and Bank Accounts oversees governments' banking related activities. This department encompasses:

- **Public accounts departments:** manage the day-to-day aspects of our Government's banking operations. The Reserve Bank also appoints commercial banks as its agents and uses their branches for greater access to the government's customers.
- **Public debt offices:** provide depository services for government securities for institutions and service government loans.
- **Central Accounts Section at Nagpur:** consolidates the government's banking transactions.

The Internal Debt Management Department based in Mumbai raises the government's domestic debt and regulates and develops the government securities market. RBI plans to enhance efficient and user-friendly conduct of banking transactions for central and state governments while ensuring cost-effective cash and debt management by deepening and widening of the market for government securities.

RBI as the Governments' Debt Manager

In this role, RBI sets policies, in consultation with the government and determine the operational aspects of raising money to help the government finance its requirements:

- Determine the size, tenure and nature (fixed or floating rate) of the loan.
- Define the issuing process including holding of auctions.
- Inform the public and potential investors about upcoming government loan auctions

The Reserve Bank also undertakes market development efforts, including enhanced secondary market trading and settlement mechanisms, authorization of primary dealers and improved transparency of issuing process to increase investor confidence, with the objective of broadening and deepening the government securities market.

4) Banker to Banks

Like individual consumers, businesses and organizations of all kinds, banks need their own mechanism to transfer funds and settle inter-bank transactions - such as borrowing from and lending to other banks – and customer transactions.

As the banker to banks, the Reserve Bank fulfills this role. In effect, all banks operating in the country have accounts with the Reserve Bank, just as individuals and businesses have accounts with their banks.

As the banker to banks, RBI focuses on:

- Enabling smooth, swift and seamless clearing and settlement of inter-bank obligations.
- Providing an efficient means of funds transfer for banks.
- Enabling banks to maintain their accounts with us for purpose of statutory reserve requirements and maintain transaction balances.
- Acting as lender of the last resort.

The RBI provides similar products and services for the nation's banks to what banks offer their own customers. Here's a look at how RBI helps:

- **Non-interest earning current accounts:** Banks hold accounts with the RBI based on certain terms and conditions, such as maintenance of minimum balances. They can hold accounts at each of our regional offices. Banks draw on these accounts to settle their obligations arising from inter-bank settlement systems. Banks can electronically transfer payments to other banks from this account, using the Real Time Gross Settlement System (RTGS).
- **Deposit Account Department:** This department's computerized central monitoring system helps banks manage their funds position in real time to maintain the optimum balance between surplus and deficit centres.
- **Remittance facilities:** Banks and government departments can use these facilities to transfer funds.
- **Lender of the last resort:** The Reserve Bank provides liquidity to banks unable to raise short-term liquid resources from the inter-bank market. Like other central banks, the Reserve Bank considers this a critical function because it protects the interests of depositors, which in turn, has a stabilizing impact on the financial system and on the economy as a whole.
- **Loans and advances:** The Reserve Bank provides short-term loans and advances to banks / financial institutions, when necessary, to facilitate lending for specified purposes.

RBI is planning to implement core banking solutions for its customers to enhance the safety and efficiency of the payments and settlement services in the country.

5) Regulator of the Banking System

Banks are fundamental to the nation's financial system. The central bank has a critical role to play in ensuring the safety and soundness of the banking system—and in maintaining financial stability and public confidence in this system. As the regulator and supervisor of the banking

system, the RBI protects the interests of depositors, ensures a framework for orderly development and conduct of banking operations conducive to customer interests and maintains overall financial stability through preventive and corrective measures.

The Reserve Bank regulates and supervises the nation's financial system. Different departments of the Reserve Bank oversee the various entities that comprise India's financial infrastructure. RBI oversees:

- **Commercial banks and all-India development financial institutions:** Regulated by the Department of Banking Operations and Development, supervised by the Department of Banking Supervision
- **Urban co-operative banks:** Regulated and supervised by the Urban Banks Department
- **Regional Rural Banks (RRB), District Central Cooperative Banks and State Co-operative Bank:** Regulated by the Rural Planning and Credit Department and supervised by NABARD.
- **Non-Banking Financial Companies (NBFC):** Regulated and supervised by the Department of Non-Banking Supervision.

The Reserve Bank makes use of several supervisory tools such as on-site inspections; Off-site surveillance, making use of required reporting by the regulated entities; and thematic inspections, scrutiny and periodic meetings. The Board for Financial Supervision oversees the Reserve Bank's regulatory and supervisory responsibilities.

The RBI's Regulatory Role

As the nation's financial regulator, the Reserve Bank handles a range of activities, including

- Licensing
- Prescribing capital requirements
- Monitoring governance
- Setting prudential regulations to ensure solvency and liquidity of the banks

- Prescribing lending to certain priority sectors of the economy
- Regulating interest rates in specific areas
- Setting appropriate regulatory norms related to income recognition, asset classification, provisioning, investment valuation, exposure limits and the like
- Initiating new regulation

In the regulatory and supervisory arena, there are several challenges going forward.

- a) **For commercial banks:** Focus is on implementing Basel II norms, which will require improved capital planning and risk management skills.
- b) **For urban cooperative banks:** Focus is on profitability, professional management and technology enhancement.
- c) **For NBFCs:** Focus is on identifying the interconnections and the roles these institutions should play as the financial system deepens.
- d) **For regional rural banks:** Focus is on enhancing capability through IT and HR for serving the rural areas.
- e) **For rural cooperative banks:** Focus is on ensuring that they meet minimum prudential standards.

6) Manager of Foreign Exchange

With the transition to a market-based system for determining the external value of the Indian rupee, the foreign exchange market in India gained importance in the early reform period. In recent years, with increasing integration of the Indian economy with the global economy arising from greater trade and capital flows, the foreign exchange market has evolved as a key segment of the Indian financial market.

The Reserve Bank plays a key role in the regulation and development of the foreign exchange market and assumes three broad roles relating to foreign exchange:

- Regulating transactions related to the external sector and facilitating the development of the foreign exchange market.

- Ensuring smooth conduct and orderly conditions in the domestic foreign exchange market.
- Managing the foreign currency assets and gold reserves of the country.

The Reserve Bank is responsible for administration of the Foreign Exchange Management Act, 1999 and regulates the market by issuing licences to banks and other select institutions to act as Authorized Dealers in foreign exchange. The Foreign Exchange Department (FED) is responsible for the regulation and development of the market. On a given day, the foreign exchange rate reflects the demand for and supply of foreign exchange arising from trade and capital transactions. The RBI's Financial Markets Department (FMD) participates in the foreign exchange market by undertaking sales / purchases of foreign currency to ease volatility in periods of excess demand for/supply of foreign currency.

The Department of External Investments and Operations (DEIO) invests the country's foreign exchange reserves built up by purchase of foreign currency from the market. In investing its foreign assets, the Reserve Bank is guided by three principles: safety, liquidity and return.

The challenge for RBI is to liberalize and develop the foreign exchange market, with an eye toward ushering in greater market efficiency while ensuring financial stability in an increasingly global financial market environment. With current account convertibility achieved in 1994, the key focus is now on capital account management.

7) Regulator and Supervisor of Payment and Settlement Systems

Payment and settlement systems play an important role in improving overall economic efficiency. They consist of all the diverse arrangements that we use to systematically transfer money - currency, paper instruments such as cheques, and various electronic channels.

The Payment and Settlement Systems Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country. In this role, RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.

The Reserve Bank has a two-tiered structure. The first tier provides the basic framework for our payment systems. The second tier focuses on supervision of this framework. As part of the basic framework, the RBI's network of secure systems handles various types of payment and settlement activities.

Most operate on the security platform of the Indian Financial Network (INFINET), using digital signatures for further security of transactions. Here is an overview of the various systems used:

- a) **Retail payment systems:** Facilitating cheques clearing, electronic funds transfer, through National Electronic Funds Transfer (NEFT), settlement of card payments and bulk payments, such as electronic clearing services. Operated through local clearing houses throughout the country.
- b) **Large value systems:** Facilitating settlement of inter-bank transactions from financial markets. These include:
 - Real Time Gross Settlement System (RTGS): for funds transfers
 - Securities Settlement System: for the government securities market
 - Foreign Exchange Clearing: for transactions involving foreign currency
- c) **Department of Payment and Settlement Systems:** The Reserve Bank's payment and settlement systems regulatory arm.
- d) **Department of Information Technology:** Tech support for the payment systems and for the Reserve Bank's internal IT systems.

RBI is proactively identifying and addressing issues that help mitigate the risks for large value systems. Efforts on the retail payment system side will focus on operational efficiencies, cost effectiveness, innovation and risk management.

8) Developmental Role

This role is, perhaps, the most unheralded aspect of our activities, yet it remains among the most critical. This includes ensuring that credit is available to the productive sectors of the economy, establishing institutions designed to build the country's financial infrastructure, expanding access

to affordable financial services and promoting financial education and literacy.

Over the years, the Reserve Bank has added new institutions as the economy has evolved. Some of the institutions established by the RBI include:

- Deposit Insurance and Credit Guarantee Corporation (1962), to provide protection to bank depositors and guarantee cover to credit facilities extended to certain categories of small borrowers.
- Unit Trust of India (1964), the first mutual fund of the country.
- Industrial Development Bank of India (1964), a development finance institution for industry.
- National Bank of Agriculture and Rural Development (1982), for promoting rural and agricultural credit.
- Discount and Finance House of India (1988), a money market intermediary and a primary dealer in government securities.
- National Housing Bank (1989), an apex financial institution for promoting and regulating housing finance.
- Securities and Trading Corporation of India (1994), a primary dealer.

The Reserve Bank continues its developmental role, while specifically focusing on financial inclusion. Key tools in this on-going effort include:

a) Directed credit for lending to priority sector and weaker sections:

The goal here is to facilitate/enhance credit flow to employment intensive sectors such as agriculture, micro and small enterprises (MSE), as well as for affordable housing and education loans.

- b) Lead Bank Scheme:** A commercial bank is designated as a lead bank in each district in the country and this bank is responsible for ensuring banking development in the district through coordinated efforts between banks and government officials. The Reserve Bank has assigned a Lead District Manager for each district who acts

as a catalytic force for promoting financial inclusion and smooth working between government and banks.

- c) **Sector specific refinance:** The Reserve Bank makes available refinance to banks against their credit to the export sector. In exceptional circumstances, it can provide refinance against lending to other sectors.
- d) **Strengthening and supporting small local banks:** This includes regional rural banks and cooperative banks
- e) **Financial inclusion:** Expanding access to finance and promoting financial literacy are a part of our outreach efforts.

The development role of the Reserve Bank will continue to evolve, along with the Indian economy. Through the outreach efforts and emphasis on customer service, the Reserve Bank will continue to make efforts to fill the gaps to promote inclusive economic growth and stability.

Financial Inclusion and Literacy:

Expanding Access & Encouraging Education

Expanding access to and knowledge about finance is a fundamental aspect of the Reserve Bank's operations. These efforts are critical to ensuring that the benefits of a growing and healthy economy reach all segments of the population. RBI's work here includes:

- Encouraging provision of affordable financial services like zero-balance, no-frills bank accounts, access to payments and remittance facilities, savings, loans and insurance services.
- Expanding banking outreach through use of technology, such as banking by cell phone, smartcards and the like.
- Encouraging bank branch expansion in parts of the country with few banking facilities.
- Facilitating use of specified persons to act as agents to perform banking functions in hard-to reach parts of the country.

RBI's effort to promote financial literacy focuses on educating people about responsible financial management. Efforts here include:

- a) **Information and knowledge-sharing:** User-friendly website includes easy-to-understand tips and guidance in multiple languages; brochures, advertisements and other marketing materials educate the public about banking services.
- b) **Credit counseling:** The Reserve Bank encourages commercial banks to set up financial literacy and credit counseling centres, to help people develop better financial planning skills.

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Lesson 2.2 - Objectives of Monetary Policy, Methods of Credit Control and Autonomy of Central Banks

Learning Objectives

- To understand the objectives of monetary policy.
- To understand the methods of quantitative and qualitative credit controls.
- To give an insight into the autonomy of central bank systems

Monetary Policy in India

Objectives and Framework of Monetary Policy

In India, the objectives of monetary policy evolved for maintaining **price stability** and ensuring **adequate flow of credit to the productive sectors** of the economy. With progressive liberalization and increasing globalization of the economy, **maintaining orderly conditions in the financial markets** emerged as an additional policy objective. Thus, monetary policy in India endeavours to maintain a **judicious balance between:**

- Price stability
- Economic growth
- Financial stability.

The case of price stability as the prime objective of monetary policy rests on the assumption that volatility in prices creates uncertainty in economic decision making. Rising prices affect savings adversely while they make speculative investments more attractive. The most important contribution of the financial system to an economy is its ability to augment savings and allocate resources more efficiently. A regime of rising prices, thus, clearly affects the atmosphere for promotion of savings and allocation of investment. Furthermore, the domestic inflation rate also has a bearing on the exchange rate of the currency.

Operating Procedures of Monetary Policy in India

Operating procedure refer to the day to day management of monetary conditions consistent with the overall stance of monetary policy. It is in essence the 'nuts and bolts' of monetary policy. It involves four activities, viz.,

- The choice of the operational target;
- The nature, extent and the frequency of different money market operations by the central bank;
- The use and width of the corridor for very short-term market interest rates; and
- The manner of signaling policy intentions.

The operating procedure is explained in detail below:

- 1) **Issues and Options:** The liquidity adjustment facility (LAF) has emerged as the key element of the present operating procedure of monetary policy. It has generally helped in steering the desired trajectory of interest rates in response to evolving market conditions.
- 2) **Monetary Transmission:** At the heart of the operating framework is the nature of monetary transmission. The pertinent question is whether the interest rate channel of monetary transmission is working. Monetary transmission is substantially more effective in a deficit liquidity situation than in a surplus liquidity situation.
- 3) **Policy Rate:** The present LAF framework is such that the operating policy rate alternates between the repo rate and the reverse repo rate, depending on the prevailing liquidity condition. In a surplus liquidity condition, the reverse repo rate becomes the operating policy rate. In a deficit liquidity situation, the repo rate becomes the policy rate. Going by international best practices, it is unconventional to have two policy rates.
- 4) **Bank Rate:** The RBI in its tool kit has the Bank Rate which is essentially a discount rate. Under Section 49 of the RBI of India Act, the Bank Rate has been defined as "the standard rate at which it [the Reserve Bank] is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under this Act". While

the Bank Rate was an important instrument of monetary control, its importance declined once the LAF system was instituted and progressively refinance facilities were provided at the repo rate. It is now used for calculating penalty on default in the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) as required by the RBI Act and BR Act.

- 5) **Constituents of the Corridor:** The prescription of the Bank Rate by itself will not make it active unless there is liquidity facilities linked to the Bank Rate. It is recommended to have the institution of a collateralized Exceptional Standing Facility (ESF) at the Bank Rate up to one per cent of the Net Demand and Time Liabilities (NDTL) of banks carved out of their required SLR portfolio. This facility is not entirely new. In the recent episode of liquidity tightness, the RBI has been providing additional liquidity up to 1 to 2 per cent of NDTL but on an *ad hoc* basis at the repo rate. The advantages of this facility are four-fold. First, it will provide an upper bound to the policy rate corridor. Second, it will provide a safety valve against unanticipated liquidity shocks. Third, it will help stabilize the overnight interest rate around the repo rate in a liquidity deficit situation. Fourth, it will enhance the liquidity attribute of the SLR portfolio without compromising its prudential nature.
- 6) **Width of the Corridor:** First, it should not be so wide as to induce volatility in short-term money market rates. Second, it should not be so narrow that it retards the development of the short-term money market by taking away the incentive from market participants to deal among themselves before approaching the central bank.
- 7) **Operating Target:** The overnight call money rate has been the operating target of monetary policy as the monetary transmission is the fastest to this segment. However, in the past few years, the turnover in the uncollateralized (inter-bank money market) segment has declined sharply, while that in the overnight collateralized market segment, *viz.*, the Collateralized Borrowing and Lending Obligations (CBLO) and market repo, has increased. The prudential limits as prescribed by the RBI have not constrained the growth of the call money market; rather it has increased the stability of the money market with an increasing share of the collateralized segment.

- 8) **Timing and Frequency of LAF:** The RBI is currently conducting LAF twice a day. This has provided flexibility to market participants and has helped contain volatility in the overnight market.
- 9) **Instruments for Liquidity Management:** In order to keep the liquidity in the LAF window at the optimal level of (+)/(-) one per cent of NDTL for effective monetary transmission, the RBI needs to have instruments at its disposal to manage excessive liquidity deficit/surplus conditions. The role of the LAF window is to deal with frictional liquidity deficit/surplus. Liquidity of a more durable nature needs to be managed with other instruments.
- 10) **Collateral:** The RBI holds Special Bonds (oil bonds), apart from government securities, in its portfolio. Oil bonds are treated as non-SLR securities. With effect from July 27, 2010, government securities obtained under reverse repo are not reckoned for the purpose of SLR of banks.
- 11) **Liquidity Forecast:** To ensure that the operating target does not deviate from the policy rate, liquidity forecast plays a crucial role. Liquidity forecast in the RBI is made on a weekly basis up to four weeks ahead. A quick back-testing analysis of these liquidity forecasts shows that the liquidity projections during the past two years have been satisfactory. The one-week-ahead forecasts show a relatively lower margin of error compared with the forecasts for the subsequent weeks. However, the discrepancy in liquidity forecast has increased, reflecting large swings in government cash balances.
- 12) **Dissemination of Liquidity Forecast:** Several central banks disseminate liquidity forecasts, such as the ECB (weekly), Bank of England (daily), Bank of Japan (daily and monthly), Bank of Canada (daily) and Reserve Bank of Australia (daily). The dissemination of forecasts is intended primarily to facilitate the liquidity management of banks. However, following the global financial crisis, some advanced countries have stopped disseminating information on liquidity forecasts, such as the US Federal Reserve, Bank of England (suspended since August 2009), and Swiss National Bank and among EMEs, Brazil and the Bank of Korea. While the dissemination of forecasts helps market participants to make better assessments on the factors affecting liquidity and on the possible direction and

quantum of central bank intervention, any inaccurate assessments may increase uncertainty in financial markets. At present, the RBI publishes the information on banks' cash balances with the RBI with a lag of three days.

13) Maintenance of the CRR: An area of uncertainty in liquidity forecast is the pattern of CRR maintenance by banks. At present, banks, on average, are required to maintain 100 per cent of the required CRR during the fortnight with a daily minimum maintenance of 70 per cent. However, banks frontload their CRR balances with the RBI in the first week of the reporting Friday, the front loading being higher in deficit liquidity situations. This accentuates the liquidity stress. But at the system level, banks tend to maintain over 80 per cent of their required balance throughout the maintenance period.

14) Seamless Movements of Funds and Securities: Interest rate in the uncollateralized segment is expected to be higher than that in the collateralized segment due to the credit risk involved in the former. However, interest rates in the overnight inter-bank call money market deviate from the operating policy rate significantly even if the interest rate in the collateralized segments, *i.e.*, the CBLO and market repo, remains close to the operating policy rate. There are two reasons for this:

- a) Difficulty in providing sufficient collateral by some banks
- b) Settlement of securities and funds under different segments occurring at different times, necessitating the use of intra-day liquidity or the need for additional securities.

Changes in Operating Procedure of Monetary Policy in India

Consistent with the objectives and policy framework, the operating procedure of monetary policy in India has also witnessed significant changes. The choice of targets, instruments and operating procedure was circumscribed to a large extent by the nature of the financial markets and the institutional arrangements.

- During the monetary targeting period (1985-1998), while M3 growth provided the nominal anchor, *reserve money* was used as

the operating target and *cash reserve ratio* (CRR) was used as the principal operating instrument.

- Besides CRR, in the pre-reform period prior to 1991, given the command and control nature of the economy, the Reserve Bank had to resort to direct instruments like interest rate regulations and selective credit control. These instruments were used intermittently to neutralize the expansionary impact of large fiscal deficits which were partly monetized.
- The administered interest rate regime kept the yield rate of the government securities artificially low. The demand for them was created through periodic hikes in the Statutory Liquidity Ratio (SLR) for banks. The year 1992-93 was a landmark in the sense that the market borrowing programme of the government was put through the auction process. This was supported by a phased deregulation of lending rates in the credit market.
- The Reserve Bank also brought down the SLR and CRR drastically. All these developments resulted in a decline in pre-emption of resources from the banking.
- The Narsimham Committee (1998), however, noted that the money market continued to remain lopsided, thin and volatile and the Reserve Bank also had no effective presence in the market. Therefore, it reiterated the need to transform the call money market into a pure inter-bank market and recommended the Reserve Bank's operations to be market-based.
- Following these recommendations, the Reserve Bank introduced the Liquidity Adjustment Facility (LAF) in June 2000 to manage market liquidity on a daily basis and also to transmit interest rate signals to the market. Under the LAF, the Reserve Bank's policy reverse repo and repo rates set the corridor for overnight market interest rates. Thus, Open Market Operations (OMSs) including LAF emerged as the dominant instrument of monetary policy, though CRR continued to be used as an additional instrument of policy.
- The call money market was transformed into a pure inter-bank market by August 2005 in a phased manner.

Notes

- Concomitantly, to enable a smooth exit of non-banks, new instruments such as the CBLO were introduced in January 2003.
- With the introduction of prudential limits on borrowing and lending by banks in the call money market, the collateralized money market segments developed rapidly.
- Maturities of other money market instruments such as commercial papers (CPs) and certificates of deposits (CDs) were gradually shortened to seven days in order to align the maturity structure.
- Managing large and persistent capital inflows in excess of the absorptive capacity of the economy added another dimension to the liquidity management operations during the 2000s. Although, initially the liquidity impact of large capital inflows were sterilized through OMOs and LAF operations, given the finite stock of government securities in the Reserve Bank's portfolio and the legal restrictions on issuance of its own paper, additional instruments were needed to contain liquidity of a more enduring nature.
- This led to the introduction of the Market Stabilization Scheme (MSS) in April 2004. Under this scheme, short-term government securities were issued but the amount remained impounded in the Reserve Bank's balance sheet for sterilization purposes.
- Interestingly, in the face of reversal of capital flows during the recent crisis, unwinding of such sterilized liquidity under the MSS helped to ease liquidity conditions.
- In response to the measures taken to develop the money market, over the years the turnover in various market segments increased significantly.
- All these reforms have also led to improvement in liquidity management operations by the Reserve Bank as evident from the stability in call money rates, which also helped improve integration of various money market segments and thereby effective transmission of policy signals.
- The rule-based fiscal policy pursued under the Fiscal Responsibility and Budget Management (FRBM) Act, by easing fiscal dominance, contributed to overall improvement in monetary management.

- Notwithstanding such improvements at the short-end of the financial market spectrum, the transmission of the policy signals to banks' lending rates has been rather slow given the rigidities in the system, particularly the preference for fixed interest rate on term deposits. Against the backdrop of ample liquidity in the system more recently, as banks have reduced their deposit rates, the effective lending rates would have shown further moderation.

Monetary Policy Formulation Processes

The process of monetary policy in India had traditionally been largely internal with only the end product of actions being made public. The process includes a wide range of inputs involving the internal staff, market participants, academics, financial market experts and the Bank's Board. At the apex of the policy process is the Governor, assisted closely by Deputy Governors and guided by deliberations of the Board of Directors. A Committee of the Board meets every week to review the monetary, economic and financial conditions and renders advice on policy. There are several other standing and *ad hoc* committees or groups which play a critical role with regard to policy advice. An interdepartmental Financial Markets Committee focuses on day-to-day market operations and tactics while periodic monetary policy strategy meetings analyze strategies on an ongoing basis.

Methods of Credit Controls

Since the 1970s, the Reserve Bank faced the twin problems of making provisions for financing economic growth and ensuring price stability in the wake of a sharp increase in money supply emanating from the rapid expansion in credit. The increased public expenditure and the coincident rise in banks deposits began to place a greater pressure on the effectiveness of monetary policy. The Reserve Bank had to adopt a balancing approach to handle this knife-edged problem and resorted to the policy of a 'controlled expansion' of credit to meet the twin objectives of making provision of credit for attaining faster rate of economic growth and ensuring price stability.

Quantitative Methods of Credit Control

The Quantitative measures of credit control include the following:

Bank Rate Policy

The bank rate is the official interest rate at which RBI rediscounts the approved bills held by commercial banks. For controlling the credit, inflation and money supply, RBI will increase the Bank Rate. If the bank rate is increased, the commercial banks will have to pay a higher rate of interest for their borrowings from RBI. In turn, commercial banks will charge higher interest rate when they grant loans to their customers. Thus, the borrowers will be discouraged to borrow. The trading and business activities will be reduced. The reduced money supply and price level in turn is brought down.

Open Market Operations

OMO-The Open Market Operations refer to direct sales and purchase of securities and bills in the open market by RBI. The aim is to control volume of credit. By selling in the money market, the RBI tries to absorb the excess money supply with the commercial banks, insurance companies and financial institutions. During inflation, the sale of security by RBI will encourage commercial banks to buy. In this process, the surplus cash with the commercial banks are left with fewer amounts of funds, they cannot lend more and so borrowers will find it difficult to obtain loan. This will bring down the economic activities and there by the income.

Variable Reserve Ratios and Rate

- a. **Cash Reserve ratio:** Cash Reserve ratio refers to that portion of total deposits in commercial banks which it has to keep with RBI as cash reserves. If CRR is reduced, the banks will be able to give more loans. Increased lending by banks will lead to more economic activities. During inflation, the CRR will be increased and this will leave the bank to lend only less.
- b. **Statutory Liquidity Ratio:** It refers to that portion of deposits with the banks which it has to keep with itself as liquid assets (old,

approved government securities, etc). This ratio helps the RBI to control money supply with the banks.

- c. **Repo rate:** Repo rate is a rate at which banks borrow rupees from RBI against approved securities to fulfill short term gap.
- d. **Reverse Repo rate:** Reverse Repo rate is rate at which RBI would borrow money from banks.

If RBI wishes to control credit and discourage credit it would increase CRR & SLR.

Qualitative Methods of Credit Control

Qualitative credit control is used by the RBI for selective purposes. Some of them are

1. **Margin requirements:** This refers to difference between the securities offered and amount borrowed by the banks. The RBI will prescribe the percentage of margin a bank should maintain while granting loan. During the inflation, the RBI will increase the margin leaving lesser amount of cash at the disposal of the borrower. This will affect their borrowing capacity and thereby demand for other goods. During depression, the margin will be reduced.
2. **Consumer Credit Regulations:** This refers to issuing rules regarding down payments and maximum maturities of installment credit for purchase of goods. Based on the scenario (inflation or depression), the RBI will increase or decrease the down payment or any other rules.
3. **Control of Bank Advances:** The RBI may instruct the banks not to lend for undesirable and unproductive purposes and direct credit only for productive purposes. By this way, the RBI controls bank advances.
4. **RBI Guidelines:** RBI issues oral, written statements, appeals, guidelines, warnings, etc. to the banks.
5. **Rationing of credit:** The RBI controls the credit granted/allocated by commercial banks. Credit rationing is a method by which the distribution of credit is done according to the conditions of the

national economy. If there is more demand in one sector (say agriculture), then the RBI may fix certain percentage of loanable funds for that sector individually and in relation to total advances.

6. **Moral Suasion:** It refers to psychological means and informal means of selective credit control. A request will be made by RBI to banks to cooperate with its policies. For this method, the RBI should have a cordial relationship with banks.
7. **Direct Action:** This step is taken by the RBI against banks that do not fulfill conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.

Autonomy of Central Bank Systems

Areas of Central Bank Independence

Central bank independence generally relates to three areas, viz., personnel matters; financial aspects; and conduct of policy.

- (i) **Personnel independence** refers to the extent to which the **Government distances itself** from appointment, term of office and dismissal procedures of top central bank officials and the governing board. It also includes the extent and nature of representation of the Government in the governing body of the central bank.
- (ii) **Financial independence** relates to the freedom of the central bank to decide the extent to which Government expenditure is either directly or indirectly financed via central bank credits. Direct or automatic access of Government to central bank credits would naturally imply that monetary policy is subordinated to fiscal policy.
- (iii) **Policy independence** is related to the flexibility given to the central bank in the formulation and execution of monetary policy.

Recent literature has stressed the difference between goal independence and instrument independence.

- (iv) **Goal independence** refers to a situation where the central bank itself can choose the policy priorities of stabilizing output or prices at any given point of time, thus setting the goal of monetary policy.
- (v) **Instrument independence** implies that the central bank is only free to choose the means to achieve the objective set by the Government.

Evolving Relationship with the Government and RBI - A Review

Rangarajan (Then RBI Governor) defined the independence of central banks as “the institutional arrangements for the conduct of monetary policy” and condemned the practice of automatic monetization of the Government’s fiscal deficit through the issue of ad hoc treasury bills as the principal factor impinging on the effective conduct of monetary policy in the Indian context.

The **evolving relationship between the Government and the RBI** can be broadly divided into four distinct phases.

First Phase

During this phase, which may be called infancy and uncertainty, the RBI was virtually subservient to the dictates of the Government and measures were taken to curb its capacity for independent actions. The fact that the rate of inflation was modest compared to other developing countries during this period is indicative of the success of macro-policy management and facilitated the task of the RBI in pursuing other developmental activities.

Second Phase

During this period, the RBI was vigorously involved in promoting the institutionalization of credit to agriculture and industry in pursuant to the overall objectives of the respective Five-Year Plans. Another important objective of the RBI was the promotion and mobilization of savings by reinforcing the foundations of the banking system. This, however, does not mean that differences between the RBI and the Government over economic policies were totally absent. For example, the RBI did not approve of the substitution of financial planning by a kind of ‘physical planning’.

Another major area of discord between the RBI and the Government in the late 1950s related to the financing of the cooperatives and the pattern of organization of the lending agencies. Interestingly, during the early 1960s, Governor Iyengar identified **four areas of potential conflict** between the Bank and the central government. These were **interest rate policy, deficit financing, cooperative credit policies and management of substandard banks**. This phase, from nationalization of the RBI in 1948 till nationalization of major commercial banks in 1969, may be considered as maturing of the RBI into a full-fledged professionally managed central bank, perhaps one of the foremost in developing countries.

Third Phase

The third phase that changed the contour of this relationship started with the nationalization of major banks in 1969. In this regard, the nationalization of banks and transfer of ownership to Government provided a captive market for the government. Simultaneously, recourse to the RBI credit was also high, leading to high levels of monetization. This phase was characterized by several features to indicate considerable influence or dominance of Government over the RBI.

Fourth Phase

During this phase, the relationship between the central bank and the Government took a new turn through a welcome development in the supplemental agreement between the Government and the RBI in September 1994 on the abolition of the ad hoc treasury bills to be made effective from April 1997. The measure eliminated the automatic monetization of Government deficits and resulted in considerable moderation of the monetized deficit in the latter half of the Nineties. Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the RBI have enhanced its credibility and instrument independence.

Conclusion

The efficacy of the emerging operating procedures of monetary policy remains a matter of debate. There is very little doubt that the Reserve Bank is now able to set an informal corridor through two-way day-to-day

liquidity management. The pass-through to the credit market, however, does not appear very effective because of a variety of factors such as the overhang of high cost deposits, large non-performing assets and high non-operating expenses in the banking system. As a result, real interest rates continue to remain high. This underscores the need to further strengthen structural measures to impart the necessary flexibility to the interest rate structure in the credit markets. The phasing out of *ad hoc* Treasury Bills and the enactment of Fiscal Responsibility and Budget Management (FRBM) legislation are two important milestones in providing safeguards to monetary policy from the consequences of fiscal expansion and ensuring better monetary-fiscal co-ordination.

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Lesson 2.3 - Indian Money Market, Capital Market And Banking Legislations

Learning Objectives

- To understand the features and components of Indian money market
- To understand the features and components of Indian capital market
- To understand the banking legislations in India

Money Market

Money market means market where money or its equivalent can be traded. Money is synonym of liquidity. Money market consists of financial institutions and dealers in money or credit who wish to generate liquidity. It is better known as a place where large institutions and government manage their short term cash needs. For generation of liquidity, short term borrowing and lending is done by these financial institutions and dealers. Money Market is part of financial market where instruments with high liquidity and very short term maturities are traded. Due to highly liquid nature of securities and their short term maturities, money market is treated as a safe place. Hence, *money market is a market where short term obligations such as treasury bills, commercial papers and bankers acceptances are bought and sold.*

The money market is a key component of the financial system as it is the fulcrum of monetary operations conducted by the central bank in its pursuit of monetary policy objectives. It is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes of money.

Structure of Money Market

The structure of money market can be divided into two parts, viz., organized and unorganized. Organized structure includes

- Reserve bank of India.
- DFHI (discount and finance house of India).
- Commercial banks (Public sector banks, SBI & its associates, Cooperative banks, Private sector banks and Foreign banks)
- Development bank IDBI, IFCI, ICICI, NABARD, LIC, GIC, UTI etc.

The unorganized structure include:

- Indigenous banks
- Money lenders
- Chits & Nidhis
- Co-operative Sector (State and central cooperative banks, Primary urban banks, Primary Agri. credit societies, State, Central and Primary Land development banks)

Functions of Money Market

The money market performs three broad functions.

- 1) It provides an equilibrating mechanism for demand and supply of short-term funds.
- 2) It enables borrowers and lenders of short term funds to fulfill their borrowing and investment requirements at an efficient market clearing price.
- 3) It provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.

The objective of monetary management by the central bank is to align money market rates with the key policy rate. As excessive money market volatility could deliver confusing signals about the stance of monetary policy, it is critical to ensure orderly market behaviour, from the point of view of both monetary and financial stability. Thus, efficient functioning of the money market is important for the effectiveness of monetary policy.

Features of Money Market in India

- 1) It is a market purely for short-term funds or financial assets called near money.
- 2) It deals with financial assets having a maturity period less than one year only.
- 3) In Money Market, transaction transactions can be done through oral communication, relevant document and written communication.
- 4) Transactions have to be conducted without the help of brokers.
- 5) It is not single homogeneous market, it comprises of several sub market like call money market, acceptance bill market.
- 6) The players in the money market include commercial banks, acceptance houses and NBFC (Non-Banking Financial Companies).

Importance of Money Market

- 1) Development of trade and industry.
- 2) Development of capital market.
- 3) Smooth functioning of commercial banks.
- 4) Effective central bank control.
- 5) Formulation of suitable monetary policy.
- 6) Non-inflationary source of finance to government.

Composition of Money Market

Money Market consists of a number of sub-markets which collectively constitute the money market. They are ***Call Money Market, Commercial Bills Market, Acceptance Market, and Treasury bill Market.***

Money Market Instruments

Investment in money market is done through money market instruments. Money market instrument meets short term requirements of the borrowers and provides liquidity to the lenders. Common Money Market Instruments are as follows:

- a. Treasury Bills (T-Bills)
- b. Central Government Securities (Gilt-edged Securities)
- c. State Government and Public Sector Instruments
- d. Municipal Bonds
- e. Commercial Papers
- f. Certificates of deposits
- g. Bills Rediscounting
- h. Call/Notice Money Market
- i. Repurchase Agreements (Repos)
- j. Inter Bank Participation
- k. Bank deposits
- l. Term Money
- m. Corporate Debentures and Bonds
- n. Bankers Acceptance
- o. Commercial Bills
- p. Fringe Market

Let us understand important money market instruments in detail.

a). Treasury Bills (T-Bills)

Treasury Bills, one of the safest money market instruments, are short-term borrowing instruments of the Central Government of the Country issued through the Central Bank (RBI in India). They are zero risk instruments, and hence the returns are not so attractive. It is available both in primary market as well as secondary market. It is a promise to pay a said sum after a specified period. T-bills are short-term securities that mature in one year or less from their issue date. They are issued with three-month, six-month and one-year maturity periods. The Central Government issues T- Bills at a price less than their face value (par value). They are issued with a promise to pay full face value on maturity. So, when the T-Bills mature, the government pays the holder its face value. The difference between the purchase price and the maturity value is the interest income earned by the purchaser of the instrument. T-Bills are issued through a bidding process at auctions. The bid can be prepared either competitively or non-competitively. In the second type of bidding, return required is not specified and the one determined at the auction is received on maturity.

Whereas, in case of competitive bidding, the return required on maturity is specified in the bid. In case the return specified is too high then the T-Bill might not be issued to the bidder. At present, the Government of India issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. There are no treasury bills issued by State Governments. Treasury bills are available for a minimum amount of ₹25K and in its multiples. While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays.

The Reserve Bank of India issues a quarterly calendar of T-bill auctions which is available at the Banks' website. It also announces the exact dates of auction, the amount to be auctioned and payment dates by issuing press releases prior to every auction. Payment by allottees at the auction is required to be made by debit to their/ custodian's current account. T-bills auctions are held on the Negotiated Dealing System (NDS) and the members electronically submit their bids on the system. NDS is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments. RBI issues these instruments to absorb liquidity from the market by contracting the money supply. In banking terms, this is called Reverse Repurchase (Reverse Repo). On the other hand, when RBI purchases back these instruments at a specified date mentioned at the time of transaction, liquidity is infused in the market. This is called Repo (Repurchase) transaction.

b) Repurchase Agreements

Repurchase transactions, called Repo or Reverse Repo are transactions or short term loans in which two parties agree to sell and repurchase the same security. They are usually used for overnight borrowing. Repo/Reverse Repo transactions can be done only between the parties approved by RBI and in RBI approved securities viz. GOI and State Government Securities, T-Bills, PSU Bonds, FI Bonds, Corporate Bonds etc. Under repurchase agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date at a predetermined price. Such a transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when viewed from the perspective

of the buyer of the securities. Thus, whether a given agreement is termed as a Repo or Reverse Repo depends on which party initiated the transaction. The lender or buyer in a Repo is entitled to receive compensation for use of funds provided to the counterparty. Effectively the seller of the security borrows money for a period of time (Repo period) at a particular rate of interest mutually agreed with the buyer of the security who has lent the funds to the seller. The rate of interest agreed upon is called the Repo rate. The Repo rate is negotiated by the counterparties independently of the coupon rate or rates of the underlying securities and is influenced by overall money market conditions.

c) Commercial Papers

Commercial paper is a low-cost alternative to bank loans. It is a short term unsecured promissory note issued by corporate and financial institutions at a discounted value on face value. They are usually issued with fixed maturity between 1 to 270 days and for financing of accounts receivables, inventories and meeting short term liabilities. Say, for example, a company has receivables of ₹ 1 lakh with credit period 6 months. It will not be able to liquidate its receivables before 6 months. The company is in need of funds. It can issue commercial papers. They yield higher returns as compared to T-Bills as they are less secure in comparison to these bills; however chances of default are almost negligible but are not zero risk instruments. Commercial paper being an instrument not backed by any collateral, only firms with high quality credit ratings will find buyers easily without offering any substantial discounts. They are issued by corporate to impart flexibility in raising working capital resources at market determined rates. Commercial Papers are actively traded in the secondary market since they are issued in the form of promissory notes and are freely transferable in demat form.

d) Certificate of Deposit

It is a short term borrowing more like a bank term deposit account. It is a promissory note issued by a bank in form of a certificate entitling the bearer to receive interest. The certificate bears the maturity date, the fixed rate of interest and the value. It can be issued in any denomination. They are stamped and transferred by endorsement. Its term generally ranges from three months to five years and restricts the holders to withdraw

funds on demand. However, on payment of certain penalty the money can be withdrawn on demand also. The returns on certificate of deposits are higher than T-Bills because it assumes higher level of risk. While buying Certificate of Deposit, return method should be seen. Returns can be based on Annual Percentage Yield (APY) or Annual Percentage Rate (APR). In APY, interest earned is based on compounded interest calculation. However, in APR method, simple interest calculation is done to generate the return. Accordingly, if the interest is paid annually, equal return is generated by both APY and APR methods. However, if interest is paid more than once in a year, it is beneficial to opt APY over APR.

e) Bankers Acceptance

It is a short term credit investment created by a non financial firm and guaranteed by a bank to make payment. It is simply a bill of exchange drawn by a person and accepted by a bank. It is a buyer's promise to pay to the seller a certain specified amount at certain date. The same is guaranteed by the banker of the buyer in exchange for a claim on the goods as collateral. The person drawing the bill must have a good credit rating otherwise the Banker's Acceptance will not be tradable. The most common term for these instruments is 90 days. However, they can vary from 30 days to 180 days. For corporations, it acts as a negotiable time draft for financing imports, exports and other transactions in goods and is highly useful when the credit worthiness of the foreign trade party is unknown. The seller need not hold it until maturity and can sell off the same in secondary market at discount from the face value to liquidate its receivables.

f) Commercial Bills

Purchase and discounting of commercial bills is a way by which banks provide funds for working capital required by commerce, trade and industry. The financial instrument trading in the bills market is the bill of exchange. It is a written instrument containing unconditional order signed by the maker, directing to pay a certain amount of money to a particular person, or to the bearer of the instrument. It is a negotiable self-liquidating instrument with low degree of risk. Its liquidity is exceeded only by T-bills, call loans and cash, in that order. The spread between the face value of the bill and ready cash paid is the discount rate. Till the bill

matures, the banks can use the same process of discounting to get ready cash. The eligibility criterion is that the bill should arise out of a genuine trade transaction and the maturity period should fall within 90 days from the date of discounting.

g) Term Money

RBI has permitted some of the Financial Institutions like IDBI, ICICI, IFCI, HBI, SIDBI, NABARD, EXIM-Bank etc. to borrow from the market for a period of 3 months and up to a period of not more than 6 months within the stipulated limits. The rate of interest on the term money is determined between the parties by mutual negotiation. The investment in term money is unsecured and the limits are fixed by RBI. The term money is accepted by their institutions at a discounted value. On the due date the payment will be equal to the face value of the instrument, which for all purpose consists of term deposit receipt.

h) Bank Deposits

The banks are permitted to keep deposits with other banks for a period of 15 days and above. The rate of interest of such deposits is freely determined by the two banks between themselves through negotiations. These deposits are not reckoned for the purpose of cash reserve ratio (CRR) requirements. Like the call/notice money transactions, the transactions relating to the bank deposit is evidenced by way of deposit receipt. These deposits are not transferable, but they could be prematurely closed at the discretion of the lender.

i) Bankers Acceptance

A banker's acceptance is a draft against a bank ordering the bank to pay some specified amount at a future date. The banker's acceptance is very safe security and is used as a money market instrument.

j) Fringe Market

The fringe market is a disorganized money market, deemed to include everything that is outside the scope of the money market (i.e., the institutional money market). The fringe market includes activities like

the Inter-Corporate Deposit (ICD) market, small scale trade financing, financing of investments in the stock market, discounting and lending against IOUs or promissory notes, etc. The ICDs market is the most visible feature of the fringe market. As its name indicates it essentially involves short-term borrowing and lending of funds amongst the corporations. Generally the fringe market exist, wherever the main borrowers and lenders of the funds are based, i.e., at the location of the industrial, corporate and trading establishments. The interest rates at which the funds can be lent in the fringe market are generally higher than those operating in the money market. The risk level of the fringe market is higher because the people who borrow at exorbitant rates are the ones who are most likely to default.

k) Call Money Market

Call money refers to that transaction which is received or delivered by the participants in the call money market and where the funds are returnable next day. The call money transactions are also referred to as overnight funds. Notice money on the other hand is a transaction where the participants will take time to receive or deliver for more than two days but generally for a maximum of fourteen days. In both the cases the transaction is unsecured. Therefore, as a prudential measure, a counter-party exposure limits are listed according to which the lender lends money.

In short, resorting to the call/notice money transactions reflect temporary mismatch of funds during the short period of one to fourteen days. The participants, who have surplus, lend their money to shed the mismatch for the relative period. The participants, who are short of funds, would borrow funds for the relative period. The rate at which the funds will be deployed or borrowed will be determined on the basis of the market conditions at a given point of time. When the market is highly liquid, the funds would be easily available where as the funds will be difficult to obtain in a tight money market conditions.

The rates are low in an easy money or liquid market and the rates would be high in a tight money market. A liquid market may fluctuate even overnight due to sudden changes in the financial environment, change in policy of the central monetary authority or the Government or even due to any other external factor which has an implication on the financial market. The document by which the call/notice money are

carried out is the call/ notice money receipt which is exchanged against Banker's Cheque/Reserve Bank Cheque. The following day or on a day fixed according to the notice, the reversal takes place by repayment from the borrower to the lender against return of the call/notice money receipt duly discharged by the lender.

Capital Market

Definition of Capital Market

It is a place where people buy and sell financial instruments be it equity or debt. It is a mechanism to facilitate the exchange of financial assets. The capital market includes primary and secondary markets. Examples of secondary markets in India include **BSE & NSE** which constitute majority of the capital market transactions. At international level, we have **NYSE, LSE & TSE**, which are the major Stock Exchanges. More details about primary and secondary markets are covered in Unit IV.

Significance of Capital Markets

A well-functioning stock market may help the development process in an economy through the following channels:

- Growth of savings.
- Efficient allocation of investment resources.
- Better utilization of the existing resources.

In market economy like India, financial market institutions provide the avenue by which long-term savings are mobilized and channeled into investments. Confidence of the investors in the market is imperative for the growth and development of the market. For any stock market, the market Indices is the barometer of its performance and reflects the prevailing sentiments of the entire economy. Stock index is created to provide investors with the information regarding the average share price in the stock market. The ups and downs in the index represent the movement of the equity market. These indices need to represent the return obtained by typical portfolios in the country. Generally, the stock price of any company is vulnerable to three types of news such as Company specific, Industry specific and Economy specific. An all-share index includes stocks from all

the sectors of the economy and thus cancels out the stock and sector specific news and events that affect stock prices (law of portfolio diversification) and reflect the overall performance of the company/equity market and the news affecting it.

The most important use of an equity market index is as a benchmark for a portfolio of stocks. All diversified portfolios, belonging either to retail investors or mutual funds, use the common stock index as a yardstick for their returns. Indices are useful in modern financial application of derivatives.

Capital Market Instruments and Participants

The capital market is a place where long term funds are borrowed and lent. Capital Market Instruments include Equity, Preference shares, Debenture/ Bonds, ADRs/ GDRs and Derivatives. In the equity segment: we have equity shares, preference shares, convertible preference shares, non-convertible preference shares, etc. In the debt segment: we have debentures, zero coupon bonds, deep discount bonds, etc. Section 85 of the Companies Act, 1956 permits public limited companies (having share capital) to have two kinds of shares namely - equity and preference. Apart from the traditional securities, we have lot of innovative (eg. Sweat equity shares) and hybrid instruments which are coming up in the market. More details about the equity and debt instruments are covered in Unit IV. The foreign capital by way of issue of American Depository Receipts and Global Depository Receipts are covered in Unit V.

Another market we have is a derivative market. A derivative is a financial instrument, whose value depends on the values of basic underlying variable. In the sense, derivatives is a financial instrument that offers return based on the return of some other underlying asset, i.e the return is derived from another instrument. For example, derivatives that can be structured around any uncertainty. Stock prices are uncertain - Lot of forwards, options or futures contracts are based on movements in prices of individual stocks or groups of stocks; Prices of commodities are uncertain - There are forwards, futures and options on commodities; Interest rates are uncertain - There are interest rate swaps and futures; Foreign exchange rates are uncertain - There are exchange rate derivatives; and Weather is uncertain - There are weather derivatives, and so on.

Financial derivatives are financial instruments whose prices are derived from the prices of other financial instruments. Although financial derivatives have existed for a considerable period of time, they have become a major force in financial markets only since the early 1970s. In the class of equity derivatives, futures and options on stock indices have gained more popularity than on individual stocks, especially among institutional investors, who are major users of index-linked derivatives. Even small investors find these useful due to high correlation of the popular indices with various portfolios and ease of use. Derivative contracts have several variants. Depending upon the market in which they are traded, derivatives are classified as 1) exchange traded and 2) over the counter. The most common variants are forwards, futures, options and swaps.

Securities market in India has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalization, trading volumes and turnover on stock exchanges and investor population. Along with this, the profiles of the investors, issuers and intermediaries have changed significantly. The market has witnessed fundamental institutional changes resulting in drastic reduction in transaction costs and significant improvements in efficiency, transparency and safety. Indian market is now comparable to many developed markets.

History of Indian Capital Market

The history of the capital market in India dates back to the eighteenth century when East India Company securities were traded in the country. Until the end of the nineteenth century, securities trading were unorganized and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860-61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for a half a decade. The first joint stock company was established on 1850. The bubble burst on July 1, 1865, when there was tremendous slump in share prices. Trading was at that time limited to a dozen brokers, their trading place was under a banyan tree in front of the Town Hall in Bombay. These stockbrokers organized an

informal association in 1875-Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmadabad, also industrial and trading centres came up later. The Bombay Stock Exchange was recognized in May 1927 under the Bombay Securities Contracts Control Act, 1925. The capital market was not well organized and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence period also, the size of the capital market remained small. During the first and second five-year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. The public sector undertakings were healthier than the private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the then Controller of Capital Issues (CCI) closely supervised and controlled the timing composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations de-motivated many companies from going public for almost four and a half decades.

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scripts of speculators. As speculation became rampant, the stock market came to be known as 'Satta Bazaar'. Despite speculation, non-payment or defaults were not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956. It was also characterized by the establishment of a network for the development of financial institutions and state financial corporations. The 1960s was characterized by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969 on forward trading and badla, technically called contracts for clearing. 'Badla' provided a mechanism for carrying forward positions as well as borrowing funds.

Financial institutions such as LIC and GIC helped to revive the sentiment by emerging as the most important group of investors. The first mutual fund of India, the Unit Trust of India (UTI) came into existence in 1964. In the 1970s, badla trading was resumed under the disguised form of hand-delivery contracts-A group. This revived the market. However, the

capital market received another severe setback on July 6, 1974 when the government promulgated the Dividend Restriction Ordinance, restricting the payment of dividend by companies. This led to a slump in market capitalization at the BSE by about 20 per cent overnight and the stock market did not open for nearly a fortnight.

Later the buoyancy in the stock markets when the multinational companies (MNCs) were forced to dilute their majority stocks in their Indian ventures in favour of the Indian public under FERA, 1973. Several MNCs opted out of India. One under and twenty-three MNCs offered shares were lower than their intrinsic worth. Hence, for the first time, the FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real fillip to the Indian stock markets. For the first time, many investors got an opportunity to invest in the stocks of such MNCs as Colgate, and Hindustan Liver Limited. Then, in 1977, a little – known entrepreneur, Dhirubhai Ambani, tapped the capital market. The scrip, reliance textiles, is still a hot favourite and dominates trading at all stock exchanges.

The 1980s witnessed an explosive growth of the securities market in India with millions of investors suddenly discovering lucrative opportunities. Many investors jumped into the stock markets for the first time. The government's liberalisation process initiated during the mid-1980s, spurred this growth. Participation by small investors, speculation, defaults ban on badla, and resumption of badla continued. Convertible debentures emerged as a popular instrument of resource mobilization in the primary market. The introduction of public sector bonds and the successful mega issues of Reliance Petrochemicals and Larsen and Toubro gave a new lease of life to the primary market. This, in turn, enlarged volumes in the secondary market. The decade of the 1980s was characterized by an increase in the number of stock exchanges, listed companies, paid up-capital, and market capitalization.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalization were the new terms coined and marketed during the decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterized by a new industrial policy, emergence of SEBI as a regulator of capital market, advent of foreign institutional investors, euro-issues, free

pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.¹² Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March, 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing, many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

The 1991-1992 securities scam revealed the inadequacies of and inefficiencies in the financial system. It was the scam, which prompted a reform of the equity market. The Indian stock market witnessed a sea change in terms of technology and market prices. Technology brought radical changes in the trading mechanism. The Bombay Stock Exchange was subject to nationwide competition by two new stock exchanges-the National Stock Exchange, set up in 1994, and Over the Counter Exchange of India, set up in 1992. The National Securities Clearing Corporation (NSCC) and National Securities Depository Limited (NSDL) were set up in April 1995 and November 1996 respectively from improved clearing and settlement and dematerialized trading. The Securities Contracts (Regulation) Act, 1956 was amended in 1995-96 for introduction of options trading. Moreover, rolling settlement was introduced in January 1998 for the dematerialized segment of all companies. With automation and geographical spread, stock market participation increased.

In the late 1990s, the Information Technology (IT) scrips were dominant on the Indian bourses. These scrips included Infosys, Wipro, and Satyam. They were a part of the favourite scrips of the period, also known as New Economy scrips, along with telecommunications and media scrips. The new economy companies are knowledge intensive unlike the old economy companies that were asset intensive. The Indian capital market entered the twenty-first century with the Ketan Parekh scam. As a result of this scam, Badla was discontinued from July 2001 and rolling settlement was introduced in all scrips. Trading of futures commenced from June 2000, and Internet trading was permitted in February 2000. On July 2, 2001, the Unit Trust of India announced suspension of the sale and

repurchase of its flagship US-64 scheme due to heavy redemption leading to panic on the bourses. The government's decision to privatize oil PSUs in 2003 fuelled stock prices. One big divestment of international telephony major VSNL took place in early February 2002.

Foreign institutional investors have emerged as major players on the Indian bourses. NSE has an upper hand over its rival BSE in terms of volumes not only in the equity markets but also in the derivatives market. It has been a long journey for the Indian capital market. Now the capital market is organized, fairly integrated, mature, more global and modernized. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. The Indian stock markets are now getting integrated with global markets.

Banking Legislations in India

Evolution of Legislative Regulation of Banking in India

In the very early phase of commercial banking in India, the regulatory framework was somewhat diffused and the Presidency Banks were regulated and **governed by their Royal Charter**, the East India Company and the Government of India of that time. Though the Company law was introduced in India way back in 1850, it did not apply to the banking companies. The banking crisis of 1913, however, had revealed several weaknesses in the Indian banking system, such as the low proportion of liquid assets of the banks and connected lending practices, resulting in large-scale bank failures.

The recommendations of the **Indian Central Banking Enquiry Committee (1929-31)**, which looked into the issue of bank failures, paved the way for legislation for banking regulation in the country. Though the RBI, as part of its monetary management mandate, had, from the very beginning, been vested with the powers, under the **RBI Act, 1934**, to regulate the volume and cost of bank credit in the economy through the instruments of general credit control, it was not until 1949 that a comprehensive enactment, applicable only to the banking sector, came into

existence. Prior to 1949, the banking companies, in common with other companies, were governed by the Indian Companies Act, 1913, which itself was a comprehensive re-enactment of the earlier company law of 1850. This Act, however, contained a few provisions especially applicable to banks.

There were also a few *ad hoc* enactments, such as the **Banking Companies (Inspection) Ordinance, 1946**, and the **Banking Companies (Restriction of Branches) Act, 1946**, covering specific regulatory aspects. In this backdrop, in March 1949, a special legislation, called the **Banking Companies Act, 1949**, applicable exclusively to the banking companies, was passed; this Act was renamed as the **Banking Regulation Act from March 1966**. The Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Important changes in several provisions of the Act were made from time to time, designed to enlarge or amplify the responsibilities of the RBI or to impart flexibility to the relative provisions, commensurate with the imperatives of the banking sector developments.

It is interesting to note that till March 1966, the Reserve Bank had practically no role in relation to the functioning of the urban co-operative banks. However, by the enactment of the Banking Laws (Application to Co-operative Societies) Act, 1965, certain provisions of the Banking Regulation Act, regarding the matters *relating to banking business*, were extended to the urban co-operative banks also. Thus, for the first time in 1966, the urban co-operative banks too came within the regulatory purview of the RBI.

Legal Framework – Financial Sector in India

Umbrella Acts

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

Acts Governing Specific Functions

- Public Debt Act, 1944/Government Securities Act (Proposed): Governs government debt market

- Securities Contract (Regulation) Act, 1956:Regulates government securities market
- Indian Coinage Act, 1906:Governs currency and coins
- Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999:Governs trade and foreign exchange market
- Acts governing Banking Operations
- Companies Act, 1956:Governs banks as companies
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980:Relates to nationalization of banks
- Bankers' Books Evidence Act
- Banking Secrecy Act
- Negotiable Instruments Act, 1881
- Acts governing Individual Institutions
- State Bank of India Act, 1954
- The Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003
- The Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act,1993
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act

Regulation and Supervision

Regulation and supervision of the financial system has received renewed focus in recent years in the context of the phenomenal expansion of the financial sector, technology-enabled innovations in financial products and deepening of global integration. The strategic importance of the banks in the financial system make it imperative for the central bank –historically, the lender of the last resort and the supervisor of the banking system - to pursue **financial stability as an important macroeconomic objective**, although, in India, there are separate institutions (*viz.*, the SEBI and the IRDA) to oversee the functioning of individual segments of the financial system.

A number of initiatives have been taken by the Reserve Bank in reorienting the supervisory and regulatory framework and aligning it

with the international best practices, while providing sufficient flexibility to the financial institutions to respond to the growing competition and taking advantage of the business opportunities unfolded by technological advancements.

- **Narasimham Committee II** made a range of recommendations for improving the vigour of the banking system (capital adequacy, asset quality, nonperforming assets, *etc.*) as also for strengthening the supervisory systems.
- The Committee observed that the issue of 'autonomous status' for the **Board for Financial Supervision (BFS)** of the Reserve Bank should be considered to segregate the regulatory and supervisory functions of the apex bank. The Committee made specific recommendations to restructure the BFS and to set up a separate Board for **Financial Regulation and Supervision (BFRS)**.
- The committee also highlighted the need for a review of banking sector laws, such as, the RBI Act, the Banking Regulation Act, the Nationalization Act and the State Bank of India Act. The recommendations made by the Committee are being progressively implemented.
- Following the recommendations of the Narasimham Committee II and more recently in the context of the **Basel II Accord**, the Reserve Bank has taken several measures to strengthen its regulatory and supervisory framework with a view to ensuring a sound, efficient and vibrant financial system in the country.
- The measures to contain the level of nonperforming assets (NPAs) include the setting up of **Debt Recovery Tribunals** for expeditious adjudication and recovery of debts due to banks and financial institutions, **LokAdalats (people's courts)** and **Asset Reconstruction Companies and Corporate Debt Restructuring (CDR) mechanisms**.
- In order to ensure the functioning of institutions and markets on the basis of informed decisions, the Reserve Bank has issued guidelines to banks to enhance the level of transparency and disclosures with regard to their financial position.

- Bank regulation is increasingly getting **risk based** with the realization that the traditional supervisory practices were out of step with the sophisticated risk management techniques.
- The International Convergence of Capital Measurement and Capital Standards: A Revised Framework (popularly known as **Basel II**) has brought regulation and risk management to the center stage.
- **Basel II rests on three pillars: minimum capital requirements, supervisory review process and market discipline.** India has decided that all the commercial banks would have to be Basel II compliant by adopting, at a minimum, the Standardized Approach for credit risk and Basic Indicator Approach for operational risk under Pillar 1. As regards the supervisory review process (Pillar 2), the role of supervisors is to evaluate whether or not the banks are assessing their capital requirements properly in relation to their risks and if necessary the supervisors may intervene to mandate a higher capital requirement. As regards Pillar 3, the Reserve Bank has been advising banks to make disclosures in order to enhance market discipline.
- A view has been expressed in certain quarters that the Indian regulatory framework should migrate to principles-based regulation from the current rules-based approach.
- The **Basel III** framework introduces a paradigm shift in capital and liquidity standards, which was constructed and agreed to in relatively record time. Basel III proposals have two main objectives:
 - To strengthen global capital and liquidity regulations with the goal of promoting and a more resilient banking sector.
 - To improve the banking sector ability to absorb shocks arising from financial and economic stress, this, in turn, would reduce the risk of a spillover from the financial sector to the real economy.
- To achieve these objectives the Basel III proposals are broken down into three parts on the basis of the main areas they address: Capital reform (including quality and quantity of capital, complete risk coverage, leverage ratio and the introduction of capital conservation buffers, and a counter cyclical capital buffer); Liquidity reform

(short term and long term ratios); and other elements relating to general improvements to the stability of the financial system)

Conclusion

The Indian regulatory regime for the banking sector has come a long way over the past six decades. The current regulatory dispensation is ownership neutral, nondiscriminatory and provides a level playing field for the market participants. There is considerable scope for improvements in the regulatory systems in India and we have been pursuing a policy of constant improvements through a participative and consultative approach with market participants. The policy outcomes so far, in terms of contribution to growth, price stability, financial stability, efficiency and robustness of banking sector have been significant by all standards of measurements, but the search of excellence, in the RBI's mission, is an unending journey.

Self Assessment Questions

- 1) Trace the global evolution of central banking system.
- 2) Explain the phases in the evolution of Central Bank in India.
- 3) Discuss the organization, management and structure of RBI.
- 4) Explain the functions of RBI.
- 5) Write short notes on: a) Financial Inclusion; b) INFINET; c) CRR and SLR; d) Bank Rate; e) Open Market Operations; f) Repo and Reverse Repo rates; g) Lead Bank Scheme
- 6) What are the objectives of monetary policy?
- 7) Explain the operating procedure involved in monetary policy?
- 8) Explain the changes in the operating procedure of monetary policy?
- 9) Explain the various (quantitative and qualitative) methods of credit control.
- 10) What are the areas of central bank independence?
- 11) Trace the evolution of relationship between RBI and Government
- 12) Define Money Market. What are its functions?

- 13) Describe the structure of money market in India.
- 14) What are the features of money market in India?
- 15) Why is money market important?
- 16) Explain the various money market instruments?
- 17) Define Capital Market.
- 18) Trace the history of capital market in India.
- 19) Who are the participants in capital market?
- 20) What are the major banking legislations in India?
- 21) Write a note on the regulation and supervision of financial system in India.

CASE STUDY

Commercial Papers – An Innovative Money Market Instrument

Commercial Paper (CP) is a short-term negotiable money market instrument used by Financial Institutions and Corporations to source funds from the public. The base rate system which came into force on July 1, 2010, in India brought about drastic changes in the Commercial Paper (CP) market in the country. Under this system, banks were not supposed to lend below the base rate. Market analysts noted, "The introduction of the so-called base rate, below which no bank could lend since July 2010, would give a leg up to the commercial paper market in India. Corporations and Non-Banking Finance Companies (NBFCs) would prefer to utilize the CP for short-term funding needs". Under base rate system, the cost of commercial paper worked out to be cheaper than the bank borrowing rate as the borrowers were no longer in a position to negotiate on the lending rate with banks. The banking system had earlier been using the Prime Lending Rate (PLR) for the best rated customers. Borrowers often took undue advantage of the system and took loans for short-term periods at a minimal rate of interest. This led to a situation where the banks were forced to quote competitive, lower rates of interest to retain customers. This posed a serious threat to the profitability of the banks. Subsequently, RBI introduced the "Benchmark Prime Lending Rate System" (BPLR) in place of PLR. It made banks quote BPLR, based on its affordability of

credit. The BPLR was arrived at after taking into account four important components like average cost of deposits, operating expenses, probable loan losses, and a profit margin. Despite these guidelines, the bargaining power of the well-rated borrower forced banks to quote sub-PLR/BPLR rates, to withstand the competition. About 70% of loans to well-rated companies were estimated to have been sanctioned at below PLR/BPLR rates. These practices were cutting into the profit of the banks. Keeping this in view, RBI advised the banks to quote a base rate and to not finance any borrower below this rate. From the month of July 2010, the banks were not allowed to lend below the base rate. Since July 2010, the base rates quoted by the banks were in the range 8.5% to 9.5%. Hence, companies found it difficult to raise credit facilities at a lower rate of interest through the banking system. Commercial Paper appeared to be a better alternate source of finance.

Question

1. Is commercial paper a better alternate source of finance? Analyse.

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UNIT - III

Have you noticed signboards on buildings with names – NABARD, NHB, HDFC, HUDCO, etc? What are these names? Have you tried ever to know about them? Have you entered those buildings? If you go inside these buildings, you can find an office layout. These offices carry out financial services relating to the development of agriculture, industries, etc. They are also called as developmental financial institutions (DFIs), because they support and develop some sectors. Apart from these DFIs, you could also see some specialized financial institutions which are support and develop sectors like housing, tourism, shipping, export & import, etc. You could also see some international financial institutions like International Finance Corporation (IFC), International Development Association (IDA), etc. Besides, you could also see some Micro Financial Institutions (MFIs). Let us understand the structure of agricultural and industrial banking system in India and the role of DFIs.

Unit Structure

Lesson 3.1 - Developmental Financial Institutions

Lesson 3.2 - State Level Financial Institutions and Investment Institutions

Lesson 3.3 - Specialised Financial Institutions

Lesson 3.4 - International Financial Institutions

Lesson 3.5 - Agricultural, Rural and Micro Financial Institutions

Lesson 3.1 - Developmental Financial Institutions

Learning Objectives

- To understand the structure of agricultural and industrial banking system in India.
- To understand the role of Industrial Finance Corporation of India (IFCI)
- To understand the role of ICICI Bank or Erstwhile Industrial Credit Investment Corporation of India (ICICI)(converted itself into Universal Bank – Private Sector Bank Category)
- To understand the role of IDBI Ltd. or Erstwhile Industrial Development Bank of India (IDBI) (now converted itself into Universal Bank – Other Public Sector Bank Category)
- To understand the role of Small Industries Development Corporation of India (SIDBI)
- To understand the role of Industrial Investment Bank of India (IIBI) or Erstwhile Industrial Reconstruction Bank of India (IRBI)

Introduction

Development Banks or Development Financial Institutions (DFIs) were established mainly to provide long-term capital for industry and agriculture. It had been found that commercial banks, by the short-term nature of their deposits which they mobilize, were in a position to grant only short-term credit to industry and agriculture to meet their working capital requirements. An attempt was made, initially in Germany, to start industrial banks or mixed banks as they were commonly called to give long term credit to industry and these banks had a fair amount of success in the industrialization of Germany.

But in developing countries like India it was not possible to have mixed banking, even though there was a great demand for such institutions to finance economic growth. The basic reason for this was that banking

habit has not fully developed and that commercial banks could not take heavy risks by freezing short-term depositor's money in long-term and medium-term loans to industry and agriculture.

It was in this context that the Government of India established a number of institutions since independence to provide long-term finance to industry, trade and agriculture. The Government of India along with RBI and the banking system set up IFCI, SFCs, ICICI, IDBI, IRBI, Unit Trust of India, LIC and GIC. All these institutions provide finance for industries. Then we have Export-Import Bank (EXIM Bank) which specializes in international trade, the National Bank for Agriculture and Rural Development (NABARD), the Shipping Credit and Investment Company Ltd to finance shipping and fishing industries, etc. These institutions were called development banks or public sector financial institutions. They are now referred to as development finance institutions (DFIs).

Structure of Industrial and Agricultural Banking System in India

The Indian agricultural and industrial banking system has travelled a lot and many changes have happened in tune with the requirements of the industry, trade, agriculture and other specialized sectors. The financial institutions which help industry, agriculture and other sectors in India can be classified into five categories and they consist of the following institutions.

Category I: All India Developmental Financial Institutions

- a) Industrial Finance Corporation of India (IFCI)
- b) Industrial Credit Investment Corporation of India (ICICI)
- c) Industrial Development Bank of India (IDBI)
- d) Small Industries Development Bank of India (SIDBI)
- e) Industrial Investment Bank of India (IIBI) or Erstwhile Industrial Reconstruction Bank of India (IRBI)

Category II: State Level Financial Institutions

- a) State Financial Corporations (SFCs)
- b) State Industrial Development Corporations (SIDCs)

Category III: Specialized Financial Institutions

- a) Export and Import Bank of India
- b) Risk Capital and Technology Finance Corporation Ltd (RCTC)
- c) Technology Development and Information Company of India Ltd. (TDICI)
- d) Shipping Credit and Investment Company of India Ltd. (SCICI)
- e) Tourism Finance Corporation of India Ltd. (TFCI)
- f) Housing and Urban Development Corporation of India (HUDCO)
- g) Housing Development and Finance Corporation (HDFC)

Category IV: Agricultural and Micro Financial Institutions

- a) National Bank for Agricultural and Rural Development (NABARD)
- b) Micro Financial Institutions (MFIs)

Category V: Investment Institutions

- a) Unit Trust of India (UTI)
- b) Life Insurance Corporation (LIC)
- c) General Insurance Corporation (GIC)

Besides the above financial institutions, there are some **international financial institutions** which help many countries. They include

- a) International Monetary Fund
- b) International Bank for Reconstruction and Development (IBRD)
- c) International Development Association (IDA)
- d) International Finance Corporation (IFC)

Let us now understand the role of all India Developmental Financial Institutions.

Role of Industrial Finance Corporation of India (IFCI)

Genesis of IFCI

At the time of independence in 1947, India's capital market was relatively under-developed. Although there was significant demand for new capital, there was a dearth of providers. Merchant bankers and underwriting firms were almost non-existent and commercial banks were not equipped to provide long-term industrial finance in any significant manner. It is against this backdrop that the government established The Industrial Finance Corporation of India (IFCI) on July 1, 1948, as the first Development Financial Institution (DFI) in the country to cater to the long-term finance needs of the industrial sector. The newly-established DFI was provided access to low-cost funds through the central bank's Statutory Liquidity Ratio or SLR which in turn enabled it to provide loans and advances to corporate borrowers at concessional rates.

Liberalization - Conversion into Company in 1993

By the early 1990s, it was recognized that there was need for greater flexibility to respond to the changing financial system. It was also felt that IFCI should directly access the capital markets for its funds needs. It is with this objective that the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956. Subsequently, the name of the company was also changed to "IFCI Limited" with effect from October 1999.

Corporate Strategy

IFCI has been able to achieve a financial turnaround with the consistent support and cooperation of all its stakeholders and is now endeavouring to re-position itself. In addition to its core competence in long term lending to industrial and infrastructure sectors, IFCI aims to enhance its organizational value through better realization of its Non-performing Assets (NPAs) and unlocking of value of its investment portfolio including unquoted investments as well as real estate assets.

Indian Economy and IFCI

Until the establishment of ICICI in 1956 and IDBI in 1964, IFCI remained solely responsible for implementation of the Government's industrial policy initiatives. It made a significant contribution to the modernization of Indian industry, export promotion, import substitution, pollution control, energy conservation and generation through commercially viable and market-friendly initiatives. Some sectors that have directly benefited from IFCI include:

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

IFCI's Economic Contribution

IFCI's economic contribution can be measured from the following:

1. By way of illustration, IFCI's assistance has been helped to create production capacities of 6.5 million spindles in the textile industry, 7.2 million tons per annum (tpa) of sugar production, million tpa of paper and paper products, 18.5 million tpa of fertilizers, 59.3 million tpa of cement, 30.2 million tpa of iron and steel, 32.8 million tpa of petroleum refining, 14,953 MW of electricity, 22,106 hotel rooms, 5,544 hospital beds, 8 port projects, 66 telecom projects and 1 bridge project.
2. The direct employment generated as a result of its financial assistance is estimated at almost 1 million persons.
3. IFCI has played a key role in the development of cooperatives in the sugar and textile sectors, besides acting as a nodal agency in both sectors. 371 cooperative societies in these sectors have been assisted by IFCI.
4. IFCI has promoted Technical Consultancy Organizations (TCOs), primarily in less developed states to provide necessary services to the

promoters of small and medium-sized industries in collaboration with other banks and institutions.

5. IFCI has also provided assistance to self-employed youth and women entrepreneurs under its Benevolent Reserve Fund (BRF) and the Interest Differential Fund (IDF).
6. IFCI has founded and developed prominent institutions like:
 - Management Development Institute (MDI) for management training and development
 - ICRA for credit assessment rating
 - Tourism Finance Corporation of India (TFCI) for promotion of the hotel and tourism industry
 - Institute of Leadership Development (ILD) for rehabilitation and training of displaced and retrenched labor force.
 - Rashtriya Gramin Vikas Nidhi (RGVN) for promoting, supporting and developing voluntary agencies engaged in uplifting rural and urban poor in east and northeast India.
7. IFCI, along with other institutions, has also promoted:
 - Stock Holding Corporation of India Ltd. (SHCIL)
 - Discount and Finance House of India Ltd. (DFHI)
 - National Stock Exchange (NSE)
 - Over the Counter Exchange of India (OTCEI)
 - Securities Trading Corporation of India (STCI)
 - LIC Housing Finance Ltd.
 - GIC Housing Finance Ltd. and
 - Biotech Consortium India Ltd. (BCIL).
8. IFCI has also set up Chairs in reputed educational/management institutions and universities.
9. A major contribution of IFCI has been in the early assistance provided by it to some of today's leading Indian entrepreneurs who may not have been able to start their enterprises or expand without the initial support from IFCI.

Role of Industrial Credit Investment Corporation of India (Erstwhile ICICI) – (Now ICICI Bank - Private Sector Bank)

History of Erstwhile ICICI

The Industrial Credit and Investment Corporation of India Limited (ICICI) incorporated in the year 1955, at the initiative of the World Bank, the Government of India and representatives of Indian industry, with the objective of creating a development financial institution for providing medium-term and long-term project financing to Indian businesses. Mr.A.Ramaswami Mudaliar elected as the first Chairman of ICICI Limited. ICICI emerged as the major source of foreign currency loans to Indian industry. Besides funding from the World Bank and other multi-lateral agencies, ICICI was also among the first Indian companies to raise funds from international markets. As a result of nationalization of major commercial banks and insurance companies (which were the shareholders of ICICI) in 1969, over 80 percent of its issued share capital was held by public sector corporations. Despite the majority public sector shareholding until the 1990, ICICI maintained the dynamism of a private sector DFI. Because of the high growth in operations and with the development of the capital market, ICICI increased equity, as well as domestic and international borrowing, and changed its shareholding pattern. In 1991/92 ICICI made a right-cum-public share issue of ₹ 1 billion. This resulted in the decline of the share of the public sector and the increase of individual holders.

Scope of Operations of Erstwhile ICICI

ICICI's operational activities consisted mainly of extending medium- and long-term loans in local and foreign currencies to assist in the creation, expansion, and modernization of medium and large industrial enterprises, predominantly in the private sector. ICICI had played a key role in providing foreign exchange financing. It also makes equity investments, underwrites new shares and debenture issues, and guarantees loans from other investment sources. Since the early 1980s, as a part of its strategy to provide various forms of assistance to industry, ICICI had diversified its activities to cover financial services, such as leasing and deferred credit. As the Indian economy began to be liberalized in the early 1990s, ICICI needed to become a financial supermarket by offering a wide range of financial services to cope with growing opportunities and competition.

ICICI entered new areas of business, such as commercial banking and asset management, and expanded its existing businesses, for example, merchant banking services, which include capital issue management. For regulatory and strategic reasons, specialized subsidiaries were established for the following activities: investment banking, commercial banking, fund management, investor services, and broking.

In addition, ICICI had diversified its own range of activities into several fee-based services, including custodial services to cater to the needs of foreign and domestic institutional investors. To facilitate the globalization of Indian industry, ICICI had established new divisions to advise Indian corporations planning to establish operations abroad and foreign companies looking for local partners. ICICI also provided technology financing for development and commercialization of technology. ICICI had already played a key role in the infrastructure sector by providing advisory services to the Central Government and state governments and to government agencies in the power and telecommunications sectors, and has sanctioned \$486 million for projects mainly in power and ports.

Emergence of ICICI Bank

ICICI Bank was originally promoted in 1994 by ICICI Limited, an Indian developmental financial institution, and was its wholly-owned subsidiary. ICICI's shareholding in ICICI Bank was reduced to 46% through a public offering of shares in India in fiscal 1998, an equity offering in the form of ADRs listed on the NYSE in fiscal 2000, ICICI Bank's acquisition of Bank of Madura Limited in an all-stock amalgamation in fiscal 2001, and secondary market sales by ICICI to institutional investors in fiscal 2001 and fiscal 2002. ICICI was formed in 1955 at the initiative of the World Bank, the Government of India and representatives of Indian industry. The principal objective was to create a development financial institution for providing medium-term and long-term project financing to Indian businesses.

In the 1990s, ICICI transformed its business from a development financial institution offering only project finance to a diversified financial services group offering a wide variety of products and services, both directly and through a number of subsidiaries and affiliates like ICICI Bank. In 1999, ICICI became the first Indian company and the first bank or financial institution from non-Japan Asia to be listed on the NYSE.

Reverse Merger of ICICI with ICICI Bank

After consideration of various corporate structuring alternatives in the context of the emerging competitive scenario in the Indian banking industry, and the move towards universal banking, the managements of ICICI and ICICI Bank formed the view that the merger of ICICI with ICICI Bank would be the optimal strategic alternative for both entities, and would create the optimal legal structure for the ICICI group's universal banking strategy. The merger would enhance value for ICICI shareholders through the merged entity's access to low-cost deposits, greater opportunities for earning fee-based income and the ability to participate in the payments system and provide transaction-banking services. The merger would enhance value for ICICI Bank shareholders through a large capital base and scale of operations, seamless access to ICICI's strong corporate relationships built up over five decades, entry into new business segments, higher market share in various business segments, particularly fee-based services, and access to the vast talent pool of ICICI and its subsidiaries.

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

Profile of ICICI Bank

ICICI Bank is India's second-largest bank with total assets of ₹ 4,736.47 billion (US\$ 93 billion) at March 31, 2012 and profit after tax ₹ 64.65 billion (US\$ 1,271 million) for the year ended March 31, 2012. The Bank has a network of 2,899 branches and 10,021 ATMs in India, and has a presence in 19 countries, including India. ICICI Bank offers a wide range of banking products and financial services to corporate and retail customers through a variety of delivery channels and through its specialized subsidiaries in the areas of investment banking, life and non-life insurance, venture capital and asset management.

The Bank currently has subsidiaries in the United Kingdom, Russia and Canada, branches in United States, Singapore, Bahrain, Hong Kong, Sri Lanka, Qatar and Dubai International Finance Centre and representative offices in United Arab Emirates, China, South Africa, Bangladesh, Thailand, Malaysia and Indonesia. Our UK subsidiary has established branches in Belgium and Germany. ICICI Bank's equity shares are listed in India on Bombay Stock Exchange and the National Stock Exchange of India Limited and its American Depositary Receipts (ADRs) are listed on the New York Stock Exchange (NYSE).

Role of ICICI Group as Universal Bank

Over the years, the ICICI Group has created a virtual Universal Banking Group that offers a comprehensive range of financial products and services in the areas of commercial banking, investment banking, asset management, venture capital, state level infrastructure financing, housing finance, personal financial services, investor servicing and broking. ICICI's vision is to be the preferred brand for total financial and banking solutions. ICICI offers the following financing products for urban infrastructure:

- Direct loan, including under the Asian Development Bank (ADB); Urban Infrastructure and Environmental facility (UEIF), which is a specialized line of credit for urban infrastructure being offered by ICICI;
- Structured & project finance for projects involving private participation in Build Operate Own (BOO)/Build Operate Transfer (BOT)/Build Own Operate Transfer (BOOT) or other variants of contractual structuring;
- Leasing, which can be an attractive option for financing of movables for municipal corporations since they are non-tax paying entities;
- Capital market issuance through our merchant banking arm, ICICI Securities Limited;
- ICICI Bank offers retail-banking products including ATMs, power pay, consumer loans, credit cards etc.;
- ICICI Group can also assist in E- Governance related products including provision of municipal forms through internet, payment gateways, electronic bill presentment and payments, etc.

Role of Industrial Development Bank of India (IDBI) (Erstwhile IDBI) – (Now IDBI Bank Ltd. – Other Public Sector Bank Category)

Brief History of IDBI

Industrial Development Bank of India (IDBI) was established in 1964 by the Government of India (GoI) under an Act of Parliament, the Industrial Development Bank of India Act, 1964 (the IDBI Act), as a wholly-owned subsidiary of Reserve Bank of India (RBI) to provide credit and extend other facilities for the development of industry. In 1976, the ownership of IDBI was transferred to the GOI and it was entrusted with the additional responsibility of acting as the principal financial institution for coordinating the activities of institutions engaged in financing, promotion or development of industry.

Over the last four decades, IDBI's role as catalyst to industrial development has encompassed a broad spectrum of activities. IDBI had extended finance to all types of industrial concerns covered under the provisions of the IDBI Act irrespective of the size or form or sector of organization. IDBI primarily provided finance to large and medium industrial enterprises engaged or to be engaged in the manufacture, processing or preservation of goods, mining, shipping, transport, hotel industry, information technology, medical and health, leasing generation and distribution of power; maintenance, repair, testing, servicing of vehicles; setting up of industrial estates as also in the research and development for promotion of industrial growth.

IDBI had also been assigned a special role for co-coordinating the activities of institutions engaged in financing, promoting or developing industries. In the past, the GOI had provided direct and indirect financial assistance and support to IDBI including access to low cost funds and assistance by way of restructuring of high cost liabilities. Though GOI has no legal obligation to provide financial assistance or extend support to IDBI, it had done so from time to time considering the unique role assigned to IDBI in the industrial development of the country. The structural changes in the industrial sector including the opening up of the economy and the ongoing disintermediation in the financial sector had changed the credit profile of IDBI. The sources and availability of cheap long term funds declined resulting in difficulties in operations as a standalone DFI.

Industrial Development Bank of India Limited

In response to the felt need and on commercial prudence, it was decided to transform IDBI into a Bank. For the purpose, Industrial Development bank (transfer of undertaking and Repeal) Act, 2003 [Repeal Act] was passed repealing the Industrial Development Bank of India Act, 1964. In terms of the provisions of the Repeal Act, a new company under the name of Industrial Development Bank of India Limited (IDBI Ltd.) was incorporated as a Govt. Company under the Companies Act, 1956 on September 27, 2004. Thereafter, the undertaking of IDBI was transferred to and vested in IDBI Ltd. with effect from the effective date of October 01, 2004. In terms of the provisions of the Repeal Act, IDBI Ltd. has been functioning as a Bank in addition to its earlier role of a Financial Institution.

Merger of IDBI Bank with IDBI

To create a more conducive environment for the transition and to give fillip to the business operations of the new entity (IDBI Ltd.), the then IDBI's Board decided that for effective transition to a banking company, IDBI Ltd. should leverage on its banking subsidiary, IDBI Bank Ltd. The scheme of Amalgamation/Merger of IDBI Bank Ltd. with IDBI Ltd became effective from October 1, 2004 after the same was approved separately by the respective General Body of Shareholders and by RBI, in terms of the provisions of the Banking Regulation Act, 1949.

The merger has brought in benefits in terms of enhanced size and improved quality of balance sheet, lower cost of funds, extended branch network, a higher technology platform, lean workforce, along with a wide array of retail and wholesale products. This has benefited the various stakeholders by increased value creation, along with the convenience of a universal bank. The benefits of economies of scale and the convenience of single-window servicing to clients is a major advantage. The opportunity for the Bank has come from the access to cheaper short-term retail funds. This has enabled the Bank to lower its overall cost of liability and price the products competitively.

Enlarging the clientele base through market penetration, product diversification or market development, market segmentation and pro-

viding structured products under a single roof are the other advantages for the Bank. Also, the enlarged capital base of the Bank has provided impetus to expanding business. The in-house knowledge and expertise in long term finance, including project finance, coupled with the skill of retail financing, has enabled the merged entity to emerge as a preferred source of finance from all segments of the market. IDBI Ltd. has, therefore, become a banking company, having a wide array of wholesale and retail products.

Merger of Erstwhile United Western Bank Ltd. (UWB)

The Government of India, by a notification dated September 30, 2006, conveyed its approval of the amalgamation of erstwhile UWB with IDBI Ltd., with effect from October 3, 2006. Following the amalgamation of erstwhile UWB into IDBI, the Bank's delivery channels now comprise 508 branches, 880 ATMs spread across 320 centers. Further, the acquisition of UWB has, inter alia, helped growing IDBI's low-cost CASA deposit base and priority sector business volumes.

Change of Name

To properly reflect the business of banking being carried on by it, the name of 'Industrial Development Bank of India Limited' has been changed to 'IDBI Bank Limited' w.e.f. May 07, 2008, the date on which the Registrar of Companies, Maharashtra, issued fresh certificate of incorporation. Subsequently, the change of name was notified by Reserve Bank of India vide DBOD.BP.BC.NO.21.01.002/2007-08 dated May 16, 2008, which was published in Government Gazette dated on June 14, 2008.

Government Holding

As on February 27, 2009, the Central Government's shareholding in IDBI Ltd. is 52.68%. The provisions of Memorandum and Articles of Association of IDBI Ltd. require that the "Central Government being a shareholder of the Company, shall at all times maintain not less than 51% of the issued capital of the Company. IDBI Ltd. has been categorized as "Other Public Sector Bank" by the RBI. Further, the Central Government has advised all its Ministries that the Bank "may be treated on par with Nationalized Banks/State Bank of India by Government Departments/

Public Sector Undertakings/ other entities for all purposes, including deposits/bonds/ investments/ guarantees and government business”.

Profile of IDBI Bank Ltd.

IDBI Bank Ltd. is today one of India's largest commercial Banks. For over 40 years, IDBI Bank has essayed a key nation-building role, first as the apex Development Financial Institution (DFI) (July 1, 1964 to September 30, 2004) in the realm of industry and thereafter as a full-service commercial Bank (October 1, 2004 onwards). As a DFI, the erstwhile IDBI stretched its canvas beyond mere project financing to cover an array of services that contributed towards balanced geographical spread of industries, development of identified backward areas, emergence of a new spirit of enterprise and evolution of a deep and vibrant capital market. On October 1, 2004, the erstwhile IDBI converted into a Banking company (as Industrial Development Bank of India Limited) to undertake the entire gamut of Banking activities while continuing to play its secular DFI role. Post the mergers of the erstwhile IDBI Bank with its parent company (IDBI Ltd.) on April 2, 2005 (appointed date: October 1, 2004) and the subsequent merger of the erstwhile United Western Bank Ltd. with IDBI Bank on October 3, 2006, the tech-savvy, new generation Bank with majority Government shareholding today touches the lives of millions of Indians through an array of corporate, retail, SME and Agri products and services.

Headquartered in Mumbai, IDBI Bank today rides on the back of a robust business strategy, a highly competent and dedicated workforce and a state-of-the-art information technology platform, to structure and deliver personalized and innovative Banking services and customized financial solutions to its clients across various delivery channels. As on March 31, 2012, IDBI Bank has a balance sheet of ₹2.91 lakh crore and business size (deposits plus advances) of ₹3.92 lakh crore. As a Universal Bank, IDBI Bank, besides its core banking and project finance domain, has an established presence in associated financial sector businesses like Capital Market, Investment Banking and Mutual Fund Business. Going forward, IDBI Bank is strongly committed to work towards emerging as the 'Bank of choice' and 'the most valued financial conglomerate', besides generating wealth and value to all its stakeholders.

Role of Small Industries Development Bank of India (SIDBI)

History

Small Industries Development Bank of India (SIDBI), set up on April 2, 1990 under an Act of Indian Parliament, is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities.

Provision of Charter

SIDBI was established on April 2, 1990. The Charter establishing it, The Small Industries Development Bank of India Act, 1989 envisaged SIDBI to be “the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto.

Business Domain of SIDBI

The business domain of SIDBI consists of Micro, Small and Medium Enterprises (MSMEs), which contribute significantly to the national economy in terms of production, employment and exports. MSME sector is an important pillar of Indian economy as it contributes greatly to the growth of Indian economy with a vast network of around 3 crore units, creating employment of about 7 crore, manufacturing more than 6,000 products, contributing about 45% to manufacturing output and about 40% of exports, directly and indirectly. In addition, SIDBI's assistance also flows to the service sector including transport, health care, tourism sectors etc.

Mandatory Objectives

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

- Financing
- Promotion

- Development
- Co-ordination

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

Development Outlook

The major issues confronting MSMEs are identified to be:

Technology obsolescence

- Managerial inadequacies
- Delayed Payments
- Poor Quality
- Incidence of Sickness
- Lack of Appropriate Infrastructure and
- Lack of Marketing Network

There can be many more similar issues hindering the orderly growth of MSMEs. Over the years, SIDBI has put in place financing schemes either through its direct financing mechanism or through indirect assistance mechanism and special focus programmes under its P&D initiatives. In its approach, SIDBI has struck a good balance between financing and providing other support services.

Co-ordination and Understanding

As an apex institution, SIDBI makes use of the network of the banks and state level financial institutions, which have retail outlets. SIDBI supplements the efforts of existing institutions through its direct assistance schemes to reach financial assistance to the ultimate borrowers in the small scale sector. Refinancing, bills rediscounting, lines of credit and resource support mechanisms have evolved over the period of time to

route SIDBI's assistance through the network of other retail institutions in the financial system. Improved levels of co-ordination for development of the small scale sector is also achieved through a system of dialogue and obtaining feedback from the representatives of institutions of small scale industries who are on the SIDBI's National Advisory Committee and Regional Advisory Committees.

SIDBI's MOUs

SIDBI has entered into Memoranda of Understanding with many banks, governmental agencies, international agencies, research & development institutions and industry associations to facilitate a co-ordinated approach in dealing with the issues for development of small scale industries. SIDBI's MOUs include the following:

- Banks - (18)
- Swiss Agency for Development and Co-operation
- Small Industries Development Organization
- Auto Components Manufactures Association
- Council for Scientific and Industrial Research
- Asia and Pacific Centre for Transfer of Technology
- United Nations Industrial Development Organization
- Confederation of Indian Industry
- National Research Development Organization
- Government of India for channelizing TREAD assistance
- Small Enterprise Assistance Funds (SEAF) For setting up of SEAF India SME Equity Fund and for other capacity building initiatives for SMEs

Mission

“To facilitate and strengthen credit flow to MSMEs and address both financial and developmental gaps in the MSME eco-system”

Vision

To emerge as a single window for meeting the financial and developmental needs of the MSME sector to make it strong, vibrant

and globally competitive, to position SIDBI Brand as the preferred and customer - friendly institution and for enhancement of share - holder wealth and highest corporate values through modern technology platform.

Shareholding

The entire issued capital of ₹450 crore has been divided into 45 crore shares of ₹10 each. Of the total ₹450 crore subscribed by IDBI, while setting up of SIDBI, 19.21% has been retained by it and balance 80.79% has been transferred / divested in favour of banks / institutions / insurance companies owned and controlled by the Central Government.

Associates of SIDBI

a) *Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE)*

Credit to micro and small enterprises sector is generally perceived as high risk lending, more so, when there is absence of any collateral. In order to encourage banks to lend more to this sector, Government of India and SIDBI have set up the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) in July 2000, to provide credit guarantee support to collateral free / third-party guarantee free loans up to ₹ 100 lakh extended by banks and lending institutions for micro and small enterprise (MSEs) under its Credit Guarantee Scheme (CGS).

India SME Technology Services Ltd. India SME Technology Services Limited (ISTSL), set up in November 2005, provides a platform for MSMEs to tap opportunities at the global level for acquisition of modern technologies. ISTSL continues to pursue its strategy of rendering technical services for technology transfer and promotion of energy efficient, environment friendly technologies in the MSME sector. Efforts are being made to facilitate reduction in Green House Gases in the MSME sector.

In order to strengthen and accelerate the process of technological modernization in the MSME sector, ISTSL has entered into partnership with various national and international organizations engaged in similar activities. ISTSL took up the project for implementing Energy Efficient technologies in Stainless Steel Re-rolling Cluster of Jodhpur, in association

with KfW, Germany. The project is now being taken up for implementing Clean Development Mechanism (CDM) project by implementing Energy Efficiency measures, which are expected to generate CDM revenues, besides reducing the cost of fuel being consumed by the units.

b) *SME Rating Agency of India Ltd. (SMERA)*

SIDBI, along with leading public, foreign and private sector banks and Dun & Bradstreet Information Services India Private Limited (D&B), set up SME Rating Agency of India Ltd. (SMERA) in September 2005, as an MSME dedicated third-party rating agency to provide comprehensive, transparent and reliable ratings and risk profiling.

c) *India SME Asset Reconstruction Company Ltd (ISARC)*

India SME Asset Reconstruction Company Ltd (ISARC) is the country's first MSME focused Asset Reconstruction Company striving for speedier resolution of non-performing assets (NPA) by unlocking the idle NPAs for productive purposes which would facilitate greater and easier flow of credit from the banking sector to the MSMEs. Set up in April 2008, ISARC's objective is to acquire NPAs and strive to maximize recovery value through innovative resolution methods. It also complied with the conditions stipulated by RBI while granting the Certificate of Registration as an ARC and became fully operational from April 15, 2009.

Subsidiaries

a) *SIDBI Venture Capital Limited (SVCL)*

SIDBI Venture Capital Ltd. (SVCL), a subsidiary of SIDBI set up in July, 1999, is an asset management company, presently managing two venture capital funds, viz. the National Venture Fund for Software and Information Technology Industry (NFSIT) and the SME Growth Fund (SGF) for providing venture capital assistance to knowledge based MSMEs, especially in the areas of auto components, textiles, life sciences, clean technologies, retailing, light engineering, information technology, services etc.

b) *SIDBI Trustee Company Limited (STCL)*

STCL has been set up to carry out trusteeship functions for Venture Capital Funds. Presently STCL is acting as Trustee of National Venture Fund for Software and Information Technology.

Role of Industrial Reconstruction Bank of India (IRBI) or Industrial Investment Bank of India (IIBI)

The Industrial Reconstruction Corporation of India Ltd. was set up in 1971 as a primary agency for rehabilitation of sick industrial units. It was renamed as the Industrial Reconstruction Bank of India (IRBI) by an Act of Parliament with effect from March 20, 1985. IRBI functions as the principal credit and reconstruction agency for industrial revival by undertaking, modernization, expansion, reorganization, diversification or rationalization of industry and also coordinates similar work of other institutions engaged therein and to assist and rehabilitate industrial concerns.

In March 1997, the **Industrial Reconstruction Bank of India itself was named as Industrial Investment Bank of India** and converted into a limited company to provide it operational flexibility to become self-reliant. The Industrial Investment Bank has thus become a full-fledged development financial institution. It will, however, continue its traditional role of nursing ailing industrial units.

The IIBI is empowered

- to grant loans and advances to industrial concerns,
- to underwrite stocks, shares, bonds and debentures,
- to guarantee loans/deferred payments and performance obligations of any contracts undertaken by industrial concerns, and
- to act as an agent of Central and State Governments, Reserve Bank, State Bank, Scheduled Commercial and State Cooperative banks, public financial institutions, SFCs, etc.

Its functions also include development activities such as providing infrastructural facilities, raw materials, consultancy, managerial and merchant banking services for reconstruction and development of

industrial concerns and providing machinery and other equipment on lease or hire-purchase basis.

The IIBI is empowered to take over management or possession or both and can transfer by way of lease and sale the property of defaulting industrial concerns. It can prepare schemes for reconstruction by scaling down the liabilities to submit the schemes of merger or amalgamation for approval of the Central Government. The Bank borrows funds from the Government and also by way of issuing bonds and debentures.

Conclusion

The role of developmental financial institutions in India is remarkable and the IFIC, erstwhile ICICI and erstwhile IDBI have contributed a lot for the development of industries. Further, both ICICI and IDBI have now emerged as universal banks and provide all the financial services under one umbrella.

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Lesson 3.2 - State Level Financial Institutions and Investment Institutions

Learning Objectives

- To understand the role of State Finance Corporations (SFCs)
- To understand the role of State Industries Development Corporations (SIDCs)
- To understand the role of Unit Trust of India (UTI)
- To understand the role of Life Insurance Corporation (LIC)
- To understand the role of General Insurance Corporation (GIC)

Introduction

In order to provide medium and long term credit to industrial undertakings, which fall outside the normal activities of Commercial Banks, a Central Industrial Finance Corporation was set up under the Industrial Finance Corporation Act, 1948 (XV of 1948). The State Governments wished that similar Corporations should also be set up in the States to supplement the work of the Industrial Finance Corporation. The intention is that the State Corporations will confine their activities to financing medium and small scale industrial and will, as far as possible, consider only such cases as are outside the scope of the Industrial Finance Corporation.

Role of Various State Finance Corporations (SFCs)

1) Andhra Pradesh State Financial Corporation (APSFC)

Andhra Pradesh State Financial Corporation [APSFC] is a term lending Institution established in 1956 for promoting small and medium scale industries in Andhra Pradesh under the provisions of the State Financial Corporations Act, 1951. The corporation came into existence on 1-11-1956 by merger of Andhra State Financial Corporation and Hyderabad State Financial Corporation.

The corporation has launched many entrepreneur-friendly schemes to provide term loans, working capital term loans, special and seed capital assistance to suit the needs of various categories of entrepreneurs. The Corporation has completed five decades of dedicated service in industrial financing of tiny, small and medium scale sector units and contributing to the balanced regional development of the state.

Objective of APSFC

- To industrialize the State through balanced regional development and dispersal of industries
- To support promotion and development of tiny, small and medium scale industries and service sector units by extending need based credit to them.
- Nurtures entrepreneurship and encourages first generation entrepreneurs
- To act as a catalyst for generation of employment

Andhra Pradesh State Financial Corporation (APSFC) extends financial assistance for setting up industrial units in Small & Medium Scale, Service enterprises in the state of Andhra Pradesh. The Corporation extends finance basically through two products the Term Loans and the Working Capital Term Loans.

2) Assam Financial Corporation (AFC)

The objective of AFC is to provide financial assistance to Micro, Small & Medium scale industries within its jurisdiction covering the North Eastern States of Assam, Meghalaya, Manipur and Tripura.

The Assam Financial Corporation was established as a Joint State Financial Corporation under Section 3(A) of the SFC's Act 1951 way back in 1954 covering the erstwhile-undivided Assam with two union territories of Manipur and Tripura and operating in this North-East Region for more than five decades. As the premier Financial Institution (F.I.) in the North-East Region, it has a wide outreach at the grass root level compared to other Financial Institutions (FIs) and Banks. The sources of capital and operating fund include: a) Share Capital from participating State Govts.

and SIDBI; b) Borrowings by way of Refinance from SIDBI; c) Market Borrowings by way of SLR Bonds; d) Ad-hoc Borrowings from RBI; and e) Recovery of Loans and Advances.

Loans & Schemes include General Loan, Scheme for Medical Professionals, Equipment Finance Scheme, Scheme For Working Capital Loan, Transport Loan Scheme and Venture Capital Scheme.

3) Bihar State Financial Corporation (BSFC)

Bihar State Financial Corporation was established in the year 1954 under SFC's Act, 1951 to promote Small and Medium Scale Industries by way of providing financial assistance. Since then it is playing major role in growth of tiny, small and medium industries in the erstwhile State of Bihar (Presently Bihar and Jharkhand). It has contributed significantly to the growth of various Sectors defined as Industrial concern under SFC's Act, 1951 (as amended from time to time). From early 70's it has also provided liberal financial assistance under special schemes like educated unemployed, composite loans to small artisans, Mahila Udyog Nidhi, Semfex etc. for creating self-employment opportunities to artisans, educated unemployed, women entrepreneurs and ex-service men. It has also provided financial assistance for setting up Hotels/Motels including Marketing Complex, Nursing Homes and also for Electro Diagnostic Equipments etc.

Many of the Industrial concern set up with financial assistance from BSFC have gone for expansion, established themselves prominently and are contributing to the exchequer of the State Government. Majority of the successful industrial units in Bihar and Jharkhand were earlier assisted by BSFC, which later on have expanded their activities with the support of Banks and other Financial Institutions, as their further requirement of fund exceeded the limit of financial assistance which BSFC could provide as per provision of SFC's Act. BSFC definitely has played a pivotal role in development of industries in the State.

4) Delhi Financial Corporation (DFC)

The objectives of DFC is to promote finance and develop industries/service activities in the small and medium scale sectors

including commercial transport in the NCT, Delhi and UT Chandigarh. The business domain of DFC consist of small scale industrial unit (Units in which the investment in plant and machinery does not exceed ₹ 10 million) and medium scale industry including service and transport industries. However, DFC does not finance new medium scale industrial units in Union Territory of Delhi in consonance with the industrial policy of Delhi Government.

5) Gujarat State Financial Corporation (GSFC)

Gujarat State Financial Corporation (GSFC) is a pioneer term lending development financial institution in the State of Gujarat. It is created under the State Financial Corporation Act, 1951 passed by Parliament. GSFC's mandate is to provide finance to small and medium scale enterprises. Formed in 1960, GSFC has sanctioned loans and advances of over ₹4400 crores; out of which, it has disbursed over ₹3,300 crores to 47,000 units in the state. This has created almost 6,83,000 jobs in Gujarat. The Corporation has played a stellar role in creating new and first time entrepreneurs, has provided much needed finance to small and medium sale enterprises and has played a significant role in the industrial development and economic growth of Gujarat.

GSFC at a Glance

- Incorporated on 1st May, 1961. Its main object is to provide financial assistance to small and medium scale new/existing industrial and service sector units all over Gujarat for acquisition of fixed assets, preliminary and pre-operative expenses, expansion, modernization, diversification etc.
- GSFC has played an important role in the industrial development of the state. Till date, it has financed 47,331 units and disbursed ₹ 3,300 crore, generating employment for over 6,00,000 persons. Many units financed by it are now well established and have also graduated from small to medium and large scale.
- Since the last few years, Corporation is passing through financially difficult times. Due to very heavy NPA and as commercial banks are now performing similar activity has stopped advancing fresh loans since October 2001.

- Currently, it is engaged in the activity of recovering dues from its borrowers and paying its lenders.
- One Time Settlement schemes have been introduced to expedite recovery.
- Cost cutting exercise has been implemented to reduce manpower by deputing staff to various Government departments and by implementing VRS
- Government has formed a high-powered committee under Chief Secretary to decide on the future of GSFC. Committee has decided to offer VRS to employees, have OTS scheme and restructure the organization.

6) **Economic Development Corporation of Goa (EDC)**

The EDC Limited, formerly known as the Economic Development Corporation of Goa, Daman & Diu Limited (EDC) incorporated on 12th March 1975, as a development bank, enjoying the twin status of a State Finance Corporation (SFC) & an Industrial Development Institution. Over the last 35 years of its existence it has been a catalyst for economic development & main stream industrial growth in Goa.

The history of EDC is a repertoire of milestone achievements. It has already extended financial assistance of over ₹800 crores by way of term loans to more than 5000 industrial & service sector projects. Some of these projects have resulted in generating large scale economic activity & crores of rupees in revenue for the state. Thousands of jobs created by these units, directly & indirectly, have certainly helped the state to ease the problem of unemployment.

The equity capital of the corporation is not only subscribed by the Govt. of Goa but also Daman & Diu Administration and IDBI.

Objectives of EDC

EDC has been a professionally managed organization and acts as an excellent Delivery Channel for conversion of the Government policies and delivering them to the citizens. The main objectives of the corporation are:

1. To carry on the business of an Investment company by providing financial assistance to Entrepreneurs for starting, expanding, modernizing their activities in the following:
 - a) Small & Medium Entrepreneurs in the industrial sector
 - b) Tourism sector
 - c) Medical Infrastructure
 - d) Service sector
 - e) Construction sector
 - f) Infrastructure Development
2. To extend financial assistance by means of various financial products, either fund based or non-fund based.
3. To participate in other development works, projects, schemes as mandated by the Government.
4. To encourage and promote participation of capital in various forms like equity, preference or debentures in industrial enterprises and other economic activities.
5. To identify and motivate entrepreneurs to set up industries and assist them in the spadework by providing required training and guidance.
6. To offer and act as an agent for the disbursement of various schemes, incentives, concessions and benefit on behalf of the State and Central Government to units and enterprises assisted by EDC.
7. EDC has launched an initiative titled "Centre for Empowerment & Excellence" aimed at training and empowering individuals to strive for excellence. To fortify this initiative the corporation has developed a cutting edge training complex inclusive of state-of-the-art auditorium "Nalanda", apart from the other smaller halls.

The products offered include General Term Loan Scheme, Scheme of Financial assistance against Mortgage of Immovable Properties, Scheme of Loans assistance for construction of residential/ residential cum commercial complexes, Scheme of Loan assistance for construction of commercial complexes, Scheme of term loan assistance to qualified Professionals, Self Employment Scheme (CMRY), Self Employment Scheme (CMRY) for Self Help Groups, Term Loan Scheme for NRG's,

Housing loan Scheme, Vehicle loan Scheme, Personal loan Scheme and Modified Interest Rebate Scheme - 2012

7) **Haryana Financial Corporation (HFC)**

Haryana Financial Corporation has been set up under an Act of Parliament known as State Financial Corporation's Act 1951 and the working is governed by this act. The Head Office of the Corporation is at Chandigarh and Branch Offices at various District Headquarter of the State.

8) **Himachal Pradesh Financial Corporation (HPFC)**

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

The Managing Director of HPFC is appointed by the State Government and Chairman by the SIDBI. The Board of Directors is highly professional and consists of senior IAS officers of the State Government, representative from SIDBI, Banks, Life Insurance Corporation and individual shareholders. It has operated a number of financial assistance schemes for the benefit of the entrepreneurs such as scheme for marketing activities, equipment finance scheme, special schemes for assistance to ex-servicemen and, single window scheme, etc. The Corporation has sanctioned loan amount of ₹ 727 crores during 45 years of operation up to 31st March 2012 out of which loans of ₹ 529 crores have been released to 4521 borrowers.

9) **Jammu & Kashmir Financial Corporation (JKFC)**

The mission of JKFC is

- To generate and access resources for giving a fillip to development and growth of the State on a sustainable basis.
- To infuse financial discipline amongst the public functionaries.

- To implement fiscal reforms programme for providing fiscal and financial stability to the State.

10) Karnataka State Financial Corporation (KSFC)

KSFC is one of the fast track term lending financial institutions in the country with assistance to over 1,65,128 units amounting to nearly ₹ 11,282 crore over the last 53 years in the State of Karnataka. KSFC is one of the robust and professionally managed State Financial Corporations. The following services are rendered by the Corporation

- Financial Services
- Infrastructure Development
- Term Loans

11) Kerala Financial Corporation (KFC)

Kerala Financial Corporation (KFC) incorporated under the State Financial Corporations Act of 1951, plays a major role in the development and industrialization of Kerala. It was established as the Travancore Cochin Financial Corporation on 01.12.1953. Consequent to the reorganization of states on linguistic basis in November 1956, Kerala State was formed and the Travancore Cochin Financial Corporation was renamed as Kerala Financial Corporation. Now KFC has 16 Branch Offices with its Head Quarters at Thiruvananthapuram and Zonal Offices at Kozhikode, Ernakulam and Thiruvananthapuram.

The Corporation is the first PSU in Kerala and first SFC in India to initiate Corporate Social Responsibility activity. As part of its Corporate Social Responsibility, KFC has set up KFC-CARE (Centre for Assistance and Rehabilitation) to rehabilitate and serve the marginalized sections of the community.

KFC provides, Term Loans Working Capital finance and Short Term Finance apart from schemes focused at the weaker sections of the society. Modernization schemes for SSIs, Special schemes for Resorts, Hospitals, TV Serial Production etc are some of the innovative schemes introduced to suit changing customer requirements. KFC has also set up KFC Consultancy Division with a view to render excellent Consultancy

Services to our Clients as a Total Solution provider. KFC has also has made a small beginning to nurture and develop a new managerial cadre that can dream, envision and create a new future by starting the KFC Training Division.

12) Madhya Pradesh Financial Corporation (MPFC)

Madhya Pradesh Financial Corporation is the premier institution of the state, engaged in providing financial assistance and related services to small to medium sized industries. Also, it is registered as Category-I Merchant Banker with Securities Exchange Board of India and setup a separate merchant banking division in the name of MPFC Capital Markets. Incorporated in the year 1955, under the State Financial Corporation Act, 1951 (No. LXIII of 1951), it works under the control of the Board of Directors, consisting of representatives from State Government, Small Industries Development Bank of India, Reserve Bank of India, Scheduled Banks, Insurance Companies, Co-operative Banks and other shareholders. MPFC is a well knit organization with its head quarters at **Indore** - the industrial hub of Madhya Pradesh, and 20 offices at different places.

M P Financial Corporation has been providing financial assistance to industrial units in the state of Madhya Pradesh for the last five decades. It has been extending wide ranging fund and non fund based services. A number of new schemes for providing financial assistance and services to industries, professionals and other business associates have been successfully introduced by the corporation.

It offers fund based schemes such as term Loan, Equipment Finance, Asset Credit, Short Term Credit, Working Capital, Electro-Medical Equipment, Hospital Finance, Finance for Professionals, HP Portfolio Management, Loan Replenishment, DG Set Finance, Finance for Marketing Activities, Scheme for financing Miscellaneous Fixed Assets, Scheme for Medical Professionals, Composite Loan and Commercial Complex.

It offers non-fund based schemes such as Public Issue Appraisal, Credit Syndication, Corporate Advisory Services and Training MBA Students

13) Maharashtra State Financial Corporation (MSFC)

MSFC is a statutory Corporation set up under the State Financial Corporations (SFCs) Act, 1951. Their jurisdictions include State of Maharashtra (since 1962), State of Goa and the Union Territory of Daman & Diu (since 1964).

It provides mainly the term loan assistance to small and medium scale industries for acquiring fixed assets like land, building, plant & machinery. Loans are presently extended for expansion, diversification, technology development, enlarging product mix / product range, quality improvement including ISO 9000 series certifications and also for Take-Over of Term Loan accounts from Banks, other Financial Institutions in case of good borrowers of the Corporation. It also provides fee based activities such as Preparation of Project Appraisal / Feasibility Report, etc.

Organizational Structure

Besides the Head Office at Mumbai (Bombay), MSFC has 7 Regional Offices and 12 Branch Offices in Maharashtra and Goa. The Regional Offices are located at Aurangabad, Kolhapur, Nagpur, Nashik, Pune & Thane in Maharashtra and at Panaji in Goa. The Branch Offices are located at Ahmednagar, Akola, Amravati, Beed, Chandraupr, Chiplun, Jalgaon, Latur, Nanded, Sangli, Satara and Solapur.

Eligible Activities

- (i) Industrial Activities such as manufacturing, assembling, servicing, processing, preservation, transportation, setting-up industrial estates, etc.
- (ii) Activities such as Nursing Homes, Hotels, Restaurants, Tourism Related Activities.
- (iii) Medical Practitioners are eligible for loan for acquiring Electro Medical and other equipment for professional use.
- (iv) Qualified Professionals in Management, Engineering, Architecture, Accountancy etc desiring to undertake expansion of their professional practice consultancy ventures.
- (v) Other Service Activities declared as eligible under the SFCs Act.

14) Orissa State Financial Corporation (OSFC)

The Odisha State Financial Corporation(OSFC) was established in 1956 under the State Financial Corporations Act,1951 with the main object of providing loan assistance to the micro, small and medium enterprise.

Vision

- Emerge as a single window for meeting the financial and developmental needs of the MSME sector in the state of Odisha; to make it strong, vibrant and nationally/ internationally competitive.
- Position OSFC brand as the preferred and customer – friendly institution.
- Enhance Share-holder's wealth.

Provide efficient and cost effective services to the customers through application of modern technology and good governance.

Mission

Empower the Micro, Small and Medium Enterprises (MSME) sector with a view to contributing to the process of economic growth, employment generation and balanced regional development.

Purpose of Assistance

Loan assistance is provided for acquisition of land, construction of factory building, purchase of plant and machinery, to meet electrification and installation expenses, and for renovation and modernization of existing units.

15) Punjab Financial Corporation (PFC)

Punjab Financial Corporation a premier leading institution of Punjab, is a body incorporated under the State Financial Corporations Act 1951. The Corporation came into existence on February 1, 1953. To perform the role of a Development Bank in the State of Punjab, Corporation

was established with an objective of granting loans for the establishment of new industrial concerns, modernization, expansion/diversification of existing activities etc.

The Corporation has played significant role in bringing about decentralized economic development, development of backward regions and also reduction in regional imbalances in the State. The Corporation also played a magnificent role for the promotion of small and tiny units in the state and creates self-employment opportunity for young entrepreneurs. During 50 years of its existence PFC has an excellent track record and has emerged a forceful prime mover of industrialization in the state. The Corporation has so far assisted more than 18000 Nos. of units with the total financial assistance of more than ₹1400 crores and also generated employment for more than two lakh persons.

The Head Office of the Corporation is situated at Chandigarh and there are nine District Offices i.e. Amritsar, Bathinda, Ferozepur, Hoshiarpur, Jalandhar, Ludhiana, Patiala, Ropar(at Mohali) and Sangrur.

The major sources for funding its activities are Refinance from Small Industries Bank of India and Industrial Development Bank of India and Bonds subscribed to by Commercial Banks. This Corporation has been financing a wide range of industrial sectors. The major recipients of finance have been Iron & Steel/Metal Industries followed by Textiles, Chemicals & others.

16) **Rajasthan Financial Corporation (RFC)**

The Rajasthan Financial Corporation (RFC) was constituted under a notification of the State Government dated 17 January, 1955 under the SFCs Act, 1951, for providing long term financial support to tiny, small scale and medium scale industries in the State of Rajasthan.

The Corporation is continuing to work as a Catalyst of development for translating into practice the industrial policies and priorities of the Central and the State Governments as also for providing and improving upon immediate assistance in the planned and balanced development of industries in the State, particularly in the small and tiny sectors. Since its very inception, the Rajasthan Financial Corporation has been striving

incessantly towards its Goal - that of extending a helping hand to varied entrepreneurial section of society for their financial requirements. A Goal, ultimately aimed at spurring up the process of industrialization of its parent State.

For the fulfillment of its prime objective it operates various loan schemes for the tiny, small and medium scale industries, many of them tailor-made for specific entrepreneurial classes. Ever prepared to adopt as well as to adapt itself to the changing industrial needs, RFC has over the period, widened its network, multiplied its numerous schemes and added multifold to its policies and incentives, liberalizing them with the need of the hour.

Organizational Set up

The general superintendence, direction and management of the affairs and business of the Corporation vests with the Board of Directors, consisting of representatives of the State Government, SIDBI, Public Sector Banks, LIC, Insurance companies and other Institutions owned and controlled by Central Govt./ State Govt. and other genuine share holders. The policies of the Corporation are executed by the Chairman & Managing director aided by Executive Director, General Managers, Dy.General Managers & Departmental heads in HO. and Branch Managers in the field.

17. Tamil Nadu Industrial Development Corporation (TIIC)

Tamilnadu Industrial Investment Corporation Ltd. [TIIC] is a premier State Financial Corporation established in the year 1949. TIIC fosters industrial development in Tamilnadu by providing financial assistance to industries for purchase of land, machinery and construction of buildings. TIIC provides financial assistance at competitive interest rates for setting up of new industrial units and for expansion / modernization / diversification of existing industries in Tamilnadu. It also offers loan for service sector projects such as hotels, hospitals and tourism related projects.

While TIIC provides assistance to micro, small, medium and large enterprises, about 90% of the assistance goes to the micro, small and medium enterprises [MSME] sector. Of this, about 40% goes to first generation entrepreneurs. Thus, TIIC acts as a catalyst for industrial

promotion within the State by creating a new generation of entrepreneurs. TIIC has so far assisted 1,11,823 units with a cumulative sanction of ₹9,412.99 crores up to 31.03.12. The products offered include Term Loan, Bill Financing, Working Capital Term Loan [WCTL] and Insurance. The schemes include General Term Loan Scheme, Single Window Scheme, Micro / Small Enterprises Funding Scheme, WCTL for Manufacturing Sector including Rice Mills, Scheme for purchase of new Windmill, Scheme for purchase of used Windmill, Bill Financing Scheme, My Doctor Scheme, Doctor Plus Scheme, Warehousing / Cold Storage, Generator, Entrepreneur Development Scheme, and Scheme for Commercial Complex / Convention Centers / Community and Marriage Halls

18. Uttar Pradesh Financial Corporation (UPFC)

In order to bridge the gap in working capital in initial years of the large & medium scale units State Govt. has formulated a scheme known as Audyogik Nivesh Protsahan Yojna in the year 2003. UPFC has been nominated along with PICUP as Operating Agency for implementation of the said scheme. The salient features of the scheme are as under:-

Eligibility

Under this scheme Interest free loan is granted to eligible Mega units which have invested ` 5.00 Crores or more in fixed assets for setting up new unit in Food Processing or live stock sector or ` 10.00 Crores or more in any sector in Bundelkhand/ Purvanchal districts of the State or ` 25.00 Crores or more in any sector in any other districts & the date of first sale from above new capital investment is on or after 11.3.2003.

UPFC shall grant the Interest free loans to the eligible Mega units as per following limits of the new capital investment made by them:

1. Food processing or Live stock units - New capital investment ₹5 to 15.00 crores.
2. Electronic units in any district - New capital investment ₹10 to 15.00 crores.
3. Purvanchal & Budelkhand Districts - New capital investment ₹10 to 15.00 crores.

4. Other than above in Any other sector of Distt - New capital investment ₹25 to 30.00 crores.

UPFC can grant loans under the scheme to its financed units above the capital investment limits as mentioned above by taking NOC from PICUP provided it is in the interest of the concerned industry/ Corporation/work.

Pioneer unit

Pioneer unit is such eligible Mega unit which is first unit set up in the district qualifying the eligibility criteria of the scheme. It is declared as Pioneer unit by the concerned D.M. of the district on the recommendation of the Committee consisting of D.M. as Chairman, GM, DIC of the concerned district as member secretary & Nominated officer of the Commercial Tax Deptt.

Availment period of Loan

The eligible mega unit shall be granted each year Interest free loan for the total period of 10 years and in the case of Pioneer unit Interest free loan shall be granted for 15 years.

19. West Bengal Financial Corporation (WBFC)

West Bengal Financial Corporation is a State level financial institution to help the small, medium and tiny sector enterprises to implement their new/ expansion/ modernization or technological up gradation schemes. The Corporation has been devoting itself to the task of promotion and development of the SSI sector of the State for the last 50 years. Despite all odds, the Corporation has been marching ahead by registering increases in the amount of sanction, disbursement and recovery. The Corporation always acts in close coordination with the State level promotional and development agencies, commercial banks, the Government and others.

Counseling and timely delivery of credit to the entrepreneurs in need are the facets of its mission. The Corporation has a strong determination to continue maneuvering the development of the under-

privileged segments of the industrial economy of the State to make it adequately strong and capable of meeting the challenges of the days ahead. The Corporation has an organized cell to undertake appraisal of the industrial projects. Timely follow-up of the projects for implementation and to carry on liaison with other co-agencies, amongst others, are its objectives to ensure successful launching of newer projects.

The Corporation has its active presence through 14 Branch Offices located at the District Head Quarters. Its Regional Offices are duly equipped to coordinate the activities in the North Bengal and South Bengal. Till date, the Corporation had its credit exposures to agro based processing, engineering, software, readymade garments, hosiery & knitting, hotels, healthcares, nursing homes, pharmaceuticals, hatcheries and many other industries and services.

Ceiling of Sanction per Project has been raised. Corporate Bodies and registered Cooperative Societies may now avail of loan up to **₹20.00 Crore** per project. For others the ceiling is **₹ 8.00 Crore** per Project. Varied activities have been made eligible for getting assistance. The following are a few indicative inclusions:

- Engineering, technical, financial, management, marketing or other services or facilities for industry,
- Medical, health or other allied services,
- Software and hardware services relating to information technology, telecommunications including satellite linkage, audio/video cable communication,
- All tourism related activities and services
- Infrastructures viz., construction, roads etc.
- Research and development services, and a host of others.

WBFC is now able to undertake a wide range of non-fund based activities including various sorts of consultancy services and arrangement for general insurance charge as corporate agent.

Role of State Industrial Development Corporations (SIDCs)

1) Profile of Council of State Industries Development and Investment Corporations of India (COSIDICI)

Established in 1976 as a Society under the Societies Registration Act, 1860, the Council of State Industrial Development and Investment Corporations of India (COSIDICI) is a national federation of state level financial and investment corporations comprising State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs) and State Infrastructure Development Corporations engaged in promotion, development and financing of industry in small, medium and large sectors, besides developing industrial infrastructural facilities like industrial estates, industrial parks, industrial townships, etc. As on 30th September, 1999, COSIDICI has a membership of 56 state level institutions, as indicated below:

- State Financial Corporation (SFCs) - 18: These corporations have been set up at the state level under State Financial Corporations Act, 1951. These corporations have been notified as 'Public Financial Institutions' under Section 4-A of the Companies Act by the Government of India
- State Industrial Development Corporations (SIDCs) - 28
- State Industrial Infrastructure Development and Investment Corporations - 10. These corporations were set up under the Companies Act, 1956 and have been functioning as 'Public Limited Companies'.

The main objective of this national federation is to act as a clearing house for sharing of experiences by member corporation across states, disseminating information of common interest among them and to provide them with a common platform to the state level corporations for ventilating their problems and grievances to the Government and all India financial institutions and serve as a mouth-piece of this sector for influencing the policies of the Government/financial institutions having bearing on the development of this sector.

COSIDICI has been playing its role creditably during the past more than two decades and has produced the desired impact on the growth of

this sector. COSIDICI has established effective liaison with the concerned departments of State Governments, Central Government and the all India Financial Institutions, including RBI, IDBI, SIDBI, etc. Besides, COSIDICI is an accredited member of CII, FICCI, SCOPE, Small Scale Industries Board, Ministry of Industry, Govt. of India and actively participates in their activities. COSIDICI has been successfully taking up various issues affecting the business operations of these corporations, with the above agencies and has been influencing the policies of the Government and all India financial institutions to the advantage of this sector. Some of the important objectives of COSIDICI are:

- To liaise with and to represent to the Central and State Governments, term lending and other financial institutions on the common problems and issues of member corporations
- To promote co-ordination, collaboration, joint participation and general understanding among the member corporations etc.
- To render assistance to member corporations in their efforts to improve efficiency of operations of their assisted and sponsored units.
- To organize common service facilities, training courses, seminars, meetings and study tours for the benefit of the member corporations.
- To sponsor studies, surveys, research and development projects pertaining to industries.
- To establish and maintain at the Registered Office a commercial and technical library and information Centre for use of member corporations.

The COSIDICI has thus been co-coordinating and integrating the activities of its member corporations and has been providing and arranging means and facilities for dissemination of knowledge and information relating to promotion and development of industries and for exchange of views and ideas on subjects of common interests. For accomplishment of these objectives and with a view to having a direct communication link with the corporations, COSIDICI has been publishing a bi-monthly journal titled 'COSIDICI COURIER' since 1978. The publication of this journal aims at integrating the interests of our member corporations and has proved to be a powerful vehicle for dissemination of information of common interest among the members.

COSIDICI has been arranging training programmes for the senior executives of its member corporations to upgrade their conceptual and operational skills. COSIDICI has been arranging special training programmes exclusively for the benefit of state level corporations in collaboration with the National Institute of Banking Studies and Corporate Management. A large number of senior executives from our member corporations have benefited from these programmes.

The affairs of COSIDICI are managed by an Executive Committee consisting of senior civil servants drawn from various state level corporations. The composition of the Executive Committee is such that all regions of the country are represented on it. As on date, the Executive Committee has 18 members, who are elected by the General Body every year.

2) State Industrial Development Corporations (SIDCs)

The State Industrial Development Corporations were set up under the Companies Act, 1956, as wholly owned state government undertakings for promotion and development of medium and large industries. In addition to provision of financial assistance, they are also involved in developing industrial infrastructure like industrial estates, industrial parks and setting up industrial projects either on their own or in the joint sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. SIDCs exist in all the States and have developed industrial infrastructure facilities to enable prospective entrepreneurs to set up their industries in the states.

These corporations render technical assistance to the entrepreneurs in the formulation of the project reports and also provide common facilities in the industrial estates. These corporations provide loans and advances to the industrial units in the medium and large sectors to the maximum of ₹400 lakhs. The interest rate ranges between 13.5% to 17% depending upon the size of the loan.

Facilities and Incentives Available for Setting up Industries in the States

In each state a State Financial Corporation and a State Industrial Development Corporation have been functioning for more than four

decades. Operating at the grass root level, these development finance institutions have played a significant role in developing industries in the states with particular emphasis on development of backward regions. These corporations have played a crucial role in the promotion of first generation entrepreneurs. They have recorded an impressive performance in providing financial assistance for promotion and development of small scale, medium scale and large scale industries in their respective states. As on 31st March, 1999, their cumulative sanctions and disbursements aggregated ₹ 44,704.6 crores and ₹34,988.6 crores forming 10.5% and 12% of the total sanctions and disbursements made by all financial institutions in the country respectively.

Role of Unit Trust of India

The Mutual Fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank.

First Phase - 1964-87

Unit Trust of India (UTI) was established in 1963 by the Act of Parliament. It was set up by and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978, UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1980, UTI had ₹6,700 Crore of assets under management.

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Second Phase - 1987-1993 (Entry of Public Sector Funds)

1987 marked the entry of non-UTI, Mutual Funds set up by public sector banks, Life Insurance Corporation of India (LIC) and General

Insurance Corporation of India (GIC). SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec '87), Punjab National Bank Mutual Fund (Aug '89), Indian Bank Mutual Fund (Nov '89), Bank of India (Jun '90), Bank of Baroda Mutual Fund (Oct '92). LIC established its Mutual Fund in June 1989 while GIC had set up its Mutual Fund in December 1990. At the end of 1993, the Mutual Fund industry had assets under management worth ₹ 47,004 Crore.

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Third Phase - 1993-2003 (Entry of Private Sector Funds)

With the entry of private sector funds in 1993, a new era started in the Indian Mutual Fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all Mutual Funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector Mutual Fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996.

The number of Mutual Fund houses went on increasing, with many foreign Mutual Funds setting up funds in India. Also, the industry has witnessed several mergers and acquisitions then. As of January 2003, there were 33 Mutual Funds with total assets worth ₹ 1,21,805 Crore. The Unit Trust of India with ₹44,541 Crore of assets under management was way ahead of other Mutual Funds.

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Fourth Phase - since February 2003

In February 2003, following the repeal of the Unit Trust of India Act, 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management worth ₹29,835 Crore as of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India is functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second one is UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. There were several reasons responsible for the current phase of consolidation and growth of the Mutual Fund industry:

- Bifurcation of the erstwhile UTI, which in March 2000 had more than ₹76,000 Crore of assets under management
- Setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations
- Recent mergers taking place among different private sector funds

UTI Mutual Fund

Mission

To be the most preferred Mutual Fund

Vision

To make UTI Mutual Fund:

- The most trusted brand that is admired by all stakeholders
- The largest and most efficient wealth manager with global presence
- The best-in-class customer service provider
- The most preferred employer
- The most innovative and best wealth creator
- A socially responsible organization known for best corporate governance

Genesis

January 14, 2003 is when UTI Mutual Fund started to pave its path following the vision of UTI Asset Management Co. Ltd. (UTIAMC), which was appointed by UTI Trustee Co, Pvt. Ltd. for managing the schemes of UTI Mutual Fund and the schemes transferred/migrated from the erstwhile Unit Trust of India.

Asset Under Management

To know latest corpus of UTIAMC please refer www.amfiindia.com. UTI Mutual Fund has a track record of managing a variety of schemes catering to the needs of every class of citizens. It has a nationwide network consisting 149 UTI Financial Centres (UFCs) and UTI International offices in London, Dubai and Singapore. UTIAMC has a well-qualified, professional fund management team, which has been fully empowered to manage funds with greater efficiency and accountability in the sole interest of the unit holders. The fund managers are ably supported by a strong in-house securities research department. To ensure investors' interests, a risk management department is also in operation.

Reliability

UTIMF has consistently reset and upgraded transparency standards. All the branches, UFCs and registrar offices are connected on a robust IT network to ensure cost-effective quick and efficient service. All these have evolved UTIMF to position as a dynamic, responsive, restructured, efficient and transparent entity, fully compliant with SEBI regulations.

Investment Philosophy

UTI Mutual Fund's investment philosophy is to deliver consistent and stable returns in the medium to long term with a fairly lower volatility of fund returns compared to the broad market. It believes in having a balanced and well-diversified portfolio for all the funds and a rigorous in-house research based approach to all its investments. It is committed to adopt and maintain good fund management practices and a process based investment management. UTI Mutual Fund follows an investment approach of giving as equal an importance to asset allocation and sectoral allocation, as is given to security selection while managing any fund. It combines top-down and bottom-up approaches to enable the portfolios/funds to adapt to different market conditions so as to prevent missing an investment opportunity. In terms of its funds performance, UTI Mutual fund aims to remain consistently in the top quartile vis-à-vis the funds in the peer group.

Life Insurance Corporation (LIC)

On the 19th of January, 1956, life insurance industry in India was nationalized. About 154 Indian insurance companies, 16 non-Indian companies and 75 provident were operating in India at the time of nationalization. Nationalization was accomplished in two stages; initially the management of the companies was taken over by means of an Ordinance, and later, the ownership too by means of a comprehensive bill. The Parliament of India passed the Life Insurance Corporation Act on the 19th of June 1956, and the Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

LIC had 5 zonal offices, 33 divisional offices and 212 branch offices, apart from its corporate office in the year 1956. Since life insurance contracts are long term contracts and during the currency of the policy it requires a variety of services need was felt in the later years to expand the operations and place a branch office at each district headquarter. Re-organization of LIC took place and large numbers of new branch offices were opened. As a result of re-organization servicing functions were transferred to the branches, and branches were made accounting units. It worked wonders with the performance of the corporation. It may be seen that from about 200.00 crores of New Business in 1957 the corporation crossed 1000.00 crores only in the year 1969-70, and it took another 10 years for LIC to cross 2000.00 crore mark of new business. But with re-organization happening in the early eighties, by 1985-86 LIC had already crossed 7000.00 crore Sum Assured on new policies.

Today LIC functions with 2048 fully computerized branch offices, 109 divisional offices, 8 zonal offices, 992 satellite offices and the Corporate office. LIC's Wide Area Network covers 109 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line Kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

LIC continues to be the dominant life insurer even in the liberalized scenario of Indian insurance and is moving fast on a new growth trajectory surpassing its own past records. LIC has issued over one crore policies during the current year. It has crossed the milestone of issuing 1,01,32,955 new policies by 15th Oct, 2005, posting a healthy growth rate of 16.67% over the corresponding period of the previous year. From then to now, LIC has crossed many milestones and has set unprecedented performance records in various aspects of life insurance business. The same motives which inspired our forefathers to bring insurance into existence in this

country inspire us at LIC to take this message of protection to light the lamps of security in as many homes as possible and to help the people in providing security to their families.

Mission

“Explore and enhance the quality of life of people through financial security by providing products and services of aspired attributes with competitive returns, and by rendering resources for economic development.”

Vision

“A trans-nationally competitive financial conglomerate of significance to societies and Pride of India.”

Objectives of LIC

- a) Spread Life Insurance widely and in particular to the rural areas and to the socially and economically backward classes with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost.
- b) Maximize mobilization of people's savings by making insurance-linked savings adequately attractive.
- c) Bear in mind, in the investment of funds, the primary obligation to its policyholders, whose money it holds in trust, without losing sight of the interest of the community as a whole; the funds to be deployed to the best advantage of the investors as well as the community as a whole, keeping in view national priorities and obligations of attractive return.
- d) Conduct business with utmost economy and with the full realization that the moneys belong to the policyholders.
- e) Act as trustees of the insured public in their individual and collective capacities.
- f) Meet the various life insurance needs of the community that would arise in the changing social and economic environment.

- g) Involve all people working in the Corporation to the best of their capability in furthering the interests of the insured public by providing efficient service with courtesy.
- h) Promote amongst all agents and employees of the Corporation a sense of participation, pride and job satisfaction through discharge of their duties with dedication towards achievement of Corporate Objective.

General Insurance Corporation Reinsurer (GIC Re)

The entire general insurance business in India was nationalised by General Insurance Business (Nationalisation) Act, 1972 (GIBNA). The Government of India (GOI), through Nationalisation took over the shares of 55 Indian insurance companies and the undertakings of 52 insurers carrying on general insurance business. General Insurance Corporation of India (GIC) was formed in pursuance of Section 9(1) of GIBNA. It was incorporated on 22 November 1972 under the Companies Act, 1956 as a private company limited by shares. GIC was formed for the purpose of superintending, controlling and carrying on the business of general insurance.

As soon as GIC was formed, GOI transferred all the shares it held of the general insurance companies to GIC. Simultaneously, the nationalised undertakings were transferred to Indian insurance companies. After a process of mergers among Indian insurance companies, four companies were left as fully owned subsidiary companies of GIC

- (1) National Insurance Company Limited,
- (2) The New India Assurance Company Limited,
- (3) The Oriental Insurance Company Limited,
- (4) United India Insurance Company Limited.

The next landmark happened on 19th April 2000, when the Insurance Regulatory and Development Authority Act, 1999 (IRDA) came into force. This act also introduced amendment to GIBNA and the Insurance Act, 1938. An amendment to GIBNA removed the exclusive privilege of GIC and its subsidiaries carrying on general insurance in India.

In November 2000, GIC is renotified as the Indian Reinsurer and through administrative instruction, its supervisory role over subsidiaries was ended. With the General Insurance Business (Nationalisation) Amendment Act 2002 (40 of 2002) coming into force from March 21, 2003 GIC ceased to be a holding company of its subsidiaries. Their ownership was vested with Government of India.

Conclusion

The state level financial institutions such as State Finance Corporations and State Industries Development Corporations operate in each of the States in India. They get financial assistance from the All India Financial Institutions. Further, the investment institutions such as UTI, LIC and GIC have transformed the investment market in India.

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Lesson 3.3 - Specialised Financial Institutions

Learning Objectives

- To understand the role of Risk Capital and Technology Finance Corporation Ltd (RCTC), Technology Development and Information Company of India Ltd. (TDICI) and Tourism Finance Corporation of India Ltd. (TFCI).
- To understand the role of Housing and Urban Development Corporation of India (HUDCO), Housing Development Finance Corporation (HDFC) and National Housing Bank (NHB).
- To understand the role of specialized institutions like EXIM Bank, North East Development Finance Corporation (NEDFC) and India Infrastructure Finance Company Ltd (IIFCL).

Introduction

India, apart from establishing a number of development financial institutions at national and state level, has also established a number of specialized institutions to develop specific sectors like housing, venture capital, tourism and north east.

The structure of these specialized institutions has undergone a lot of restructuring and consolidation. Besides, new specialized institution, like North East Development Finance Corporation (NEDFi) also got developed. Let us understand the role of all specialized institutions and their present status in this lesson.

Risk Capital and Technology Finance Corporation Ltd (RCTC)

IFCI Venture Capital Funds Ltd. (IFCI Venture) was promoted as a Risk Capital Foundation (RCF) in 1975 by the IFCI Ltd., a society to provide financial assistance to first generation professionals and technocrat entrepreneurs for setting up own ventures through soft loans, under the Risk Capital Scheme. In 1988, RCF was converted into a company,

Risk Capital and Technology Finance Corporation Ltd. (RCTC), when it also introduced the Technology Finance and Development Scheme for financing development and commercialization of indigenous technology. Besides, under Risk Capital Scheme, RCTC started providing financial assistance to entrepreneurs by way of direct equity participation.

Based on IFCI Venture's credentials and strengths, Unit Trust of India (UTI), entrusted RCTC with the management of a new venture capital fund named **Venture Capital Unit Scheme (VECAUS-III)** in 1991. The size of VECAUS-III was ₹80 Crores, contributed by UTI and IFCI. To reflect the shift in the company's activities, the name of RCTC was changed to IFCI Venture Capital Funds Ltd. (IFCI Venture) in February 2000. In order to focus on Asset Management Activities, IFCI Venture discontinued Risk Capital and Technology Finance Scheme(s) in 2000-01 and continued managing VECAUS-III. In 2007, as UTI had ceased to carry out its activities and its assets vested with Specified Undertaking of the Unit Trust of India (SUUTI), the portfolio of VECAUS-III under management of IFCI Venture was transferred to SUUTI.

Present Business Activities

Over the years, IFCI Venture acquired expertise and experience of investing in technology-oriented & innovative projects. It has pioneered efforts for widening entrepreneurial base in the country and catalyzed the introduction of Venture Capital activity in India. It also provides advisory services and short term lending besides managing private equity/venture capital funds.

Technology Development and Information Company of India Ltd. (TDICI)

ICICI Venture Funds Ltd - formerly known as Technology Development & Information Company of India Limited (TDICI), was founded in 1988 as a joint venture with the Unit Trust of India. Subsequently, it became a fully owned subsidiary of ICICI. It is a technology venture finance company, set up to sanction project finance for new technology ventures.

The industrial units assisted by it are in the fields of computer, chemicals/polymers, drugs, diagnostics and vaccines, biotechnology, environmental engineering, etc. ICICI Venture is a specialist alternative assets manager based in India. The firm is a wholly owned subsidiary of ICICI Bank, the largest private sector financial services group in India.

ICICI Venture has been at the forefront of driving entrepreneurship in India for over two decades, both as a partner and capital provider for individuals with a clear common objective, the passion to pursue business ideas in the quest for creating value for all stakeholders and for the larger good of the nation.

The firm has played a key role in establishing the foundation for several new age businesses in India, by providing growth capital funding to companies in sectors as diverse as Information Technology, Life Sciences and Healthcare, Media & Entertainment, Banking & Financial Services, Infrastructure, Retail, Aviation, Auto Components, Construction services, Real Estate, Biotechnology, Textiles, Fine Chemicals, Consumer Products, Logistics, etc.

The firm played a pioneering role in the Indian Venture Capital industry during the 1990s but shifted focus to other alternative asset classes during the past decade in line with the evolution of Indian industry. Across sectors, the firm has helped in establishing several new business models to enable productivity improvements, technology up gradation and import substitution as a means of enhancing the competitive advantage of Indian industry in a rapidly changing global market environment.

The firm is widely regarded as a prime mover in the Indian alternative assets industry, having established a successful track record of investing and nurturing companies across economic cycles and across various classes of alternative assets such as Private Equity, Real Estate and Mezzanine Finance, with Infrastructure & Special Situations being the latest additions to its spectrum of activities.

Going forward, the firm continues to explore new avenues within the alternative assets industry as a means of addressing funding requirements of Indian entrepreneurs and also as a means of offering a comprehensive alternative asset management platform to long term investors who are

interested in participating in India's economic development. Currently, the firm has 5 practice areas such as Private Equity, Real Estate, Mezzanine finance, Infrastructure and Special Situations.

Shipping Credit and Investment Company of India Ltd. (SCICI)

With effect from April 1, 1996, Shipping Credit and Investment Company of India Ltd, (SCICI) was merged with ICICI.

Tourism Finance Corporation of India Ltd. (TFCI)

Yunus Committee set up in 1988, under the aegis of Planning Commission recommended the need of an All-India Financial Institution for providing financial assistance to tourism sector in the country. In accordance with the above recommendation, IFCI Limited, other All-India Financial Institutions, Investment Institutions and nationalized Banks promoted a public limited company under the name of "Tourism Finance Corporation of India Ltd (TFCI)" to function as a specialized All-India Financial Institution to cater to the financial needs of the tourism industry.

TFCI was incorporated as a Public Limited Company under the Companies Act, 1956 on 27th January 1989 and became operational with effect from 1st February 1989 on receipt of Certificate of the Commencement of Business from the Registrar of Companies. In 1990, TFCI has been notified as a Public Financial Institution under section 4A of the Companies Act, 1956.

Objective

TFCI provides financial assistance to enterprises for setting up and/or development of tourism-related projects, facilities and services, such as Hotels, Restaurants, Holiday Resorts, Amusement Parks, Multiplexes and Entertainment Centers, Education and Sports, Safari Parks, Rope-ways, Cultural Centers, Convention Halls, Transport, Travel and Tour Operating Agencies, Air Service, Tourism Emporia, Sports Facilities etc. Since its inception, TFCI provides high-quality research and Consultancy services to the tourism industry in general and to the investors in tourism industry in particular. In line with this, TFCI has been providing Consultancy

services to different central and state agencies by undertaking broad-based assignments to cover macro & micro level tourism-related studies/exercises to facilitate identification, conceptualization, promotion/implementation of specific tourism-related projects & for taking policy level decisions with respect to investment and infrastructure augmentation etc. Besides, TFCI has been providing specific project-related services to various clients. It has also undertaken appraisal of individual projects for various state government agencies/individual clients.

TFCI has also successfully handled projects involving development of viable project concepts around lakes/water bodies, development of a multi-facility amusement park complex etc. TFCI's range of activities in the Consultancy Division covers tourism-related studies, surveys and project-related services. Coverage under project-related services and tourism-related studies include Project-Related Services; Tourism-Related Studies/Services; Govt Sector; Private Sector and other Activities /Programmes.

a) Project-Related Services

1. Site evaluation studies
2. Market-potential assessment for tourism projects
3. Techno- economic feasibility studies
4. Loan / Equity syndication services
5. Financial restructuring of project proposals, review and appraisal
6. Project implementation and monitoring services
7. Pre-opening technical and facility planning services
8. Property evaluation including determination of terms for transfer / lease, preparation of related RFQ & RFP & transfer / lease documents etc.
9. Other project related services include assistance in finalization of arrangements for lease / transfer of management, franchise tie-ups, selection of design / project / architectural consultants etc.

b) Tourism-Related Studies/ Services

1. Undertaking tourism-potential studies and identification of tourism circuits.

2. Preparing tourism-development Master Plans for state/ travel circuit / destination.
3. Undertaking tourist profiles and image-rating studies.
4. Undertaking Tourist-flow surveys to assess destination draws, infrastructure gaps and defining agenda for development.
5. Carrying out accommodation and other infrastructure assessment, augmentation improvement studies.
6. Undertaking studies for sustainable tourism development, environment impact assessment and determining carrying capacity of tourism activities in wild-life sanctuaries, national parks and other sensitive / critical areas.
7. Assessing need for and identifying specific policies and other promotional measures for tourism development in any State.
8. Undertaking appraisal of various Government programmes relating to tourism promotion, development and making suggestions for improving effectiveness.
9. Assistance in marketing projects identified by State Govt. including drawing up of bankable project profiles

The range of TFCL's activities encompass a wide spectrum of tourism-related services: from financial assistance for setting up and / or development of tourism-related activities, tourist-flow surveys, facilities and services for tourists, preparation of tourism master plans, to individual tourism products; from project evaluation exercises to support services for privatization; from planning for amusement / nature parks, etc. to undertaking of environmental/ carrying-capacity studies.

c) Other Activities /Programmes

1. Study of Security and Safety aspects of the hospitality industry
2. Study of need for and devising of suitable Programmes for the promoters entrepreneurs from the hospitality industry.
3. Organized & co-ordinated National Seminar on Hotel Project Management for entrepreneurs venturing into Hotel Industry.

TFCI follows RBI guidelines with regard to Individual and Group exposure norms in relation to the net owned funds of TFCI. Appraisal criteria for processing of tourism-related projects with regard to Promoters' contribution, Debt-Equity Norms, Average Room Occupancy levels and Rates are constantly reviewed by TFCI Board and the guidelines are formulated accordingly.

For meeting the fund requirements thereof as well as towards its various other business operations, TFCI raises resources directly from the market (at market-related interest rates) from retail as well as institutional investors - both within India and abroad, through a variety of investor-friendly instruments. TFCI's resource raising efforts have brought it closer to all sections of society. It has been mobilizing resources through a combination of debt and equity.

Forms of Financial Assistance

The forms of financial assistance provided by the TFCI include Rupee Loan, Underwriting of public issues of shares/debentures and direct subscription to such securities, Guarantee of deferred payments and credit raised abroad, Equipment Finance, Equipment Leasing, Assistance under Suppliers' Credit, Working-Capital Financing, Takeover Financing and Advances against Credit-Card Receivables.

Eligibility for Assistance

TFCI provides financial assistance to projects with capital cost of ₹ 3 crore and above. In respect of projects costing between ₹ 1 crore and ₹ 3 crore, TFCI will consider financial assistance to the extent of unavoidable gap, if any, remaining after taking into account assistance from State Level Institutions/Banks. Unique projects, which are important from the tourism point of view and for which assistance from State Level institutions/ Banks is not available, may be considered on exceptional basis even though their capital cost is below ₹ 1 crore. Financial assistance is considered on similar lines for heritage and restaurant projects. Projects with high capital cost may be financed along with other All-India Financial/Investment Institutions.

Promoters' Contribution

The minimum promoters' contribution for the projects is 30%. Relaxation may, however, be allowed in respect of large projects involving capital cost exceeding ₹ 50 crore.

Debt Equity Ratio

TFCI extends term-loan assistance based on debt-equity ratio not exceeding 1.5:1. However, in case of hotels in seasonal locations/ multiplexes/ entertainment centers, amusement parks and other tourism-related projects, the debt-equity ratio would be stipulated in the range of 1:1 to 1.25:1.

Norms for Takeover Financing

TFCI may consider financing well-established, assisted concerns having over 3 years' satisfactory track record for takeover of tourism-related project/company.

Norms for Working-Capital Financing

The Working Capital assistance would be provided to firms in the tourism sector with proven track record of at least 3 years and assisted firms of TFCI with satisfactory credit record. The working capital limit would be calculated based on the turnover method as may be considered appropriate.

Housing and Urban Development Corporation of India (HUDCO)**Genesis**

The housing and urban development sector plays a significant role in the economic and social development of a country. The access to and the quality of housing and urban basic services directly influence the quality of life of people, their productivity levels and growth potential. Before the establishment of HUDCO, the Government of India was operating a number of subsidized housing schemes and loan schemes. The subsidized housing schemes were meant for industrial workers, economically weaker section of the society and slum dwellers, while the loan schemes were

targeted for the people in the low-income and middle-income groups as well as rental housing schemes for State Government employees. All these schemes were under the direct control of the Ministry of Works and Housing. Such a system of housing finance did not give the required thrust for promoting housing development activities, which in many cases were considered of lower priority.

Towards the close of the 1960s, it was realized the need of a setting up a housing organization in the country as the availability and cost of bank credit were the prime constraints in this development. Since the banking industry, until then, was in the hands of a few industrial houses, the first major step taken to initiate change in favour of the poor was the nationalization of the banks in June 1969. However, when the then Hon'ble Prime Minister Smt Indira Gandhi looked for ways to improve the living conditions of slum-dwellers and economically less fortunate peoples, she found that while we had a host of All India Term Lending Institution such as IDBI, IFCI, ICICI etc; catering to the diverse credit and related needs of the Indian industry, there was no institution to provide housing finance to the rural and urban poor or the even to meet the credit needs of housing boards, development authorities and other urban bodies which were being setup by the State Government during the fourth Plan period.

It was in this context that a decision was taken at the highest level to set a Housing and Urban Development Corporation (HUDCO) which could take a comprehensive look at the need of the sector and find workable and effective solutions. This experiment of establishing a unique techno-financial institution and the fascinating journey it undertook during the last four decades would certainly qualify as one of the key developments in this sector in the whole world. The establishment of HUDCO in 1970 as a sectoral institution for comprehensively dealing with the problems of growing housing shortages, rising number of slums and for fulfilling the pressing needs of the economically weaker section of the society was one of the significant steps in the series of initiatives taken by Government. Thus the setting up of HUDCO was aimed at accelerating the pace of construction and elimination of housing shortages and for orderly development of urban centres. The Housing and Urban Development Corporation Ltd. (HUDCO) was incorporated on April 25, 1970 under the Companies Act 1956, as a fully owned enterprise of the Government of India.

Objectives

The Article of Association of HUDCO stipulates the Major Objective of HUDCO as under:

- To provide long term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.
- To finance or undertake, wholly or partly, the setting up of new or satellite town.
- To subscribe to the debentures and bonds to be issued by the State Housing (and or Urban Development) Boards, Improvement Trusts, Development Authorities etc., specifically for the purpose of financing housing and urban development programmes.
- To finance or undertake the setting up of industrial enterprises of building material.
- To administer the moneys received, from time to time, from the Government of India and other sources as grants or otherwise for the purposes of financing or undertaking housing and urban development programmes in the country.
- To promote, establish, assist, collaborate and provide consultancy services for the projects of designing and planning of works relating to Housing and Urban Development programmes in India and abroad.

Recognition

HUDCO received the following recognitions

- a) **UNCHS –Habitat Scroll of Honour** in 1991 in recognition of innovation, development and promotion of building materials, design & construction of affordable housing for the poor and training in construction skills.
- b) **Prime Minister's MoU Award** for Excellence in Performance 1998-99 from the Honourable Prime Minister for being among the Top Ten Public Sector Institutions in Performance.

- c) **ISO 9001: 2008 Certification for Quality Management**
- d) **HUDCO – Mini Ratna Status in 2004-05**
- e) **Awards during 2008-09 by the outside agencies such as** Enterprise Excellence Award 2007 by the Indian Institute of Industrial Engineering, No.1 institution in Construction of Dwelling Units for Poor Sections by 'Business Sphere Magazine', Building Industry Leadership Award 2008 by Building Information Bureau, and "Gold Rating" for the proposed building in Noida for "Rajiv Gandhi HSMT" by Ministry of Environment & Forest.

Housing Development and Finance Corporation Ltd. (HDFC Ltd.)

Housing Development Finance Corporation Limited (HDFC Ltd.) was established in 1977 with the primary objective of meeting a social need of encouraging home ownership by providing long-term finance to households. Over the last three decades, HDFC has turned the concept of housing finance for the growing middle class in India into a world-class enterprise with excellent reputation for professionalism, integrity and impeccable service. A pioneer and leader in housing finance in India, since inception, HDFC has assisted more than 4.02 million customers to own a home of their own, through cumulative housing loan approvals of over ₹ 4.63 trillion and disbursements of over ₹ 3.74 trillion as at March 31, 2012.

HDFC has a wide network of 322 offices (which includes 77 offices of HDFC's wholly owned distribution company HDFC Sales Private Limited) catering to over 2,400 towns & cities spread across the country. It also has offices in *Dubai, London and Singapore* and service associates in the Middle East region, to provide housing loans and property advisory services to Non-Resident Indians (NRIs) and Persons of Indian Origin (PIOs). Over the years, HDFC has emerged as a financial conglomerate with its presence in the entire gamut of financial services including banking, insurance (life and non-life), asset management, real estate venture capital and more recently education loans.

Background

HDFC was incorporated in 1977 by **Mr. Hasmukhbhai Parekh** with the primary objective of meeting a social need - that of promoting home ownership by providing long-term finance to households. The launching of HDFC was meant to be one small step in dealing with the availability of housing accommodation in India which was then virtually non-existent. HDFC as a pioneer launched India's first specialized home loan company with an initial capital of ₹ 100 million.

Business Objective

The primary objective is to enhance residential housing stock in the country through the provision of housing finance in a systematic and professional manner, and to promote home ownership. We aim to increase the flow of resources to the housing sector by integrating the housing finance sector with the overall domestic financial markets. The goals of HDFC include:

- a) Develop close relationships with individual households;
- b) Maintain our position as the premier housing finance institution in the country;
- c) Transform ideas into viable and creative solutions;
- d) To grow through diversification by gaining leverage from our existing client base;
- e) To nurture the values and ethos of Brand HDFC through all its Subsidiaries and Associate Companies.

Growth Strategies

- Increase the return on equity each year by 1 percentage point in order to maximize shareholder value;
- Maintain gross Non-Performing Assets (NPAs) below 1%;
- Consistently grow the loan book;
- Improve operational efficiency by consistently bringing down the cost to income ratio.

The HDFC Advantage

- Pioneers of Housing Finance in India with over 34 years of lending experience.
- Widest range of home loan & deposit products.
- Vast network of over 322 interconnected offices which includes 3 international offices.
- Most experienced and empowered personnel to ensure smooth & easy processing.
- Online loan application facility at www.hdfc.com and across-the-counter services for new deposits, renewals & repayments.
- Counseling and advisory services for acquiring a property.
- Flexible loan repayment options
- Free & safe document storage.

National Housing Bank (NHB)

Genesis

The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) identified the non-availability of long-term finance to individual households on any significant scale as a major lacuna impeding progress of the housing sector and recommended the setting up of a national level institution. The Committee of Secretaries considered the recommendation and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI to examine the proposal and recommended the setting up of National Housing Bank as an autonomous housing finance institution.

The recommendations of the High Level Group were accepted by the Government of India. The Hon'ble Prime Minister of India, while presenting the Union Budget for 1987-88 on February 28, 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. Following that, the National Housing Bank Bill (91 of 1987) providing the legislative framework for the establishment of NHB was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on December 23, 1987, became an Act of Parliament.

The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing. In pursuance of the above, NHB was set up on July 9, 1988 under the National Housing Bank Act, 1987. NHB is wholly owned by Reserve Bank of India, which contributed the entire paid-up capital. The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors. The Head Office of NHB is at New Delhi.

Objectives

NHB has been established to achieve, inter alia, the following objectives –

- To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
- To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
- To augment resources for the sector and channelize them for housing.
- To make housing credit more affordable.
- To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
- To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
- To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

Organization

NHB is a lean, officer oriented, professionally managed institution with its headquarters in Delhi and offices in Mumbai, Hyderabad, Bangalore, Chennai, Kolkata, Lucknow and Ahmedabad. It has 84 professionals at different levels. NHB is committed to pursuit of excellence through innovation, doer work culture and contemporary work practices with technology intervention.

Functions of NHB

a) Regulation

In terms of the National Housing Bank Act, 1987, National Housing Bank is expected, in the public interest, to regulate the housing finance system of the country to its advantage or to prevent the affairs of any housing finance institution being conducted in a manner detrimental to the interest of the depositors or in a manner prejudicial to the interest of the housing finance institutions. For this, National Housing Bank has been empowered to determine the policy and give directions to the housing finance institutions and their auditors.

Besides the regulatory provisions of the National Housing Bank Act, 1987, National Housing Bank has issued the Housing Finance Companies (NHB) Directions, 2001 as also Guidelines for Asset Liability Management System in Housing Finance Companies. These are periodically updated through issue of circulars and notifications. As part of the supervisory process, an entry level regulation is sought to be achieved through a system of registration of housing finance companies. National Housing Bank supervises the sector through a system of on-site and off-site surveillance.

b) Financing

NHB supports housing finance sector by

- i) **Refinance Operations:** HDFC extends refinance to different primary lenders in respect of eligible housing loans extended by them to individual beneficiaries, for project loans extended by them to various implementing agencies. A number of Primary Lending Institutions (PLIs) are currently active in the housing finance sector in India. The institutions provide finance to individual borrowers, builders, corporate houses etc. for purchase/construction of houses and for repair / up gradation of existing house. With the objective of providing long-term funds to these institutions, NHB extends refinance in respect of the loans extended by them. The following categories of institutions are eligible to take refinance from NHB; Scheduled Commercial Banks; Scheduled Urban Cooperative Banks; Regional Rural Banks; State Level Apex Co-

operative Housing Finance Companies; Agriculture and Rural Development Banks and New Schemes.

ii) **Project Finance:** HDFC lends directly in respect of projects undertaken by public housing agencies for housing construction and development of housing related infrastructure. The eligible agencies for project lending are public agencies, micro financial institutions/ Self Help Groups/NGOs/ registered Societies and joint ventures and Public Private Partnerships. The Bank offers financial assistance for various types of projects right from township development, land acquisition and development, slum redevelopment projects etc. The same are enumerated below under three main heads namely special projects, general projects and short term facility:

- **Special Projects** which include Slum redevelopment projects and Housing for EWS/LIG etc.
- **General Projects** which include Township cum housing development projects; Construction of houses on individual plots or group housing; and Land acquisition for the purpose of township and housing development; Land development for housing including provision of facilities like roads, water supply, storm water drains, sewerage system etc.; Development of land into buildable plots; Employee Housing; Special housing projects for people affected by natural calamities; and Water & Sanitation.
- **Short Term Facility** which includes short term finance facility up to a maximum period of 2 years to public agencies engaged in housing projects.
- **Takeover of Term Loan Liabilities** of Public Housing and development Agencies

The option of availing fixed or floating interest rates is available. The interest rates are determined based on the Prime Lending Rate of the Bank. NHB reviews and resets the interest rates from time to time, depending upon the market conditions, commercial interest etc. Prepayment of loans is permissible with payment of prepayment levy. The extent of financing is based on the type of project and also the rating assigned by National Housing Bank. It varies between 65 to 100% of the project cost. The maximum period of loan is 15 years. Depending on the Agency/

project, the project finance shall be secured through one or more of the following such as Mortgage/charge over immovable property acceptable to NHB, Charge over receivables, Bank Guarantee, Government Guarantee, Corporate Guarantee, Charge on Book Debts, Fixed Deposit Receipts, Hypothecation of property, Any other security acceptable to NHB, and interim Security (in some cases interim security may be required till the main security is lodged with the Bank). NHB provides excellent customer service by quick disposal of project proposals and individual attention. It will also provide requisite financial and technical expertise and guidance in project formulation, if so required by the borrowers.

- iii) **Guarantee:** HDFC guarantee the repayment of principal and payment of interest on bonds issued by Housing Finance Companies. Housing Finance companies depend to a great extent on refinance assistance from NHB. However, the extension of refinance assistance by NHB is constrained by various factors like NHB's own Net Owned Funds (NOF), HFCs' borrowing power etc. In addition, in the present liberalized environment, the HFCs prefer to raise resources directly from market in order to eliminate the cost of intermediation. Besides NHB refinance, HFCs mainly depend upon term loans from banks and public deposits. The guarantee scheme envisages provision of guarantee by NHB to the investors regarding repayment of principal and interest during the top end (say last two years) irrespective of the repayment schedule fixed by the HFC and the guarantee shall not exceed 67% of the total amount to be raised and the interest thereof. The HFCs desirous of availing the guarantee will have to create a floating charge on the assets equivalent to 125% of the principal amount in favour of NHB. For extending the guarantee, the HFCs shall be charged 75 basis points per year of the amount to be floated as guarantee commission and this shall be payable upfront. The HFC shall create appropriate bond/debenture redemption reserves as may be laid down under the Companies Act from time to time. The HFC shall furnish such returns/information as may be laid down from time to time for the purpose of availing refinance. The HFC desirous of availing the guarantee from NHB shall comply with the following terms and conditions:

- The bond issue shall carry at least a rating of “AA-” from an approved rating agency.
 - The maturity of the bonds/debentures shall be for a period of five years to begin with.
 - The market shall determine the coupon rate.
- iv) **Securitization:** Acting as Special Purpose Vehicle for securitizing the housing loan receivables. NHB has been playing a lead role in starting up Mortgage Backed Securitization and development of a secondary mortgage market in the country. NHB launched the pilot issues of Mortgage Backed Securities (MBS) in August 2000 in the Indian financial market, followed by other MBS issues cumulating to ₹664 crores. Support to Mortgage Backed Securitization has been a major policy initiative of the Government as manifested in its National Housing and Habitat Policy announced in 1998. The policy has enjoined upon National Housing Bank (NHB) to play a lead role in starting mortgage backed securitization and development of a secondary mortgage market in the country. A major milestone in creating a framework for such transactions has been the amendment of the National Housing Bank Act, 1987 by the Government of India. The National Housing Bank (Amendment) Act, 2000 has come into force from June 12, 2000, which, inter alia, provides for creating Special Purpose Vehicle (SPV) Trust by NHB for taking up such transactions and issuing MBS in various forms.

Export and Import Bank of India (EXIM BANK)

Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export-Import Bank of India Act 1981. Government of India launched the institution with a mandate, not just to enhance exports from India, but to integrate the country's foreign trade and investment with the overall economic growth. Since its inception, Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, Exim Bank of India has, over the period, evolved into an institution that plays a major role in partnering Indian

industries, particularly the Small and Medium Enterprises, in their globalization efforts, through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.

The Initiatives

Exim Bank of India has been the prime mover in encouraging project exports from India. The Bank provides Indian project exporters with a comprehensive range of services to enhance the prospect of their securing export contracts, particularly those funded by Multilateral Funding Agencies like the World Bank, Asian Development Bank, African Development Bank and European Bank for Reconstruction and Development. The Bank extends lines of credit to overseas financial institutions, foreign governments and their agencies, enabling them to finance imports of goods and services from India on deferred credit terms. Exim Bank's lines of Credit obviate credit risks for Indian exporters and are of particular relevance to SME exporters. The Bank's Overseas Investment Finance programme offers a variety of facilities for Indian investments and acquisitions overseas. The facilities include loan to Indian companies for equity participation in overseas ventures, direct equity participation by Exim Bank in the overseas venture and non-funded facilities such as letters of credit and guarantees to facilitate local borrowings by the overseas venture. The Bank provides financial assistance by way of term loans in Indian rupees/foreign currencies for setting up new production facility, expansion/modernization/up gradation of existing facilities and for acquisition of production equipment/technology. Such facilities particularly help export oriented Small and Medium Enterprises for creation of export capabilities and enhancement of international competitiveness.

Under its Export Marketing Finance programme, Exim Bank supports Small and Medium Enterprises in their export marketing efforts including financing the soft expenditure relating to implementation of strategic and systematic export market development plans. The Bank has launched the Rural Initiatives Programme with the objective of linking Indian rural industry to the global market. The programme is intended to benefit rural poor through creation of export capability in rural enterprises. In order to assist the Small and Medium Enterprises, the Bank has put in

place the Export Marketing Services (EMS) Programme. Through EMS, the Bank seeks to establish, on best efforts basis, SME sector products in overseas markets, starting from identification of prospective business partners to facilitating placement of final orders. The service is provided on success fee basis. Exim Bank supplements its financing programmes with a wide range of value-added information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness, thereby helping them in their globalization efforts.

Genesis

- Set up by an act of Parliament in September 1981.
- Wholly owned by government of India
- Commenced operations in March 1982
- Apex financial institution

Finance and Services

Exim Bank plays four-pronged role with regard to India's foreign trade: those of a co-coordinator, a source of finance, consultant and promoter. Exim Bank is the Coordinator of the Working Group Mechanism for clearance of Project and Services Exports and Deferred Payment Exports (for amounts above a certain value currently US\$ 100 million). The Working Group comprises Exim Bank, Government of India representatives (Ministries of Finance, Commerce, External Affairs), Reserve Bank of India, Export Credit Guarantee Corporation of India Ltd. and commercial banks who are authorized foreign exchange dealers. This inter-institutional Working Group accords clearance to contracts (at the post-award stage) sponsored by commercial bank or Exim Bank, and operates as a one-window mechanism for clearance of term export proposals. On its own, Exim Bank can now accord clearance to project export proposals up to US\$ 100 million in value.

Export Credits

Exim Bank offers the following Export Credit facilities, which can be availed of by Indian companies, commercial banks and overseas entities.

a) For Indian Companies executing contracts overseas

- **Pre-shipment credit:** Exim Bank's Pre-shipment Credit facility, in Indian Rupees and foreign currency, provides access to finance at the manufacturing stage - enabling exporters to purchase raw materials and other inputs.
- **Supplier's Credit:** This facility enables Indian exporters to extend term credit to importers (overseas) of eligible goods at the post-shipment stage.

b) For Project Exporters: Indian project exporters incur Rupee expenditure while executing overseas project export contracts i.e. costs of mobilization/acquisition of materials, personnel and equipment etc. Exim Bank's facility helps them meet these expenses.**c) For Exporters of Consultancy and Technological Services:** Exim Bank offers a special credit facility to Indian exporters of consultancy and technology services, so that they can, in turn, extend term credit to overseas importers.**d) Guarantee Facilities:** Indian companies can avail of these to furnish requisite guarantees to facilitate execution of export contracts and import transactions.**e) Finance for Export Oriented Units:** Term Finance (For Exporting Companies), Project Finance, Equipment Finance, Import of Technology & Related Services, Domestic Acquisitions of businesses/companies/brands, Export Product Development/ Research & Development, and General Corporate Finance. Working Capital Finance (For Exporting Companies), EXIM Bank provides funded and non-funded finance.**f) Working Capital Finance (For Non- Exporting Companies):** Bulk Import of Raw Material; Term Finance (For Non- Exporting Companies); Import of Equipment; and Export Finance. Pre-shipment Credit; Post Shipment Credit; Buyers' Credit; Suppliers' Credit [including deferred payment credit]; Bills Discounting; Export Receivables Financing; Warehousing Finance; Export Lines of Credit (Non-recourse finance.)**g) Equity Participation (In Indian Exporting Companies):** To part finance project expenditure (Project, inter alia, includes new

project/ expansion/ acquisition of business/company/ brands/ research & development); Term finance, except for long term working capital, is available for periods up to 10 years [in select cases 15 year finance can also be made available]; Interest: Fixed & Floating options [Benchmarks for floating rates-LIBOR/G-Sec/MIBOR]. Repayments are in the form of Amortizing/ Ballooning/ Bullet [As per cash flows].

Overseas Investment Finance

- Finance for Indian Company's equity participation in the overseas Joint Venture (JV)/ Wholly Owned Subsidiary (WOS)
- Direct Finance (Term & Working Capital) to the overseas JV / WOS
- Finance (for equity/debt component) for acquisition of overseas businesses / companies including leveraged buy-outs including structured financing options.
- Direct Equity by EXIM Bank in the overseas JV/ WOS of an Indian Company

SME & AGRI Finance

India has a vibrant SME sector that plays an important role in sustaining economic growth, increasing trade, generating employment and creating new entrepreneurship in India. Indian SMEs require business advisory services to enhance their international competitiveness in a highly competitive globalizing world. The SMEs find the services of reputed national and international consultants as not cost effective and often, not adequately focused.

Recognizing this knowledge gap, Exim Bank of India has been endeavoring to provide a suite of services to its SME clients. These include providing business leads, handholding during the process of winning an export contract and thus assisting the generation of export business on success fee basis, countries/ sector information dissemination, capacity building in niche areas such as quality, safety, export marketing, etc. and financial advisory services such as loan syndication, etc.

Agri Finance

The globalization and post-WTO scenario offers considerable scope for exports of Indian agricultural products. Exim Bank has a dedicated Agri Business Group to cater to the financing needs of export oriented companies dealing in agricultural products. Financial assistance is provided by way of term loans, pre-shipment/post-shipment credit, overseas buyers' credit, bulk import finance, guarantees etc. Term loans with varying maturities are provided for setting up processing facilities, expansion, modernization, purchase of equipment, import of equipment/technology, financing overseas joint ventures and acquisitions etc. The Bank has strong linkages with other stakeholders in agri sector such as Ministry of Food Processing Industries, GoI, NABARD, APEDA, Small Farmers' Agri-Business Consortium (SFAC), National Horticultural Board etc. Apart from financing, the Bank also provides a range of advisory services to agri exporters.

Services

The SME sector can avail of a comprehensive range of products and services that Exim Bank offers. Broadly, these can be classified into three categories, viz., export credit, finance for export oriented companies and project finance.

Overseas Investment Finance

Overseas investment by Indian companies may be in the form of Joint Ventures (JVs) or Wholly Owned Subsidiaries (WOS). Term loans are extended by Exim Bank against equity contribution/loan extended by Indian companies to their JVs/WOS. Term finance is provided directly to the JVs/WOS with corporate guarantee of the Indian promoter companies. Exim Bank can also participate in the equity of the overseas JV/WOS of the Indian company selectively subject to certain conditions.

Special Programmes

Export Marketing Finance (Finance for developing strategic forward linkages): Term loans are extended to important strategic marketing plan covering inter-alia, overseas market research, participating

in international trade fairs, promotion of product, brand positioning, international quality certification, mirror product adaptation, pre-operative expenses for overseas offices, prospective buyers visits to India, etc.

Export Product Development: Term Loan for product adaptation, pilot plants, product/process development, etc.

Backward Linkage/ Vendor Development Programme: The Export Vendor Development Programme aims to support development of backward linkages by exporters. Rupee term finance is available on competitive terms to exporters for implementing strategic vendor development plans i.e. backward linkage for production of goods for exports in order to increase exports. Export/Trading Houses or manufacturer-exporters with satisfactory track record and strategic plan for development of backward linkages for exports are eligible to seek finance under this programme. Exim Bank may provide farm finance to exporters entering into backward linkages through contract farming with farmers on partnership basis for exports.

Finance for Research & Development: Exim Bank also provides lending for Research & Development activities for facilitating exports.

SME Initiatives

Exim Bank has signed a Memorandum of Cooperation with DHAN Foundation, Madurai (a leading NGO covering 3 lakh families in 4 states) for advisory and financial support for export related activities for their grass root enterprises. It has also taken the following initiatives: Set up units to produce value-added products from organic tamarind grown in the area; CFTRI technology has been tied-up; Steps are on to set up an export oriented coco-peat projects; To market products made out of palm leaves and handmade papers in Europe through our overseas offices; To devise marketing strategy for marketing local handicrafts to foreign tourists through 5 star hotels; Exim Bank has signed Memorandum of Cooperation with BASIX, Hyderabad.

BASIX promotes development for the rural poor and women, mainly through Micro-credit and Micro Finance; Exim Bank along with BASIX to organize skill up gradation workshop for handloom weavers in Mahabubnagar Mandal & for tussar silk weavers in Kosgi, Andhra Pradesh;

BASIX in association with Govt. of Rajasthan and UNDP is engaged in discussions for developing export clusters in Rajasthan including Stone Carving and Dari Cluster in Lawan, Dausa and Pottery Cluster in Basawa; Exim Bank is engaged in helping the clusters in product development and establishing export market linkages, organizing workshops and training programs for skill up gradation of rural artisans; Exim Bank's Dubai (formerly Budapest) office helped in exporting sandstone slabs to Hungary; Exim Bank has signed a Memorandum of Cooperation with Uravu (an NGO involved in employment generation programs in the bamboo sector for tribal & poor families in Waynad, Kerala) to provide larger visibility to bamboo-based handicraft products.

Exim Bank has initiated discussion with handloom weavers cooperative societies in Fulia (West Bengal) for marketing their products overseas; National Institute of Fashion Design, Handloom & Handicraft Export Promotion Council and Directorate of Handloom, Govt. of West Bengal participated in the discussions at Exim's office in Kolkata; One suggestion under discussion is to form a marketing company with equity participation by the weavers co-op, West Bengal Govt. and Exim Bank which will take up marketing of the products; Feasibility report under preparation by Indian Institute of Social Welfare & Business Management, Kolkata; Exim Bank is also associated with rural knowledge centre of M.S. Swaminathan Research Foundation for providing technology inputs to rural areas.

Export Market through Lines of Credits

Exim Bank's extends export Lines of Credit (LOC) to overseas financial institutions, regional development banks and foreign governments and their agencies and **Buyers' Credits** (BC) to foreign corporate. LOCs serve as a market entry mechanism to Indian exporters and provide a safe mode of non-recourse **financing option to Indian exporters**.

LOCs/BCs are particularly relevant for **Indian SME exporters** as the payment risk is borne by Exim Bank; Obviate the need for credit insurance from ECGC, etc. Bank has supported a no. of SMEs through LOC/BC mechanism for entering export market without payment risks. Bank's exposure to SMEs will increase considerably when these LOCs get disbursed.

Export Factoring Services

Exim Bank's joint venture company, Global Trade Finance Limited, Mumbai (joint venture with **IFC** and **FIM Bank**) offers export factoring services to SME exporters.

Market and Skill Development

Exim Bank recently launched an 'Export Marketing Services' programme which seeks to help Indian SME sector to establish their products overseas and enter new markets through Exim's overseas offices and MOU partner network. There is no upfront fees, but operates on success-fee basis. Eximius Centres of Learning in Bangalore/ Pune/ Ahmedabad has been set up for knowledge building & capacity creation for SMEs by way of seminars and workshops. Enterprise Management Development Services Programme under implementation in association with International Trade Centre, Geneva comprise:

- a) Development of IT tool kit which will enable SMEs to develop bankable business plans thereby enhancing their access to finance;
- b) Tool kit will also enable lending institutions to screen viable projects
- c) Exim Bank has allocated funds for providing loans to number of small units with export orientation.

Institutional Linkages

- Tie-up with CFTRI, Mysore - Adoption of technologies that can be up scaled with relatively lower amount of investments; and Promotion of SME projects based on CFTRI technologies in overseas market
- Tie-up with CBI Netherlands - Trade capacity creation and knowledge building; Select workshops for SMEs done in the past include specialty & fine chemicals, engineering goods, market entry and market access strategies for Indian SMEs to EU; Recently conducted a series of workshops (Jaipur, Shillong, Delhi) with Dutch experts for promotion of Indian handicrafts abroad
- Tie-up with a number of commercial banks for easier credit delivery

Film Finance

The Bank has till date sanctioned loans more than ₹ 33.15 crores for film production. The first three films financed by Exim Bank have been commercially successful across India and overseas markets.

Nature of Finance

- Cash flow financing for film production
- Cash flow financing for film distribution/exhibition in overseas markets
- Term loans for fixed assets finance
- Term financing for export market development

Rural Initiatives

With the advent of globalization, the barriers to trade are getting dismantled and the dividing line between national and global markets is slowly disappearing. While this phenomenon has resulted in expansion of market opportunities for products and services, it has also made certain sections in developing countries more vulnerable to market vagaries. Thus, the objectives of Exim Bank's rural initiatives are twofold, viz., a) Poverty reduction through export linkages and b) Benefit of Globalization to grass root rural enterprises.

EXIM Bank's Export Marketing Service

In order to assist SMEs and rural enterprises, EXIM Bank has put in place an Export Marketing Service (EMS) programme. Under EMS, EXIM Bank undertakes export marketing of good quality products through its own overseas offices, its network partners abroad on 'success fee' basis. The Bank does not charge any upfront fees, but collect 2-3% of the sales value as service fee only if it is successful in securing orders for the products. The Bank has been successful in securing lucrative orders for rural enterprises from USA, UK, Singapore, Dubai and Johannesburg, where the Bank has its own offices.

The products supported include embroidered clothing, bamboo pens, incense sticks, pomegranate fruit juice concentrate, sandstone blocks, matches, etc. During the course of its interactions with overseas

buyers, the Bank could collect lot of information on quality, packaging, design requirements and guide the Indian suppliers accordingly and thereby enhance the market acceptance of the products.

Exim Bank has been organizing specialized export marketing training programmes to SMEs and rural enterprises with faculty drawn from industry and management institutions at the Bank's training centres located in various cities in India. Faculty support is also accessed from international trade promotion agencies like CBI (Netherlands), JETRO (Japan) for specialized inputs on market entry strategies. Bank has entered into a formal cooperation arrangement with CBI (Netherlands) to organize regular training programmes in India. Recently, two Dutch experts in handicrafts imparted training to number of Indian artisans including tribals at various centres in Indian on product quality, marketing strategy, etc. for entering European markets.

Export Services

Exim Bank offers a diverse range of information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness.

North Eastern Development Finance Corporation(NEDFi)

The North Eastern Development Finance Corporation Ltd (NEDFi) is a Public Limited Company registered under the Companies Act 1956 on 9th August, 1995. It is notified as a Public Financial Institution under Section 4A of the said Act and was registered as an NBFC in 2002 with RBI. The shareholders of the Corporation are IDBI, SBI, LIC, SIDBI, ICICI, IFCI, SUUTI, GIC and its subsidiaries. The management of NEDFi has been entrusted upon the Board of Directors comprising representatives from shareholder institutions, DoNER, State Governments and eminent persons from the NE Region and outside having wide experience in industry, economics, finance and management.

NEDFi provides financial assistance to micro, small, medium and large enterprises for setting up industrial, infrastructure and agri-allied projects in the North Eastern Region of India and also Microfinance through MFI/NGOs. Besides financing, the Corporation offers Consul-

tancy & Advisory services to the state Governments, private sectors and other agencies. It conducts sector or state specific studies under its Techno-Economic Development Fund (TEDF) and is the designated nodal agency for disbursement of Govt. of India incentives to the industries in the North-East India under North-East Industrial and Investment Promotion Policy 2007 (NEIIPP 2007). Our promotional activities include NEDFi Haat, NEDFi Convention Center, NEDFi Pavillion etc. NEDFi is an ISO 9001:2008 certified company since 2001 and our mission is for the economic development of the North Eastern Region of India by identifying, financing and nurturing commercially and financially viable projects in the region.

Genesis

In 1994, the I. K. Borthakur Committee Report conceptualized the formation of a North-Eastern Development Bank to cater to the needs of the region. Following this report, the then Finance Minister, Dr. Manmohan Singh, in his budget speech in March 1995 announced setting up of a development bank for the North Eastern States of India. Pursuant to this, the North Eastern Development Finance Corporation Ltd. (NEDFi) was incorporated under the Companies Act, 1956, on August 9, 1995 with its Registered Office at Guwahati, Assam. The Corporation was formally inaugurated by the then Prime Minister, Shri P.V. Narashima Rao on February 23, 1996. At the time of its establishment, the corporation was placed under the Ministry of Finance, Banking Division for administrative purpose. However, with the formation of Ministry of Development of North Eastern Region (DoNER), Govt. of India in 2004, the Corporation has been placed under the Ministry of DoNER for administrative purpose.

Management of NEDFi

NEDFi is a Board-managed organization. The Board of Directors comprises CMD of NEDFi, representatives from shareholder institutions, DoNER, State Governments and individuals having wide experience in industry, economics, finance and management. The responsibility for the day-to-day management of operations of NEDFi is vested with the Chairman & Managing Director and its management team. Management of NEDFi is supported by a team of professional and qualified employees from various fields of management, law, accountancy, engineering, computer technology and economics.

NEDFi being lean organization, at present the organization structure of NEDFi is flexible, flat and dynamic to meet the challenges and the need of the region. NEDFi believes in strong management and professionals from various fields having knowledge of the region. NEDFi is headed by Chairman cum Managing Director which is assisted by General Managers and senior managers for day to day operation of the corporation. Moreover NEDFi has a pool of talented and qualified young people from the reputed institutions.

Performance Highlights

Sanction, Disbursement (Figure in ₹ Cr.)& No of Project Sanctioned (As on March 31, 2012)

Particulars	FY 2009-10	FY 2010-11	FY 2011-12	Cumulative as on 31/03/2012
Sanction	333	421	432	2481
Disbursement	208	281	335	1617
No of Projects	211	198	253	2458

Products

NEDFi has wide variety of financial products to provide financial assistance to micro, small, medium and large enterprises in the North Eastern Region of India. Considering the need and the requirement specific to the region, NEDFi's products are designed and broadly classified into Project Finance, MSE Finance and Micro Finance.

Project Finance

Under project finance, various schemes are available for providing financial assistance to viable industrial, infrastructure and agri-allied projects in the North Eastern States of India. Typically, NEDFi provide Rupee Term Loans for setting up new ventures, expansion, diversification etc. The schemes under project finance are as under:

- Rupee Term Loan Scheme
- Equipment Finance Scheme
- Corporate Finance Scheme
- WCTL for Contract Finance Scheme
- Working Capital Term Loan Scheme etc.

For availing financial assistance under the above mentioned schemes of project finance, a Loan Application along with Detailed Project Report (DPR) and other relevant documents will have to be submitted to NEDFi

MSE Finance

To cater the need of micro & small industrial enterprises and to boost up entrepreneurship of the North East region, NEDFi has formulated the MSE department. This department gives special attention to budding enterprises of every nook and corner of the region. With the broader objective to encourage & cheering up micro – small entrepreneurs, some specialized schemes have been designed and placed under MSE department as elaborated below:

- North East Entrepreneur's Development Scheme [NEEDS]
- Women Enterprises Development Scheme (WEDS)
- Initiative for Development of Entrepreneurs in Agriculture (IDEA)
- Jute Enterprises Development Scheme (JEDS)
- Scheme for North East Handloom and Handicrafts (SNEHH)

Micro Finance

With the objective of developing & supporting NGOs/Voluntary Agencies (VA)s with good track record for on-lending to the “needy” for taking up any income generating activities in the rural areas, NEDFi has Micro Finance scheme for extending financial assistance to NGOs/VAs for on-lending to the people for self-employment projects that generate income, allowing them to care for themselves and the families.

India Infrastructure Finance Company Ltd (IIFCL)

Background

IIFCL was incorporated under the Companies Act as a wholly-owned Government of India company in January 2006 and commenced operations from April 2006 to provide long term finance to viable infrastructure projects through the Scheme for Financing Viable Infrastructure Projects through a Special Purpose Vehicle called India Infrastructure Finance Company Ltd (IIFCL), broadly referred to as SIFTI. The sectors eligible for financial assistance from IIFCL are roads and highways, power, airport, port, urban infrastructure, cold storage, warehousing, fertilizer manufacturing etc. IIFCL accords overriding priority to Public-Private Partnership (PPP) Projects. The authorized & paid up capital of the company as on 30th June 2012 was ₹ 5,000 crore and ₹ 2,500 crores respectively.

IIFCL's Current Offerings

Direct Lending

Provides long term Senior and subordinate debt through participation in lending consortium.

Refinance

Provides refinance to Banks and eligible institutions against their infrastructure lending portfolio.

Takeout Finance

Takeout Finance Scheme of IIFCL is aimed at addressing the Asset Liability Mismatch and exposure constraints faced by banks by taking out loan from the books of the banks. This helps banks to free up their funds for investing in newer infrastructure projects.

Credit Enhancement

IIFCL is presently undertaking pilot transactions under its Credit

Enhancement initiative. Under this scheme IIFCL provides partial credit guarantee to enhance the ratings of the project bond issue thereby enabling channelization of long term funds from investors like insurance companies and pension funds. Further, during the pilot phase, Asian Development Bank (ADB) is participating in this endeavor by committing to support IIFCL by providing backstop guarantee facility up to 50% of IIFCL's underlying project risk

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Lesson 3.4 - International Financial Institutions

Learning Objectives

- To understand the role of International Bank for Reconstruction and Development (IBRD).
- To understand the role of International Finance Corporation (IFC).
- To understand the role of International Development Association (IDA).

Introduction

In this lesson, let us understand the role of international financial institutions such as IBRD, IFC and IDA.

International Bank for Reconstruction and Development (IBRD)

Background

Founded in 1944 to help Europe recover from World War II, the International Bank for Reconstruction and Development (IBRD) is one of five institutions that make up the World Bank Group. IBRD is the part of the World Bank (IBRD/IDA) that works with middle-income and creditworthy poorer countries to promote sustainable, equitable and job-creating growth, reduce poverty and address issues of regional and global importance.

Structured something like a cooperative, IBRD is owned and operated for the benefit of its 188 member countries. Delivering flexible, timely and tailored financial products, knowledge and technical services, and strategic advice helps its members achieve results. Through the World Bank Treasury, IBRD clients also have access to capital on favorable terms in larger volumes, with longer maturities, and in a more sustainable manner than world financial markets typically provide.

Specifically, the IBRD

- supports long-term human and social development needs that private creditors do not finance;
- preserves borrowers' financial strength by providing support in crisis periods, which is when poor people are most adversely affected;
- uses the leverage of financing to promote key policy and institutional reforms (such as safety net or anticorruption reforms);
- creates a favorable investment climate in order to catalyze the provision of private capital;
- provides financial support (in the form of grants made available from the IBRD's net income) in areas that are critical to the well-being of poor people in all countries.

Middle-income countries, where 70 percent of the world's poor live, have made profound improvements in economic management and governance over the past two decades and are rapidly increasing their demand for the strategic, intellectual and financial resources the World Bank has to offer. The challenge facing the IBRD is to better manage and deliver its resources to best meet the needs of these countries. To increase its impact in middle-income countries, IBRD is working closely with the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), the International Monetary Fund (IMF) and other multilateral development banks. In the course of its work, IBRD is also striving to capitalize on middle-income countries' own accumulated knowledge and development experiences and collaborates with foundations, civil society partners and donors in the development community.

IBRD Products and Services

IBRD aims to reduce poverty in middle-income and creditworthy poorer countries by promoting sustainable development through loans, guarantees, risk management products, and (non-lending) analytical and advisory services.

IBRD has three main business lines:

- **Strategy and Coordination Services**
- **Financial Services**
- **Knowledge Services**
 - Poverty Assessments
 - Social and Structural Reviews
 - Public Expenditure Reviews
 - Sector Reports
 - Country Economic Memoranda
 - Knowledge Sharing

How IBRD is Financed

IBRD raises most of its funds on the world's financial markets. It has become one of the most established borrowers since issuing its first bond in 1947 to finance the reconstruction of Europe after World War Two. Investors see IBRD bonds as a safe and profitable place to put their money and their cash finances projects in middle-income countries. The income that IBRD has generated over the years has allowed it to fund development activities and to ensure its financial strength, which enables it to borrow at low cost and offer clients' good borrowing terms.

IBRD became a major player on the international capital markets by developing modern debt products, opening new markets for debt issuance, and by building up a broad investor base around the world of pension funds, insurance companies, central banks, and individuals. The World Bank's borrowing requirements are primarily determined by its lending activities for development projects. As World Bank lending has changed over time, so has its annual borrowing program. In 1998 for example, IBRD borrowing peaked at \$28 billion with the Asian financial crisis. It is now projected to borrow between \$10 to 15 billion a year. IBRD borrows at attractive rates on the capital markets thanks to its triple-A status that it has had with credit rating agencies since 1959. This has enabled it to borrow in U.S. dollars, for example, at an overall funding cost that comes close to that of the U.S. Treasury.

IBRD enjoys its high credit rating because it is backed by the capital commitments of its 186 shareholder governments. It is also the result of IBRD's strong balance sheet, prudent financial policies, and its expected treatment as a preferred creditor when a country has difficulty in repaying its loans. IBRD has also profited from anticipating shifts in investor preferences and investing in the risk management and systems to take advantage of those trends. IBRD has to its credit a string of firsts in its borrowing program. These include the first currency swap in international markets in 1981, through to the introduction of the first global bond in 1989, to the first fully integrated electronic bond offering via the Internet in 2000. In 2003, the World Bank executed the first fully electronic swap auction.

Innovations by IBRD have also supported its goal of promoting development. Although much of its borrowing is in U.S. dollars, IBRD has over the years offered bonds in more than 40 different currencies. Its issues in nascent capital markets have often been a catalyst for improving market infrastructure and efficiency. IBRD's earns an income every year from the return on its equity and from the small margin it makes on lending. This pays for IBRD's operating expenses, goes into reserves to strengthen the balance sheet and also provides an annual transfer to the International Development Association (IDA). IBRD has raised the bulk of the money loaned by the World Bank to alleviate poverty around the world. This has been done at a relatively low cost to taxpayers, with governments paying in \$11 billion in capital since 1946 to generate more than \$400 billion in loans.

International Finance Corporation (IFC)

A daring new idea when created in the 1950s, IFC is the largest organization of its kind in the world. A sense of innovation and the strength of our core corporate values--excellence, commitment, integrity and teamwork--have driven this remarkable growth over the years. Holding a \$48.8 billion portfolio touching almost every major industry, we now reach millions of people in more than 100 countries, creating jobs, raising living standards, and building a better future.

- **Vision** is that people should have the opportunity to escape poverty and improve their lives.

- **Values** are excellence, commitment, integrity, teamwork, and diversity.
- **Purpose** is to create opportunity for people to escape poverty and improve their lives by:
 - Mobilizing other sources of finance for private enterprise development
 - Promoting open and competitive markets in developing countries
 - Supporting companies and other private sector partners where there is a gap
 - Helping generate productive jobs and deliver essential services to the poor and the vulnerable

To achieve the said purpose, IFC offers development-impact solutions through firm-level interventions (direct investments, advisory services, and the IFC Asset Management Company); by promoting global collective action; by strengthening governance and standard-setting; and through business-enabling-environment work.

Organization

IFC coordinates its activities with the other institutions of the **World Bank Group** but is legally and financially independent.

Ownership & Governance

IFC's **184 member countries**, through a **Board of Governors** and a **Board of Directors**, guide IFC's programs and activities. Each country appoints one governor and one alternate.

Management

The **World Bank Group's president** also serves as IFC's president. The **Management Team** assists the Executive Vice President and CEO in decision-making and strategic planning. IFC's projects and programs are evaluated by the **Independent Evaluation Group**. Accountability is ensured by the independent **Office of the Compliance Advisor/Ombudsman**. IFC's operations are carried out by its departments, most of which are

organized by world region or global industry/sector. IFC has over 3,400 staff, of which 51% work in field offices and 49% at headquarters in Washington, D.C.

IFC Investment Services

Through Investment Services IFC provides a broad suite of financial products and services—including loans, equity, trade finance, structure finance, and syndications—designed to promote development in emerging economies, help reduce poverty and spur long-term growth by promoting sustainable enterprises, encouraging entrepreneurship, and mobilizing resources that wouldn't otherwise be available.

IFC continues to develop new financial products that enable companies to manage risk and broaden their access to foreign and domestic capital markets. In FY11, IFC invested \$12.2 billion in 518 projects, of which \$4.9 billion went to the poorest countries eligible to borrow from the World Bank's International Development Association. Also an additional \$6.5 billion has been mobilized to support the private sector in developing countries.

IFC Advisory Services

Through Advisory Services IFC offers advice, problem solving, and training to companies, industries, and governments, all aimed at helping private sector enterprises overcome obstacles to growth.

IFC Asset Management Company

IFC Asset Management Company, a wholly owned subsidiary of IFC, mobilizes and manages third-party capital funds for investment in developing and frontier markets. IFC Asset Management Company mobilizes and manages funds on behalf of a wide variety of institutional investors—including sovereign funds, pension funds, and development finance institutions. A wholly owned subsidiary of IFC, it invests alongside IFC and all its investments adopt IFC Performance Standards. It raises funds targeted at large institutional investors who are looking to increase their exposure to emerging markets and who are interested in accessing IFC's transaction pipeline, investment approach, and track record of

superior returns. As of June 30, 2011, IFC Asset Management Company had approximately \$4.1 billion in assets under management.

International Development Association (IDA)

What Is IDA?

The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries. Established in 1960, IDA aims to reduce poverty by providing loans (called "credits") and grants for programs that boost economic growth, reduce inequalities, and improve people's living conditions. IDA complements the World Bank's original lending arm—the International Bank for Reconstruction and Development (IBRD). IBRD was established to function as a self-sustaining business and provides loans and advice to middle-income and credit-worthy poor countries. IBRD and IDA share the same staff and headquarters and evaluate projects with the same rigorous standards.

IDA is one of the largest sources of assistance for the world's 81 poorest countries, 39 of which are in Africa. It is the single largest source of donor funds for basic social services in these countries. IDA-financed operations deliver positive change for 2.5 billion people, the majority of whom survive on less than \$2 a day. IDA lends money on concessional terms. This means that IDA charges little or no interest and repayments are stretched over 25 to 40 years, including a 5- to 10-year grace period. IDA also provides grants to countries at risk of debt distress. In addition to concessional loans and grants, IDA provides significant levels of debt relief through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). Since its inception, IDA has supported activities in 108 countries. Annual commitments have increased steadily and averaged about \$15 billion over the last three years, with about 50 percent of that going to Africa. For the fiscal year ending on June 30, 2012, IDA commitments reached \$14.8 billion spread over 160 new operations.

IDA History

The International Bank for Reconstruction and Development (IBRD), better known as the World Bank, was established in 1944 to help Europe recover from the devastation of World War II. The success

of that enterprise led the Bank, within a few years, to turn its attention to the developing countries. By the 1950s, it became clear that the poorest developing countries needed softer terms than those that could be offered by the Bank, so they could afford to borrow the capital they needed to grow. In the early 1950's, reports from the United Nations and the U.S. government supported the establishment of a program to lend to poor countries on concessional terms with the backing of multilateral donors. After initial deliberations, the idea to create the International Development Association (IDA), an agency to provide 'soft-loans' to developing countries, was floated within the Bank under the stewardship of President Eugene Black. **Monroney Resolution** received support from Democratic Senator Mike Monroney of Oklahoma, who was interested in the provision of soft-loans for developing nations with the World Bank as the dispenser of the aid. When appointed chairman of the Senate Subcommittee on International Finance, he proposed what came to be known as the Monroney Resolution.

Articles of Agreement for IDA

As the resolution was passed in the U.S. Senate, the U.S. Treasury Secretary announced at the 1958 annual Bank and Fund meetings in New Delhi that the U.S. was seriously studying the proposal of a Bank-based IDA and hoped others would do the same. After consultations, which began among the member governments of the World Bank in 1958, the Bank's Board of Governors at its Annual Meeting in 1959 approved a United States resolution calling on the Bank's Executive Directors to draft the Articles of Agreement for IDA. Before the end of January 1960, the Bank had circulated the Articles of Agreement to all of the members for ratification, and received approval from member countries including the U.S. under President Dwight D. Eisenhower.

Launch of IDA

With an initial funding of \$912.7 million, IDA was launched on September 24, 1960 with 15 signatory countries - Australia, Canada, China, Germany, India, Italy, Malaysia, Norway, Pakistan, Sudan, Sweden, Thailand, United Kingdom, United States, and Vietnam. Within its first eight months of launch, IDA had 51 members and allocated credits worth \$101 million to four countries. Honduras received the first IDA credit

for highway maintenance. Chile, Sudan, and India were the other three recipients. IDA has grown to include 172 member countries, and has become the leading source of concessional lending to 81 of the world's poorest countries, with 39 countries in Africa. Overall, 36 countries have graduated from IDA and some have 'reverse-graduated' or re-entered IDA. Since its inception, IDA credits and grants have totaled \$255 billion, averaging \$15 billion a year in recent years with Africa receiving 50% of the share.

IDA Financing

IDA funds are allocated to the recipient countries in relation to their income levels and record of success in managing their economies and their ongoing IDA projects. IDA's lending terms are highly concessional, meaning that IDA credits carry no or low interest charges.

FY12 Top 10 IDA Borrowers*	\$ million
India	2,733
Nigeria	1,345
Pakistan	1,290
Vietnam	1,049
Ethiopia	920
Kenya	878
Bangladesh	866
Ghana	470
Tanzania	420
Côte d'Ivoire	390

Commitments include country commitments for regional projects and guarantees. The lending terms are determined with reference to recipient countries' risk of debt distress, the level of GNI per capita, and creditworthiness for the International Bank for Reconstruction and Development (IBRD) borrowing. Recipients with a high risk of debt distress receive 100 percent of their financial assistance in the form of

grants and those with a medium risk of debt distress receive 50 percent in the form of grants. Other recipients receive IDA credits on regular or blend and hard-terms with 40-year and 25-year maturities respectively. In fiscal year 2012 (which ended June 30, 2012), IDA commitments totaled \$14.8 billion (including IDA guarantees), of which 15 percent was provided on grant terms. New commitments in FY12 comprised 160 new operations. Since 1960, IDA has provided \$255 billion to 108 countries. Annual commitments have increased steadily and averaged about \$15 billion over the last three years. IDA-financed operations address primary education, basic health services, clean water and sanitation, environmental safeguards, business climate improvements, infrastructure and institutional reforms. These projects pave the way toward economic growth, job creation, higher incomes and better living conditions.

IDA emphasizes broad-based growth, including: a) Sound economic policies, rural development, private business, and sustainable environmental practices; b) Investment in people, in education and health, especially in the struggle against HIV/AIDS, malaria, and TB; c) Expansion of borrower capacity to provide basic services and ensure accountability for public resources; d) Recovery from civil strife, armed conflict, and natural disaster; e) Promotion of trade and regional integration. IDA carries out analytical studies to build the knowledge base that allows intelligent design of policies to reduce poverty. IDA advises governments on ways to broaden the base of economic growth and protect the poor from economic shocks. IDA also coordinates donor assistance to provide relief for poor countries that cannot manage their debt-service burden. IDA has developed a system for allocating grants based on countries' risk of debt distress, designed to help countries ensure debt obligations are met (debt sustainability).

Lesson 3.5 - Agricultural, Rural and Micro Financial Institutions

Learning Objectives

- To understand the role of National Bank for Agriculture and Rural Development (NABARD).
- To understand the role of Small Farmers' Agri-Business Consortium (SFAC).
- To understand the role of Irrigation & Water Resources Finance Corporation (IWRFC).
- To understand the role of Micro Financial Institutions (MFIs).

Introduction

There are financial institutions which help the agriculture, irrigation and rural development of the nation. In this lesson, we will try to understand the role of National Bank for Agriculture and Rural Development (NABARD), Small Farmers' Agri-Business Consortium (SFAC), Irrigation & Water Resources Finance Corporation (IWRFC) and Micro Financial Institutions (MFIs).

National Bank for Agriculture and Rural Development (NABARD)

NABARD is set up by the Government of India as a development bank with the mandate of facilitating credit flow for promotion and development of agriculture and integrated rural development. The mandate also covers supporting all other allied economic activities in rural areas, promoting sustainable rural development and ushering in prosperity in the rural areas. With a capital base of ₹ 2,000 crore provided by the Government of India and Reserve Bank of India, it operates through its head office at Mumbai, 28 regional offices situated in state capitals and 391 district offices at districts. It is an apex institution handling matters concerning policy, planning and operations in the field of credit for agriculture and for other economic and developmental activities in rural areas. Essentially, it is a refinancing agency for financial institutions offering production

credit and investment credit for promoting agriculture and developmental activities in rural areas.

In discharging its role as a facilitator for rural prosperity NABARD is entrusted with a) providing refinance to lending institutions in rural areas; b) bringing about or promoting institutional development; and c) evaluating, monitoring and inspecting the client banks. Besides this pivotal role, NABARD also acts as a coordinator in the operations of rural credit institutions; extends assistance to the government, the Reserve Bank of India and other organizations in matters relating to rural development; offers training and research facilities for banks, cooperatives and organizations working in the field of rural development; helps the state governments in reaching their targets of providing assistance to eligible institutions in agriculture and rural development; and acts as regulator for cooperative banks and RRBs.

NABARD Today

- Initiates measures toward 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.
- Coordinates the rural financing activities of all the institutions engaged in developmental work at the field level and maintains liaison with the government of India, State governments, the Reserve Bank of India and other national level institutions concerned with policy formulation.
- Prepares, on annual basis, rural credit plans for all the districts in the country. These plans form the base for annual credit plans of all rural financial institutions.
- Undertakes monitoring and evaluation of projects refinanced by it.
- Promotes research in the fields of rural banking, agriculture and rural development.
- Functions as a regulatory authority, supervising, monitoring and guiding cooperative banks and regional rural banks.
- It supports State Governments in creation of infrastructure.

NABARD's Roles and Functions

- Credit Functions
- Developmental and Promotional Functions
- Supervisory Functions
- Institutional and Capacity building
- Role in Training

Credit Functions

NABARD's credit functions cover planning, dispensation and monitoring of credit. This activity involves:

- Framing policy and guidelines for rural financial institutions
- Providing credit facilities to issuing organizations
- Preparation of potential-linked credit plans annually for all districts for identification of credit potential
- Monitoring the flow of ground level rural credit

Development and Promotional Functions

Credit is a critical factor in development of agriculture and rural sector as it enables investment in capital formation and technological up gradation. Hence, strengthening of rural financial institutions, which deliver credit to the sector, has been identified by NABARD as a thrust area. Various initiatives have been taken to strengthen the cooperative credit structure and the regional rural banks, so that adequate and timely credit is made available to the needy.

In order to reinforce the credit functions and to make credit more productive, NABARD has been undertaking a number of developmental and promotional activities such as:-

- Help cooperative banks and Regional Rural Banks to prepare development actions plans for themselves.
- Enter into MoU with state governments and cooperative banks specifying their respective obligations to improve the affairs of the banks in a stipulated timeframe.

- Help Regional Rural Banks and the sponsor banks to enter into MoUs specifying their respective obligations to improve the affairs of the Regional Rural Banks in a stipulated timeframe obligation to improve the affairs of the banks in a stipulated timeframe.
- Monitor implementation of development action plans of banks and fulfillment of obligations under MoUs.
- Provide financial assistance to cooperatives and Regional Rural Banks for establishment of technical, monitoring and evaluations cells.
- Provide organization development intervention (ODI) through reputed training institutes like Bankers Institute of Rural Development (BIRD), Lucknow, National Bank Staff College, Lucknow and College of Agriculture Banking, Pune, etc.
- Provide financial support for the training institutes of cooperative banks.
- Provide training for senior and middle level executives of commercial banks, Regional Rural Banks and cooperative banks.
- Create awareness among the borrowers on ethics of repayment through Vikas Volunteer Vahini and Farmer's clubs.
- Provide financial assistance to cooperative banks for building improved management information system, computerization of operations and development of human resources.

Supervisory Functions

As an apex bank involved in refinancing credit needs of major financial institutions in the country engaged in offering financial assistance to agriculture and rural development operations and programmes, NABARD has been sharing with the Reserve Bank of India certain supervisory functions in respect of cooperative banks and Regional Rural Banks (RRBs).

As part of these functions, it

1. Undertakes inspection of Regional Rural Banks (RRBs) and Cooperative Banks (other than urban/primary cooperative banks)

under the provisions of Banking Regulation Act, 1949.

2. Undertakes inspection of State Cooperative Agriculture and Rural Development Banks (SCARDBs) and apex non-credit cooperative societies on a voluntary basis.
3. Undertakes portfolio inspections, systems study, besides off-site surveillance of Cooperative Banks and Regional Rural Banks (RRBs)
4. Provides recommendations to Reserve Bank of India on issue of licenses to Cooperative Banks, opening of new branches by State Cooperative Banks and Regional Rural Banks (RRBs).
5. Administering Credit Monitoring Arrangements (CMA) in SCBs and CCBs.

Core Functions

NABARD has been entrusted with the statutory responsibility of conducting inspections of State Cooperative Banks (SCBs), District Central Cooperative Banks (DCCBs) and Regional Rural Banks (RRBs) under the provisions of Section 35(6) of the Banking Regulation Act (BR Act), 1949. In addition, NABARD has also been conducting periodic inspections of state level cooperative institutions such as State Cooperative Agriculture and Rural Development Banks (SCARDBs), Apex Weavers Societies, Marketing Federations, etc., on a voluntary basis.

Objectives

The rural financial system in the country calls for a strong and efficient credit delivery system, capable of taking care of the expanding and diverse credit needs of agriculture and rural development. More than 50% of the rural credit is disbursed by the Co-operative Banks and Regional Rural Banks. NABARD is responsible for regulating and supervising the functions of Co-operative banks and RRBs. In this direction NABARD has been taking various initiatives in association with Government of India and RBI to improve the health of Co-operative banks and Regional Rural Banks.

Development Action Plan (DAP)/Memorandum of Understanding (MoU)

In order to strengthen Co-operative Credit Institutions both in Short Term and Long Term Structures as viable units on a sustainable basis, NABARD had introduced a mechanism of DAP/MoU aiming at institution specific measures in 1994-95. The performance obligations arising out of DAP formed the basis of the Memorandum of Understanding (MoU) between stake holders. The mechanism of DAP/MoU has helped in building appreciation and awareness for strategic planning facilitating, in turn, sustainable viability at all levels. The feedback received indicates that there was positive impact on the performance of banks as a result of introduction of DAP/MoU through reduction of CoM and cost of resources. The DAP planning process, as an internal strategy for corporate planning, had facilitated in creating an awareness in the cooperative banking structure and RRBs about the need for strategic planning for corporate success.

Subsidiaries of NABARD

NABCONS

NABARD Consultancy Services (NABCONS) is a wholly owned subsidiary promoted by National Bank for Agriculture and Rural Development (NABARD) and is engaged in providing consultancy in all spheres of agriculture, rural development and allied areas. Nabcons leverages on the core competence of the NABARD in the areas of agricultural and rural development, especially multidisciplinary projects, banking, institutional development, infrastructure, training, etc., internalized for more than two decades. The Company is registered under the Company's Act, 1956, with an authorized capital of ₹ 250 million (US \$5.75 million) and paid up capital of ₹ 50 million (US \$1.15 million). In tune with NABARD's mission to bring about rural prosperity, Nabcons has more than just commercial interest in the assignments it undertakes.

NABARD Financial Services Limited [NABFINS]

NABFINS is a subsidiary of National Bank for Agriculture and Rural Development (NABARD) with equity participation from

NABARD, Government of Karnataka, Canara Bank, Union Bank of India, Dhanalakshmi Bank and Federal Bank. It is a non-deposit taking NBFC registered with the Reserve Bank of India and shall operate throughout India. The main objectives of the Company are to provide financial services in two broad areas of agriculture and microfinance. NABFINS provides credit and other facilities for promotion, expansion, commercialization and modernization of agriculture and allied activities.

NABFINS shall engage in the business of providing micro finance services (with or without thrift) and other facilities to needy and disadvantaged sections of the society for securing their prosperity in both rural and urban areas. NABARD, which is the world renowned apex development bank of our country and pioneered the world's largest microfinance movement, while promoting NABFINS has envisaged that NABFINS shall evolve into a Model Microfinance Institution to set standards of governance among the MFIs, operate with exemplary levels of transparency and operate at reasonable / moderate rates of interest.

Associates

NABARD's international associates range from World Bank-affiliated organizations to global developmental agencies working in the field of agriculture and rural development. These agencies offer material and advisory help in implementing schemes that are aimed at uplifting the rural poor and in making agricultural processes effective and yielding.

Some of the Milestones in NABARD's Activities

a) Business Operations

Production Credit: Production Credit (or Crop Loans) to Cooperative Banks and Regional Rural Banks (RRBs) stood at ₹48,981 crore during 2011-12, registering a growth of 45 per cent over the previous year.

Investment Credit: Investment Credit for capital formation in agriculture & allied sectors, non-farm sector activities and services sector to commercial banks, RRBs and co-operative banks reached a level of ₹15,421 crore as on 31 March 2012 registering an increase of 14 per cent, over the previous year.

Rural Infrastructure Development Fund (RIDF): Through the Rural Infrastructure Development Fund (RIDF) ₹14927 crore was disbursed during 2011-12. A cumulative amount of ₹142470.65 crore has been sanctioned for 462229 projects as on 31 March 2012 covering irrigation, rural roads and bridges, health and education, soil conservation, drinking water schemes, flood protection, forest management etc.

b) New Business Initiatives

NABARD Infrastructure Development Assistance (NIDA): NABARD has set up NIDA, a new line of credit support for funding of rural infrastructure projects. The cumulative sanctions under NIDA during the year 2011-12 was ₹890.85 crore and disbursement was ₹422.90 crore.

Producers Organizations Development Fund (PODF): In order to support and finance Producers' Organizations, NABARD set up PODF. During the year, 13 projects were sanctioned to Producers Organizations and 70 projects to PACS, with an assistance of ₹32.29 crore and ₹7.75 crore, respectively. The cumulative sanction under the fund was ₹40.04 crore.

Direct Lending to CCBs: Under Direct lending to CCBs, ₹937.74 crore was disbursed during the year 2011-12.

PACS as Multi Service Centres: A total of 2,335 PACS have been developed as Multi-service Centres through various interventions from NABARD.

Core Banking Solutions (CBS): Through Core Banking Solution (CBS), Co-operatives are being brought to a higher technology platform so as to compete with other banks for business and growth.

c) Development Initiatives

Watershed Development Fund (WDF): During 2011-12, NABARD provided assistance of ₹239.99 crore for watershed development covering an area of 5.29 lakh ha, as against ₹152 crore during 2010-11. The cumulative support stood at ₹598 crore in respect of 620 projects as on 31 March 2012

Farm Innovation and Promotion Fund (FIPF): During 2011-12, 41 projects were sanctioned under FIPF in 14 States with financial assistance of ₹56.53 crore under the Fund. The Fund also supported the pilot testing of the unique mobile-enabled Kisan Credit Project (m-KCC) project.

Farmers' Technology Transfer Fund (FTTF): During the year 2011-12, 395 proposals were sanctioned in 29 States with grant assistance of ₹20.59 crore. The cumulative disbursement as at the end of March 2012 was ₹44.59 crore.

Farmers' Clubs: With the launching of 25,243 new Farmers' Clubs during the year, the number of clubs reached 1,01,951 as on 31 March 2012

Umbrella Programme on Natural Resource Management (UPNRM): UPNRM aims to boost rural livelihoods by supporting community-managed sustainable natural resource management projects and supported 104 projects in 16 States with disbursements to the tune of ₹131.89 crore.

Tribal Development Fund (TDF): During the year 2011-12, financial assistance of ₹290.63 crore was sanctioned for 98 projects benefiting 72,419 tribal families in 16 States. The cumulative sanction as on 31 March 2012 was ₹1,208.23 crore, covering 3.23 lakh families in 415 projects across 26 States/UTs.

Financial Inclusion Fund (FIF) and the Financial Inclusion Technology Fund (FITF): As on 31 March 2012, the cumulative sanctions under FIF and FITF were ₹114.62 crore and ₹343.48 crore, respectively and disbursements were ₹36.46 crore and ₹184.16 crore, respectively.

SHG-Bank Linkage Programme: As on 31 March 2011, there were more than 74.62 lakh savings linked Self Help Groups (SHG) and more than 47.87 lakh credit-linked SHGs covering 9.7 crore poor households under the micro-finance programme. The SHG - Bank Linkage Programme was given a renewed thrust with the launch of SHG-2.

Small Farmers' Agri-Business Consortium (SFAC)

Mission Statement

Indian agriculture today is essentially smallholder agriculture; as much as 83% of all cultivators are either marginal or small (which means that they till less than 2 hectares, or 5 acres, of land). The average landholding size has shrunk to 1.2 hectares. Yet across a range of parameters, from intensity of cultivation to per capita use of irrigation and fertilizer, small and marginal farmers are more productive and efficient than large landholders. The challenges that these small producers face can be summed up in three words, viz., Investments, Technology and Markets.

Establishment of SFAC

Realizing that the prevailing need for creating a conducive environment for generating rural employment and enhancing farmers income, the then Hon'ble Finance Minister announced the decision of Government of India's new innovative for setting up of Small Farmer's Agri-Business Consortium in his budget speech for the year 1992-93 in the following words: **"Special attention needs to be paid to supporting innovative ideas for generating income and employment in rural areas through support to various types of agri-business".**

The setting up of the Small Farmers' Agri-Business Consortium (SFAC) in 1994 was a sequel to the above announcement for bringing about and facilitating a farm-focus growth through new ventures in agro-based industries. SFAC has emerged as a Developmental Institution with its core aims and objectives focused on increased production and productivity, value addition, provision of efficient linkages between producers and consumers. SFAC deals with agriculture in its wider connotation, including fisheries and horticulture.

Objectives

- To catalyze agro-industrial growth in the country based on the principles of Ecological sustainability, Economic efficiency and Social equity.
- To undertake or assist in undertaking programs for employment

generation, growth and diversification of agriculture & agro-based industries to increase food production and export of agriculture products, in both primary and processed forms.

- To identify and promote post-harvest processing/manufactures units in the public, private and cooperative sector.
- To promote organization of marketing chain both for domestic and export marketing.
- To influence Government policies for agriculture, thereby increasing the flow of resources and augmenting the rate of capital formation in agriculture sector.
- To pave the way for establishment of integrated producers' organizations with forward and backward linkages.
- To prepare, print and publish papers, periodicals, monographs in furtherance of the objectives of the society.

Work Scope

SFAC in addition to the endeavors complying with its core objectives, also takes up implementation of the schemes and programs of various Government of India (GOI) Ministries and Departments and other Financial Institutions and Banks on a service charge basis. The SFAC society is currently implementing the following schemes and programs viz.

- The Schematic Pattern of Assistance from SFAC, out of GOI grants-in-aid for promotion of value addition in the hands of farmers, through setting up part-processing, Semi-processing and full-processing facilities, through the setting up of Agri-Business ventures all over the country mostly in collaboration with the private sector. and active corporation of commercial banks.
- SFAC also provides to agri-business projects involving value addition in the hands of the farmers. Most of these projects involve agri-partner and post harvest management, marketing etc.
- Horticulture Mission For North East And Himalayan States (HMNEH) on Behalf of the Department of Agriculture & Cooperation, which seeks to create a viable alternative livelihood

option for the people of NER, taking into account the entire gamut of horticulture development, with all backward and forward linkages in a holistic manner.

Irrigation & Water Resources Finance Corporation (IWRFC)

In the Budget Speech for 2008-09, the Finance Minister made an announcement that keeping in view the massive investments required to be made in irrigation projects, Government proposes to establish the Irrigation and Water Resources Finance Corporation (IWRFC) with an initial capital of ₹.100 crore contributed by the Central Government to mobilize the very large resources that will be required to fund major and medium irrigation projects. In compliance with the above Announcement, Irrigation and Water Resources Finance Corporation Limited (IWRFC) has been set up as a Company under the Companies Act, 1956 on March 29, 2008 with an initial paid up capital of ₹.100 crore contributed by Central Govt. In the Budget speech of 2012-13, Hon'ble FM has announced that 'To mobilize large resources to fund irrigation projects, a Government owned Irrigation and Water Resource Finance Company is being operationalized. The Company would start its operations in 2012-13 by focusing on financing sub-sectors like micro-irrigation, contract farming, waste water management and sanitation'. In pursuance of the Budget Announcement IWRFC has been operationalized and Shri S.K. Goel, Chairman & Managing Director, India Infrastructure Finance Company Limited (IIFCL) has been appointed as CMD, IWRFC (Additional Charge).

Micro Finance Institutions (MFIs)

MFIs could play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. Many of them operate in a limited geographical area, have a greater understanding of the issues specific to the rural poor, enjoy greater acceptability amongst the rural poor and have flexibility in operations providing a level of comfort to their clientele. There are several legal forms of MFIs. However, firm data regarding the number of MFIs operating under different forms is not available. It is roughly estimated that there are about 1,000 NGO-MFIs and more than 20 Company MFIs. Further, in Andhra Pradesh, nearly 30,000 cooperative organizations are engaged in MF activities. However, the company MFIs are major players accounting for over 80% of the microfinance loan portfolio.

Definition of Microfinance and MFIs

The proposed Microfinance Services Regulation Bill defines micro finance services as “providing financial assistance to an individual or an eligible client, either directly or through a group mechanism for:

- i) an amount, not exceeding rupees fifty thousand in aggregate per individual, for small and tiny enterprise, agriculture, allied activities (including for consumption purposes of such individual) or
- ii) an amount not exceeding rupees one lakh fifty thousand in aggregate per individual for housing purposes, or
- iii) such other amounts, for any of the purposes mentioned at items (i) and (ii) above or other purposes, as may be prescribed.”

The proposed regulations further define an MFI as “an organization or association of individuals including the following if it is established for the purpose of carrying on the business of extending microfinance services:

- a) a society registered under the Societies Registration Act, 1860,
- b) a trust created under the Indian Trust Act, 1880 or public trust registered under any State enactment governing trust or public, religious or charitable purposes,
- c) a cooperative society / mutual benefit society / mutually aided society registered under any State enactment relating to such societies or any multistate cooperative society registered under the Multi State Cooperative Societies Act, 2002 but not including:
 - a cooperative bank as defined in clause (cci) of section 5 of the Banking Regulation Act, 1949 or
 - a cooperative society engaged in agricultural operations or industrial activity or purchase or sale of any goods and services.”

MF-NBFCs as BCs

MF-NBFCs operate in a limited geographic area and have local feel. To enable the poor to have access to savings services, MF-NBFCs may be recognized as Business Correspondents of banks for only providing savings and remittance services.

Relaxation in FIPB Guidelines

- Current guidelines used by FIPB (Foreign Investment Promotion Board) require a minimum of US\$ 500,000 equity investment from a foreign entity. NBFCs are eligible to access such funds and leverage local capital market financing. MFNBFCs may be able to attract social investors with relatively modest means for whom such a high level of investment may be beyond reach. As MF-NBFCs' initial capital needs may not be very large, the Committee is of the view that the minimum amount of foreign equity for MF-NBFCs may be reduced to a level of US\$ 100,000.
- To facilitate raising Indian equity, NABARD may extend equity support out of its MFDEF to such MF-NBFCs based on objective rating / criteria. NABARD may accord priority in providing equity support to those MF-NBFCs operating in regions featuring high levels of exclusion.
- To further facilitate raising India equity, the SEBI Venture Capital Guidelines may permit Venture Capital Funds to invest in MF-NBFCs.

Tax Concessions

To facilitate build up of reserves, MF-NBFCs may be allowed, like Housing Finance Companies and Infrastructure Companies, tax concessions to the extent of 40% of their profits, as a proportion to their business portfolio in excluded districts as identified by NABARD without attracting tax. For this, the Committee recommends that MF-NBFCs may be included as eligible institutions under Section 36(1) (viii) of the Income Tax Act.

MF-NBFCs as Micro Insurance Agents

The lives and livelihoods of poor households are full of uncovered risk. Hence insurance is essential for them. To enable MF-NBFCs to offer risk mitigation services to the poor, the Committee recommends that the IRDA Micro insurance Guidelines, 2005 may permit MF-NBFCs to offer micro insurance services as agents of regulated life and non-life insurance companies.

Code of Conduct

A voluntary mutual code of conduct has been prepared by some MFIs covering aspects including mission, governance, transparency, interest rates, handling of customer grievances, staff conduct, recovery practices, etc. After due consultations within the sector, such code of conduct may be made mandatory for MFIs.

Accounting and Disclosure Norms

- The Institute of Chartered Accountants of India (ICAI) may be involved in formulating appropriate accounting and disclosure norms for MFIs, so that they can generate confidence.
- The cost of funds for MFIs, their operating costs, risk premium, etc., have to be studied for a better understanding of viable and economic rates of interest that can be charged by them. Banks lending to MFIs may undertake such studies and exercise a lender's discipline in enforcing reasonable rates of interest and acceptable modes of recovery.

Unifying Regulatory Oversight

At present, all the regulatory aspects of microfinance are not centralized. For example, while the Rural Planning and Credit Department (RPCD) in RBI looks after rural lending, MF-NBFCs are under the control of the Department of Non-Banking Supervision (DNBS) and External Commercial Borrowings are looked after by the Foreign Exchange Department. The Committee feels that RBI may consider bringing all regulatory aspects of microfinance under a single mechanism. Further, supervision of MF-NBFCs could be delegated to NABARD by RBI.

Micro Financial Sector (Development and Regulation) Bill, 2007

The Micro Financial Sector (Development and Regulation) Bill, 2007 has been introduced in Parliament in March 2007. The Committee feels that the Bill, when enacted, would help in promoting orderly growth of microfinance sector in India. For improving the effectiveness of the Bill, the Committee makes the following suggestions:

- NBFCs and Section 25 companies are left out of the purview of the proposed Bill. NBFCs are currently regulated by RBI, though RBI has exempted them for registration as NBFCs if they do not take deposits. It is recommended that Section 25 companies can be brought under the purview of this Bill.
- Cooperative societies registered under the “MACS Act” – promulgated by some of the States – are eligible to mobilize savings from their members. For mobilizing savings, these societies also need to be registered with NABARD under the proposed Bill. Hence, there is likely to be conflict between “MACS Act” and the proposed Bill. Moreover, cooperative societies provide savings and credit facilities to their own members. It is, therefore, suggested that the cooperatives can be taken out of the purview of the proposed Bill.

SIDBI Foundation for Micro Credit (SFMC)

Mission

SIDBI Foundation for Micro Credit (SFMC) was launched by the Bank in January 1999 for channelizing funds to the poor in line with the success of pilot phase of Micro Credit Scheme. SFMC's mission is to create a national network of strong, viable and sustainable Micro Finance Institutions (MFIs) from the informal and formal financial sector to provide micro finance services to the poor, especially women.

Approach

SFMC is the apex wholesaler for micro finance in India providing a complete range of financial and non-financial services such as loan funds, grant support, equity and institution building support to the retailing Micro Finance Institutions (MFIs) including two-tier MFIs so as to facilitate their development into financially sustainable entities, besides developing a network of service providers for the sector. SFMC is also playing significant role in advocating appropriate policies and regulations and to act as a platform for exchange of information across the sector. The launch of SFMC by SIDBI has been with a clear focus and strategy to make it as the main purveyor of micro finance in the country. Operations of SFMC in the coming years, are not only expected to contribute significantly towards development of a more formal, extensive and effective micro

finance sector serving the poor in India, but also ensure sustainability at all levels viz. at the apex level (SFMC), at the MFI level and at the client level to ensure continuance of such arrangement. Most importantly, SFMC has strived to create a mechanism in which there should be no barriers to growth. Under the dispensation, there is focus on innovation and action research.

Uniqueness

a) Rating of MFIs

Most micro finance programmes are being operated by NGOs and are not subjected to regulation and supervision as they are registered as Societies or Trusts. Non-regulation of these institutions has worked to their detriment and these institutions are not able to have smooth access to funds from the financial sector which is vary of lending to such entities. This constraint, coupled with the fact that SFMC was launched with a view to upscale the flow of micro credit with enabling policy modifications relating to simplification of the procedures in availment of assistance and substantial relaxation in the security/ collateral requirement posed a difficult challenge. Therefore, to meet the requirements of the revised dispensation which called for selection of suitable micro finance intermediaries which could be trusted with bulk assistance without collateral constraints, Capacity Assessment Rating [CAR] was introduced by SFMC as a supplementary tool to assess the risk perception. On SFMC's initiative, the rating of MFIs have been started by four agencies. Till March 31, 2009, 497 ratings have been commissioned to MCRIL/ CRISIL/ CARE/ Access Development Services (ADS). SFMC has also organized trainings on CAMEL methodology of ACCION to build the internal capacity of SFMC officers.

b) Customized Support to MFIs

MFIs are provided annual need based assistance. One of the unique features of the scheme is the comprehensive Capacity Building Support being provided to the MFIs/ NGOs to expand their operations as well as to increase their efficiency. Customized financial support comprising of loans, capacity building grant as well as equity/ quasi equity is being provided to the client institutions.

c) Minimal Security Requirement

Credit worthiness is based on the rating of the borrowing institutions rather than availability of security/ collateral requirements. Term Deposit Receipts (TDRs) issued by Scheduled Commercial Banks/ SIDBI for an amount equivalent to 10% /5% /2.5% (depending upon geographical area of operation and duration of partnership with SIDBI).

d) Methodology Neutral

SIDBI's support is not for any specific methodology. MFIs may on lend directly to SHGs/ individuals or route their assistance through their partner NGOs & MFIs. They may also adopt any other lending channel so as to effectively reach financial assistance to the poor clients.

e) Capacity Building Support for the Sector

SFMC's capacity building efforts are directed not only towards MFIs but also towards smaller/ grass root institutions engaged in micro finance operations, training, consultancy, rating and impact assessment etc., and other service providers in the form of training, seminars, workshops, orientation and exposure visits.

f) Innovation & Action Research

SIDBI has taken a number of initiatives in launching / facilitating introduction / market-making of new concepts in the sector. The launch of an electronic portal for information dissemination and knowledge sharing within the sector and development of MIS software for MFIs are some such initiatives. Other major initiatives include developing a common charter of accounts for the sector, creating gender and environment awareness, promoting innovations and action research on emerging concepts etc. The environment appraisal of SFMC activities was carried out by the Society for Participatory Research in Asia (PRA), New Delhi and covered areas like identification of environmental risks associated with some of the most relevant activities funded through the SFMC microfinance route, developing a format for identifying these risks in micro-project identification and drawing up some simple guidelines on risk mitigation.

The appraisal covered 15 partner MFIs of the Bank located in and around Chennai, Hyderabad, Bhubaneswar and Kolkata.

g) Opening of Specialized Microfinance Branches

Seven dedicated microfinance branches have been opened by the Bank at Lucknow, Chennai, Hyderabad, Bangalore, Kolkata, Bhubaneswar and Guwahati to deliver micro finance services through intermediaries in a timely and customer-friendly manner. While Hyderabad, Chennai, Bangalore are major hubs of microfinance activity in the country, the other centres viz. Lucknow, Kolkata, Bhubaneswar and Guwahati have been targeted with the primary objective of giving an impetus to microfinance programmes in the underserved areas.

Support Offered to MFIs

a) On-lending

In keeping with its mission, SIDBI Foundation identifies, nurtures and develops select potential MFIs as long term partners and provides credit support for their micro credit initiatives. The eligible partner institutions of SIDBI Foundation, therefore, comprise large and medium scale MFIs having minimum fund requirement of ₹ 10 lakh per annum. Large and medium scale MFIs having considerable experience in managing micro credit programmes, high growth potential, good track record, professional expertise and committed to viability are provided financial assistance for on-lending. Under the present dispensation, annual need based assistance is provided to enable MFIs to expand their scale of operations and achieve self sufficiency at the earliest. Lending is based strictly on an intensive in-house appraisal supplemented with the capacity assessment rating by an independent professional agency. Liberal security norms have also been adopted to reduce procedural bottlenecks as well as to facilitate easy disbursements.

b) Capacity Building

The long-term future of the micro-finance sector depends on MFIs being able to achieve operational, financial and institutional sustainability. The constraints and challenges vary with the different types

and development stage of MFIs. Most MFIs are currently operating below operational viability and use grant funds from donors for financing up-front costs of establishing new groups and covering initial losses incurred until the lending volume builds up to a break-even level. The MFIs are generally constrained in reaching a break-even level and finally achieving sustainability, primarily due to a narrow client and product base, high operational and administrative costs for delivering credit to the poor, and their inability to mobilize requisite resources. Moreover, lack of technical manpower, operational systems, infrastructure and MIS are prevalent. In view of the above, to scale up micro-finance initiatives at a faster pace, a special effort is required for capacity building of the Micro Finance Institutions. In this background, SFMC has in the past under the DFID collaboration (which has since come to an end on March 31, 2009) provided need based capacity building support to the partner MFIs, in the initial years, to enable them to expand their operations, cover their managerial, administrative and operational costs besides helping them achieve self-sufficiency in due course.

c) Liquidity Management

In view of the fact that liquidity is a major concern of many of the middle level MFIs and a small working capital support can go a long way in their better liquidity management and thus pave way for faster growth, SFMC has introduced a special short term loan scheme, Liquidity Management Support (LMS) for the long term partners.

d) Equity

Provision of equity capital to the NBFC-MFIs is perceived as an emerging requirement of the micro finance sector in India. SIDBI provides equity capital to eligible institutions not only to enable them to meet the capital adequacy requirements but also to help them leverage debt funds. Keeping in tune with the sectoral requirements, the bank has also introduced quasi-equity products viz., Optionally convertible Preference share capital; Optionally convertible debt and Optionally convertible Subordinate debt for new generation MFIs which are generally in the pre-breakeven stage requiring special dispensation for capital support by way of a mix of Tier I and Tier II capital.

e) Transformation Loan

The Transformation Loan (TL) product is envisaged as a quasi-equity type support to partner MFIs that are in the process of transforming themselves / their existing structure into a more formal and regulated set-up for exclusively handling micro finance operations in a focused manner. Being quasi-equity in nature, TL helps the MFIs not only in enhancing their equity base but also in leveraging loan funds and expanding their micro credit operations on a sustainable basis. The product has the feature of conversion into equity after a specified period of time subject to the MFI attaining certain structural, operational and financial benchmarks. This non-interest bearing support facilitates the young but well performing MFIs to make long term institutional investments and acts as a constant incentive to transform themselves into formal and regulated entities.

f) Micro Enterprise Loans

In order to build and strengthen new set of intermediaries for Micro Enterprise Loans, the Bank has formulated new scheme for Micro Enterprise Loans. Institutions/ MFIs with minimum fund requirement of ₹ 25 lakh p.a. and having considerable experience in financial intermediation/ facilitating or setting up of enterprises/ providing escort services to SSI/ tiny units/ networking or active interface with SSIs etc. and having professional expertise and capability to handle on-lending transactions shall be eligible under the dispensation. The institutions would be selected based on their relevant experience, potential to expand, professional management, transparency in operations and well laid-out systems besides qualified/ trained manpower. Lending to be based strictly on an intensive in-house appraisal supplemented with the credit rating by an independent professional agency. Relaxed security norms more or less on line with micro credit dispensation to be adopted to reduce procedural bottlenecks as well as to facilitate easy disbursements.

Micro Enterprise Loans Scheme - Direct Credit

The Micro Enterprise Loan Scheme - Direct Credit provides need based composite loan (ranging from ₹50,000 to ₹5 lakh) to Micro Enterprises directly for acquiring capital assets and also for their working capital / marketing related requirements. The assistance is covered under the CGTMSE scheme. The scheme is currently operated by the 7 specialized

Micro Finance Branches.

Loan Syndication

Keeping in view the increased fund requirement of major partner MFIs, the Bank has also undertaken fee based syndication arrangement where loan requirement is comparatively higher.

Self Assessment Questions

1. What are Developmental Financial Institutions?
2. Describe the structure of industrial and agricultural banking system in India.
3. Describe the role of IFCI in industrial financing.
4. Describe the role of ICICI.
5. Describe the role of IDBI in industrial development.
6. What is Universal Bank? Explain its role.
7. Describe the merger of IDBI Bank with IDBI.
8. Describe the reverse merger of ICICI with ICICI Bank.
9. Describe the role of SIBDI.
10. Describe the role of IIBI.
11. What are state level financial institutions? Explain their role.
12. Describe the role of APSFC.
13. Describe the role of GSFC.
14. Describe the role of TIIC.
15. Describe the role of COSIDICI.
16. Describe the role of SIDCs.
17. What are investment institutions? Explain their role
18. Describe the role of UTI Mutual Fund.
19. Describe the role of LIC.
20. Describe the role of GIC.
21. What are specialized institutions?
22. Describe the role of Risk Capital and Technology Finance Corporation Ltd (RCTC).
23. Describe the role of Technology Development and Information

Company of India Ltd. (TDICI).

24. Describe the role of Tourism Finance Corporation of India Ltd. (TFCI).
25. Describe the role of Housing and Urban Development Corporation of India (HUDCO).
26. Describe the role of Housing Development Finance Corporation (HDFC).
27. Describe the role of National Housing Bank (NHB).
28. Describe the role of EXIM Bank.
29. Describe the role of NEDFC.
30. Describe the role of IIFCL.
31. What are international financial institutions?
32. Describe the role of IBRD.
33. Describe the role of IFC.
34. Describe the role of IDA.
35. What are agricultural financial institutions?
36. Describe the role of NABARD.
37. Describe the role of SFAC.
38. Describe the role of IWRFC.
39. What are MFIs?
40. Describe the role of SIDBI Foundation for Micro Credit (SFMC)

CASE STUDY

The Making of a Successful Microfinance Institution

Vikram Akula (Akula), the founder of one of the world's fastest growing microfinance institution (MFI), SKS Microfinance Private Limited (SKS), was recognised by the Time magazine in its list of 100 'people who shape our world' in 2006. For Akula, who had left his job as a consultant at McKinsey to start SKS in India, the honour came as a recognition for the work done by SKS in providing microfinance to the poor in India, a country which is reported to have the highest number of operating MFIs. Vikram Akula set up SKS Microfinance Pvt. Ltd. (SKS) in 1998 to provide microfinance to the poorest sections of the Indian society that earns a per

capita less than INR 6,000 (\$120) per year. Negating the traditional assumption that microcredit is not a viable business in developing countries, SKS has brought in a new micro financing model in India, which is profitable and self-sustaining.

By reducing costs through prevention of wastage at each step of the loan process coupled with innovative technologies and an efficient management system, Akula has transformed SKS into one of the fastest growing microfinance institutions in the world. By attracting capital from global financial institutions like Citibank and through its automated MIS system and its award winning Smart Cards Pilot Project, SKS aims to grow at 400% per annum in the future. SKS Microfinance follows the Joint Liability Group (JLG) model.

The methodology involves lending to individual women, using five-member groups as the ultimate guarantor for each member. Through group lending, situations of adverse selection and moral hazard due to asymmetric information are better managed. "Social collateral" replaces asset collateral (which is lacking in the poorer segments of society). Such a system works because India is still a highly community-centric society.

The concept of honour and respect within society is deeply rooted in Indian culture and willful default invites condescending glances, humiliation and even ostracism. The company lists some of the social benefits of its financial product and service offerings as "providing self-employed women financial assistance to support their business enterprises, such as raising livestock, running local retail shops called kirana stores, providing tailoring and other assorted trade and services."

Question

1. Evaluate the micro financing model of SKS Micro Finance Pvt. Ltd. along with the reasons for its success.

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UNIT - IV

You hear lot of news about financial institutions, instruments, markets, regulators every day. What do they do and how are they structured? In this unit, let us understand the components of Indian financial system, financial markets with its types, and the structure of Indian fiscal system.

Unit Structure

Lesson 4.1 - Overview of Indian Financial System

Lesson 4.2 - Financial Markets – Primary & Secondary Markets

Lesson 4.3 - Listing Regulations, Mutual Funds and Indian Fiscal System

Lesson 4.1 - Overview of Indian Financial System

Learning Objectives

- To understand the components of Indian Financial System
- To review the performance of Indian Financial System
- To understand the role of Financial Intermediaries

Financial System

The word “system”, in the term “financial system”, implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Financial System deals about the arrangements that can be made for raising different types of funds required for the business so that the economic conditions of the country can improve. It is the functioning of a healthy financial

system on which depends the business prospects of a country. With more expansion of business and production in the country, the service sector will improve and more employment opportunities will be created. The financial system helps the primary sector (the agriculture), secondary sector (the industry) and the service sector.

Besides, *Financial System* deals about (a) various financial institutions, (b) with their financial services, (c) financial markets which enable individual, business and government concerns to raise finance; and (d) various instruments issued in the financial markets for the purpose of raising financial resources.

Thus, financial system consists of

- Financial Markets
- Financial Instruments/assets
- Financial Institutions/intermediaries and their services

Role of Financial System in Economic Development

The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate, government and household sector. While performing their activities, these units will be placed in a surplus/ deficit/ balanced budgetary situations. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit.

Thus, a Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities. Economic growth and development of any country depends upon a well-knit financial system. Financial system comprises a set of sub-systems of financial institutions financial markets, financial instruments and services which help in the formation of capital. Thus a financial system provides a mechanism by which savings are transformed into investments and it can be said that financial system play an significant role in economic growth of the country by mobilizing surplus funds and utilizing them effectively for productive purpose.

The financial system is characterized by the presence of integrated, organized and regulated financial markets, and institutions that meet the short term and long term financial needs of both the household and corporate sector. Both financial markets and financial institutions play an important role in the financial system by rendering various financial services to the community. They operate in close combination with each other.

Functions of Financial System

A financial system performs the following functions:

a) Increase the Savings

- It provides a measure for managing and controlling the risk involved in mobilizing savings and allocating credit.
- It promotes the process of capital formation by bringing together the supply of saving and the demand for investible funds.
- It helps in lowering the cost of transaction and increase returns.

b) Mobilization of Savings

- It is a link between savers and investors. It utilizes mobilized savings of savers (who are not organized /scattered) in more efficient and effective manner.
- It provides payment mechanism for exchange of goods and services.
- It facilitate for the transfer of resources across geographic boundaries.
- It provides detailed information to the operators/ players in the market such as individuals, business houses, Governments etc.

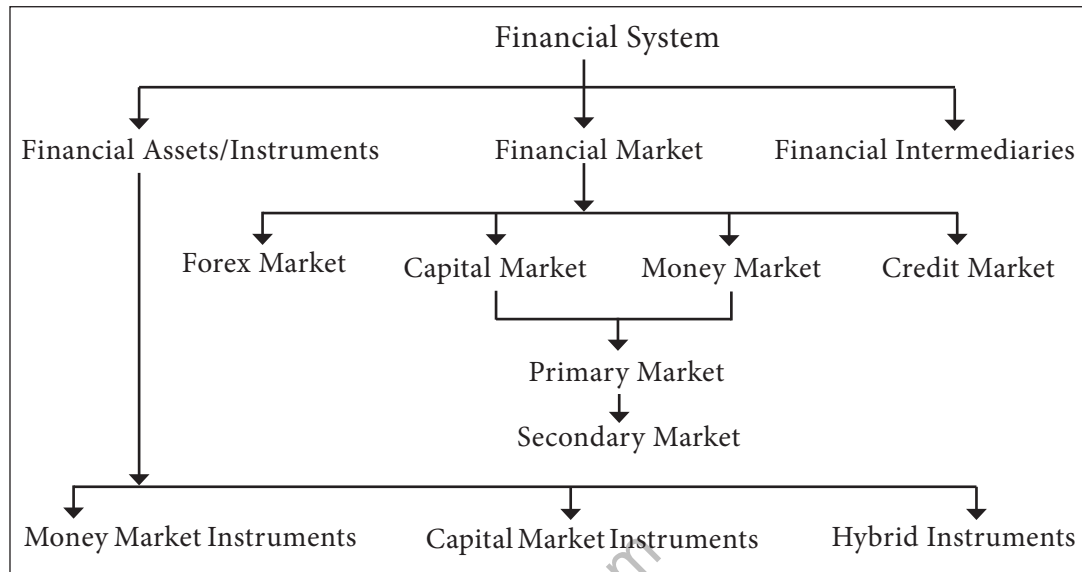
c) Proper Investment

- It assists in the selection of the projects to be financed and also reviews the performance of such projects time to time.
- It channelizes flow of saving into productive investment.

Indian Financial System

India's financial system is a very strong and efficient one which is evidenced by India's flourishing stock markets, fast-growing mutual funds, and capable banking sector.

Indian financial system consists of financial market, financial instruments and financial intermediation (See the figure below)



Shortcomings of Indian Financial System

The Indian financial system's shortcomings fall largely into three areas.

- First, formal financial institutions attract only half of India's household savings
- Second, these financial institutions allocate more than half of the capital to the economy's least productive areas: state-owned enterprises (SOEs), agriculture, and the unorganized sector (made up mostly of tiny businesses).
- Third, since the financial system is inefficient in both of its main task mobilizing savings and allocating capital, Indian borrowers pay more for capital and depositors receive less than they do in comparable economies.

Review of Indian Financial System

Saving Trends

India has a surprisingly small share of the economy's total capital, despite a 130-year-old stock market, a long history of private banks, and generally well-developed public institutions. The relative shallowness of the financial system (measured by comparing the value of all Indian financial assets with GDP) exemplifies the problem. The country's financial depth is significantly lower than that of other Asian economies, notably China. The detailed examination revealed how much saving and investment occurs outside the formal financial system. The country's households save 28 percent of their disposable income at a very high rate by international standards but invest only half of these savings in bank deposits and other financial assets.

Of the other half, they invest 30 percent in housing and put the remainder into machinery and equipment for the 44 million tiny household enterprises that make up the economy's unorganized sector. As a result, Indian households account for 42 percent of the economy's total physical investment, a surprisingly high proportion. Yet with a few exceptions, household businesses are below efficient scale, lack technology and business know-how, and have low levels of productivity. Indian households bought more than \$10 billion worth of gold, arguably another form of nonfinancial savings. They are now the world's largest consumers of gold. India's economy would grow faster if the financial system attracted more of the country's savings and channelled them into larger, more productive enterprises.

Finance to the Least Productive Investments

India's financial system is better at allocating capital than are its counterparts in many other emerging markets. It has some high-performing private and foreign banks, and its stock of non-performing loans is manageable. It has well-run equity markets that list mostly private companies and a dynamic private corporate sector that includes some world-class competitors, especially in business process outsourcing, information technology, and research and development.

The private corporate sector, as the most productive part of the economy, should be the main recipient of funding from the financial system. But most of the funding goes to the government and to investments it designates as priorities. Private corporations receive just 43 percent of the country's total commercial credit and that level hasn't increased since 1999. The rest goes to SOEs, agriculture, and the tiny businesses in the unorganized sector. This pattern of capital allocation impedes growth because SOEs are, on average, only half as productive as private ones and require twice as much investment to achieve the same additional output. Productivity in the agricultural and unorganized sectors is only one-tenth as high as it is in India's modern private sector, and their investment efficiency is commensurately low.

Reforms that enabled the financial system to channel a larger portion of the available credit to private companies would raise the economy's productivity. State-owned companies and household enterprises would then have to improve their operations to compete successfully for financing. If such reforms were accompanied by complementary reforms to India's labour and product markets, the country would get more output for each rupee invested.

Government Control

The government's tight control of the financial system explains its poor allocation of capital. Regulations oblige banks and other intermediaries to direct a high proportion of their funding to the government and its priority investments. Banks must hold 25 percent of their assets in government bonds, and in practice the state-owned banks that dominate the sector choose to hold even more. Government policies require banks to direct 40 percent of their loans to agriculture, household businesses, and other priority sectors. Directed loans have relatively high default rates and are costly to administer because of their small size. Besides diverting credit from the more productive private sector, these policies reduce the overall level of lending, since the unprofitable directed loans of banks must expand in proportion to their discretionary loans. Banks therefore lend just 60 percent of their deposits, compared with 83 percent for Thai, 90 percent for South Korean, and 130 percent for Chinese banks.

The government maintains strict controls on the financial system to achieve social-welfare objectives, such as ensuring that credit flows to rural areas and keeping levels of public-sector employment robust. It also uses these policies to finance a persistently large budget deficit.

Overcoming the Political Obstacles

Some of India's regulators understandably resist reform of the financial system because they fear that change involves risks and political trade-offs. They worry, for instance, that the abolition of directed lending would stifle growth in the rural economy and thus potentially increase unemployment in the countryside. But India's rural poor, as well as its entrepreneurs, would be better served if the financial system could freely allocate all available capital to more productive businesses capable of creating jobs. These extra revenues would help the government control its deficit and still leave money for social programs to support rural living standards, which would no longer have to be maintained by diverting capital from the financial system. If its total liberalization seems a step too far, the government could, as a transitional measure, promote bank lending to the priority areas by providing market-based incentives (such as tax breaks or subsidies) rather than by fiat.

Costly Intermediary

The government's influence on the financial system also lowers its efficiency and raises the cost of financial intermediation. Apart from China, India now has the highest level of state ownership of banks in any major economy and even China is now seeking foreign investment in most of its major commercial banks. The prevalence of state-owned banks means that they experience little competitive pressure to improve the way they operate. They meet their costs by maintaining high margins between their lending and deposit rates. If India developed a vibrant corporate-bond market and the financial system offered the mix of bonds and bank loans seen in other emerging economies, companies large and small would enjoy substantially lower funding costs. Even India's flourishing equity markets are constrained by heavy regulation elsewhere in the financial sector. These markets would have still greater success if domestic financial intermediaries, with their long-term mind-set, held more shares, but they are now required to invest in government bonds.

Key Reforms

An integrated program to reform the financial system could substantially raise India's growth rate. If the system improved its allocation of capital, captured more savings, and reduced its operating inefficiencies, the country's real GDP could expand. Since many problems of India's financial system cut across its markets, the government must carefully integrate the necessary reforms, which will primarily affect the banking sector, the corporate-bond market, and domestic institutional investors. To achieve the full potential, reforms in one area will require complementary changes in others for instance, changes in capital account and foreign-investment policies.

Financial Intermediation

The term **financial intermediary** may refer to an institution, firm or individual who performs intermediation between two or more parties in a financial context. Typically the first party is a provider of a product or service and the second party is a consumer or customer. Financial intermediaries are banking and non-banking institutions which transfer funds from economic agents with surplus funds (surplus units) to economic agents (deficit units) that would like to utilize those funds. FIs are basically two types:

Bank Financial Intermediaries (BFIs - Central banks and Commercial banks) and Non-Bank Financial Intermediaries (NBFIs - insurance companies, mutual trust funds, investment companies, pensions funds, discount houses and forex agencies). Financial intermediaries can be Banks, Financial adviser or broker, Insurance Companies (life and non-life), Mutual Funds and Pension Funds. The borrower who borrows money from the Financial Intermediaries/Institutions pays higher amount of interest than that received by the actual lender and the difference between the Interest paid and Interest earned is the profit for Financial Intermediaries/Institutions.

Financial Intermediaries are broadly classified into two major categories:

- 1) Fee-based or Advisory Financial Intermediaries
- 2) Asset Based Financial Intermediaries

Fee-Based/Advisory Financial Intermediaries

These Financial Intermediaries/ Institutions offer advisory financial services and charge a fee accordingly for the services rendered. Their services include Issue Management, Underwriting, Portfolio Management, Corporate Counseling, Stock Broking, Syndicated Credit, Arranging Foreign Collaboration Services, Mergers and Acquisitions, Debenture Trusteeship and Capital Restructuring.

Asset-Based Financial Intermediaries

These Financial Intermediaries/Institutions, finance the specific requirements of their clientele. The required infra-structure, in the form of required asset or finance is provided for rent or interest respectively.

The financial institutions may be regulated by various regulatory authorities. In addition, regulatory authorities may impose specific standards of conduct requirements on financial intermediaries when providing services to investors.

Role of Financial Intermediaries

Micro Finance

Finding innovative ways to provide financial services to the poor so that they can improve their productive capacity and quality of life is the role of the financial intermediaries in the 21st century. Most of the poor live in the rural areas, and are engaged in agricultural activities or a variety of micro-enterprises. The poor are vulnerable to income fluctuations and hence are exposed to risk. They are unable to access conventional credit and insurance markets to offset this. Providing efficient micro-finance to the poor is important. Efficient provision of savings, credit and insurance facilities can enable the poor to smoothen their consumption, manage risks better, gradually build assets, develop micro-enterprises, enhance income earning capacity, and generally enjoy an improved quality of life. Efficient micro-finance services can also contribute to improvement of resource allocation, development of financial markets and system, and ultimately economic growth and development.

Restructuring of Assets

Financial intermediaries appear to have a key role in the restructuring and liquidation of firms in distress. In particular, there is rich evidence that financial intermediaries play an active role in the reallocation of displaced capital, meant both as the piece-meal reallocation of assets and, more broadly as the sale of entire bankrupt corporations to healthy ones.

Pension Funds

Pension funds may be defined as forms of institutional investor, which collect pool and invest funds contributed by sponsors and beneficiaries to provide for the future pension entitlements of beneficiaries. They thus provide means for individuals to accumulate saving over their working life so as to finance their consumption needs in retirement, either by means of a lump sum or by provision of an annuity, while also supplying funds to end-users such as corporations, other households (via securitized loans) or governments for investment or consumption.

Lesson 4.2 - Financial Markets – Primary & Secondary Markets

Learning Objectives

- To understand the components, operations and benefits of financial markets.
- To understand the need, role and functioning of primary market.
- To understand the functioning of secondary market.

Financial Markets

In the last lesson, you have studied the components of Indian financial system and understood that financial market is one of the components.

Financial market is a place or a system where financial assets or instruments are created and exchanged by market participants. One of the barometers to measure the economic health of a nation is to look at the efficiency of the financial market of the country. Financial markets play a significant role in performing the resource management in an economy through various financial assets namely equity, debt, currency and other quasi instruments. Financial markets facilitate the price discovery and provide liquidity of financial assets. Financial market performs the crucial role of capital creation that is acting as a bridge between providers of finance and the seekers of finance.

The financial assets, also called financial claims or financial securities are issued by the seekers of finance. They issue the instruments to investors who have surplus money to invest. Between the two parties, there are financial intermediaries who act who act as conduits between the investors and issuers. Thus, there are four important elements of securities markets namely investors, issuers, intermediaries and regulators. The issuers can be government or corporate houses. The government issues gilt- edged securities whereas the corporate issue shares, debentures etc., depending on the time period for which the fund is required, and the financial instruments could be short term and long term. Depending

on the participants, the financial markets are classified as primary and secondary market.

Components of Financial Markets

a) Money market

The money market is a wholesale debt market for low-risk, highly-liquid, short-term instruments. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions. The following are the money market instruments;

- Call/Notice Money
- Treasury Bills
- Term Money
- Certificate of Deposit
- Commercial Papers

- i) **Call /Notice-Money Market:** Call/Notice money is the money borrowed or lent on demand for a very short period. When money is borrowed or lent for a day, it is known as Call (Overnight) Money. Intervening holidays and/or Sunday are excluded for this purpose. Thus money, borrowed on a day and repaid on the next working day, (irrespective of the number of intervening holidays) is “Call Money”. When money is borrowed or lent for more than a day and up to 14 days, it is “Notice Money”. No collateral security is required to cover these transactions.
- ii) **Inter-Bank Term Money:** Inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call/Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.
- iii) **Treasury Bills:** Treasury Bills are short term (up to one year) borrowing instruments of the union government. It is an IOU of the Government. It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue (14/91/182/364 days i.e. less than one year). They are issued at a

discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

- iv) **Certificate of Deposits:** Certificates of Deposit (CDs) is a negotiable money market instrument issued in dematerialized form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by
- a. scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and
 - b. Select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers and inter corporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.
- v) **Commercial Paper:** CP is a note in evidence of the debt obligation of the issuer. CP is thus an innovative unsecured promissory note privately placed with investors at a discount rate to face value determined by market forces. CP is freely negotiable by endorsement and delivery. A company shall be eligible to issue CP provided -
- a. The tangible net worth of the company, as per the latest audited balance sheet, is not less than ₹4 crore;
 - b. The working capital (fund-based) limit of the company from the banking system is not less than ₹4 crore and
 - c. The borrowed account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.

b) Capital Market

Now let us look into the capital market which mainly involves creation of long term instruments. The capital market generally consists of the long term financial instruments. The instruments used in the equity segment include equity shares, preference shares, convertible preference shares, non-convertible preference shares, etc; and in the debt segment include debentures, zero coupon bonds, deep discount bonds, etc. Section 85 of the Companies Act, 1956 permits public limited companies (having share capital) to have two kinds of shares namely - equity and preference. The various capital market instruments are explained below:

- i) **Equity share capital:** An equity interest in a company may be said to represent a share of the company's assets and a share of any profits earned on those assets after other claims have been met. The equity shareholders are the owners of the business; they purchase shares, the money is used by the company to buy assets, the assets are used to earn profits, which belong to the ordinary shareholders. After satisfying the rights of preference shares, the equity shares shall be entitled to share in the remaining amount of distributable net profits of the company. The dividend on equity shares is not fixed and may vary from year to year depending upon the amount of profits available. The rate of dividend is recommended by the Board of Directors of the company and declared by shareholders in the Annual General Meeting. Equity shareholders have a right to vote on every resolution placed in the meeting and the voting rights shall be in proportion to the paid-up capital. Equity capital can either be (i) With voting rights; or (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed.
- (ii) **Preference share capital:** Preference share is a hybrid security because it has features of both ordinary shares and bonds. Preference shareholders have preferential rights in respect of assets and dividends. In the event of winding up the preference shareholders have a claim on available assets before the ordinary shareholders. In addition, preference shareholders get their stated dividend before equity shareholders can receive any dividends. The dividends on preference shares are fixed and they must be declared

before a legal obligation exists to pay them. The fixed nature of dividend is similar to that of interest on debentures and bonds. The declaration feature is similar to that of equity shareholders dividends. The general forms of preference shares are as follows:

- **Cumulative and Non-cumulative Preference Shares:** The cumulative preference share gives a right to demand the unpaid dividend of any year, during the subsequent years when the profits are ample.
- **Cumulative Convertible Preference Shares:** The cumulative convertible preference (CCP) share is an instrument that embraces features of both equity shares and preference shares, but which essentially is a preference share. The CCPs are convertible into equity shares at a future specified date at a predetermined conversion rate once it is converted into equity shares, it passes all the characteristics of an equity share.
- **Participating and Non-participating Preference Shares:** Participating preference shares are those shares which are entitled to a fixed preferential dividend and, in addition, carry a right to participate in the surplus profits along with equity shareholders after dividend at a certain rate has been paid to equity shareholders.
- **Redeemable and Irredeemable Preference Shares:** Subject to an authority in the articles of association, a public limited company may issue redeemable preference shares to be redeemed either at a fixed date or after a certain period of time during the life time of the company. The Companies Act, 1956 prohibits the issue of any preference share which is irredeemable or is redeemable after the expiry of a period of twenty years from the date of issue.

iii) Deferred/Founders Shares: A private company may issue deferred or founder's shares. Such shares are normally held by promoters and directors of the company. That is why they are usually called 'founders shares'. These shares are usually of a smaller denomination, say one rupee each. However they are generally given equal voting rights with equity shares which may be of higher denomination, say ₹10 each. Thus, by investing relatively lower

amounts, the promoters may gain control over the management of the company. As regards the payment of dividends to holders of such shares, the articles usually provide that these shares will carry a dividend fixed in relation to the profits available after dividends have been declared on the preference and equity shares.

- iv) **Sweat Equity Shares:** Under section 79A of the Companies Act, 1956, a company can issue sweat equity shares to its employees or directors at discount or for consideration other than cash for providing knowhow or making available rights in the nature of intellectual property rights or value addition etc.

c) Hybrid Market and Instruments

Hybrid instruments have both the features of equity and debenture. This kind of instruments is called as hybrid instruments. Examples are convertible debentures, warrants etc. Financing from capital markets - There are two ways a company can raise money from the financial markets namely - Debt and Equity.

- i) **Foreign Exchange Market (Forex Market):** The third important element of financial market is the forex market. The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe. In India till 1992-93 the forex market had been highly regulated as the government had strict import- export policy. The erstwhile FERA (Foreign exchange regulation Act) enacted in 1973 acted tough on foreign exchange violations. From 1992 onwards, India brought in number of policy changes with respect to Foreign Direct Investment (FDI), foreign portfolio investments and other aspects of trade. One of the important milestones was the current account convertibility of INR (Indian Rupees). That would mean the foreign exchange payments and receipts can be converted at market determined rate such that individuals and companies have the freedom to transact in foreign currency for non-capital creation activities such as foreign travel, medical expenses, business expenses etc., contrasting to current account

convertibility is the capital account convertibility which involve creation of long term assets like house properties, loan etc., Even though the exchange rate has been market determined, from time to time RBI intervenes in spot and forward market, if it feels exchange rate has deviated too much.

Financial Intermediaries in the Financial Market

The financial intermediaries are operating both in organized and unorganized sectors. The unorganized sector of the Indian financial market consists mainly of Indigenous bankers, money lenders, Nidhi's and chit funds. Some of the important intermediaries operating in the financial markets include; investment bankers, underwriters, stock exchanges, registrars, depositories, custodians, portfolio managers, mutual funds, financial advisors, financial consultants, primary dealers, satellite dealers, self regulatory organizations, etc. Though the markets are different, there may be a few intermediaries offering their services in more than one market, e.g. underwriter. However, the services offered by them vary from one market to another. The Table below analyzes the various intermediaries and their role:

Table showing Financial intermediaries and the roles in various market		
Intermediary	Market	Role
Stock Exchange	Capital Market	Secondary market to securities
Investment Bankers	Capital Market and Credit Market	Corporate advisory services and issue of securities
Underwriters	Capital and Money Market	Subscribe to unsubscribed portion of securities
Registrars, Depositories and Custodian	Capital Market	Issue securities to the investors on behalf of the companies and handle share transfer activity
Primary Dealers, Satellite Dealers	Money Market	Market making in government securities
Forex Dealers	Forex Market	Ensure exchange in currencies

Primary Markets

Having learnt the difference between money market and capital market, let us move to primary market which is one of the components of capital market. Capital market is the place where long term requirements of funds are met by issuing various instruments. The Primary market is the segment in which new issues are made whereas secondary market is the segment in which outstanding securities are traded. It is for this reason that the Primary Market is also called new issues market or IPO (Initial Public Offer)/FPO (Follow on Public Offer) market and the Secondary market is called Stock Market. New issue market is not only a platform for raising finance to establish new enterprises but also for expansion / diversification / modernizations of existing units. The issues of shares by the company can be classified as

- (a) IPO (Initial Public Offer)
- (b) FPO (Follow on Public Offer).

Functions of New Issue Market/Primary Market

The main function of new issue market is to facilitate transfer of resources from savers to the users. The savers are individuals, commercial banks, insurance companies, public limited companies and the government. The new issue market plays an important role of mobilizing the funds from the savers and transfers them to borrowers for production purposes, an important requisite of economic growth. The main function of new issue market can be divided into a triple service functions

- (a) Origination
- (b) Underwriting
- (c) Distribution.

Origination

Origination refers to the work of investigation, analysis and processing of new project proposals. Origination starts before an issue is actually floated in the market. Technical, economic and financial viability are studied at this stage to ensure soundness of the project. This is a preliminary investigation undertaken by the sponsors of the issue.

Other advisory services depending of type of issue are provided such as magnitude, time of floating, price, methods and techniques of selling are provided at this stage of an issue. These services improve the quality of the issue.

Underwriting

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed then there is no liability for the underwriter. If a part of share issues remain unsold, the underwriter will buy the shares. Thus underwriting is a guarantee for the marketability of shares

Method of Underwriting

An underwriting agreement may take any of the following three forms:

- (i) **Standing behind the issue:** Under this method, the underwriter guarantees the sale of a specified number of shares within a specified period. If the public do not subscribe to the specified amount of issue, the underwriter buys the balance in the issue.
- (ii) **Outright purchase:** The Underwriter, in this method, makes outright purchase of shares and resale them to the investors.
- (iii) **Consortium method:** Underwriting is jointly done by a group of underwriters in this method. The underwriters form a syndicate for this purpose. This method is adopted for large issue.

Advantages of Underwriting

Underwriting assumes great significance as it offers the following advantages to the issuing company.

- The issuing company is relieved from the risk of finding buyers for the issue offered to the public. The company is assured of raising adequate capital.
- The company is assured of getting minimum subscription within the stipulated time, a statutory obligation to be fulfilled by the issuing company.

- Underwriters undertake the burden of highly specialized function of distributing securities.
- Provide expert advice with regard to timing of security issue, the pricing of issue, the size and type of securities to be issued etc.
- Public confidence on the issue enhances when underwritten by reputed underwriters.

The underwriters in India may be classified into two categories:

- Institutional underwriters
- Non – institutional underwriters.

The Institutional Underwriters are

- Life Insurance Corporation of India (LIC)
- Unit Trust of India (UTI)
- Industrial Development Bank of India (IDBI)
- Industrial Credit and Investment Corporation of India (ICICI)
- Commercial banks and general insurance companies.

The pattern of underwriting of the above institutional underwriters differs vastly in India. LIC and UTI have purchased industrial securities from the new issue market with a view to hold them on their own portfolio. They have a preference for underwriting shares in large and well established firms. The development banks have given special attention to the issues in backward states and industries in the priority list. The thrust of the development banks is also towards small and new issues which do not have adequate support from other institutions. General insurance companies have shown preference in underwriting the securities of fairly new issues.

The non-institutional underwriters are brokers. They guarantee shares only with a view to earn commission from the company floating the issue. They are known to off load the shares later to make a profit. The brokers work profit motive in underwriting industrial securities. After the elimination of forward trading, stock exchange broker has begun to take an underwritten to the total private capital issue varies between 72 percent to 97 percent.

Distribution

Distribution is the function of sale of securities to ultimate investors. This service is performed by brokers and agents who maintain regular and direct contact with the ultimate investors.

Methods of floating of new issues: The various methods which are used in the floating of securities in the new issue market are:

- Public issues
- Offer for sale
- Placement
- Rights issues

The following figure shows the classification of issues:

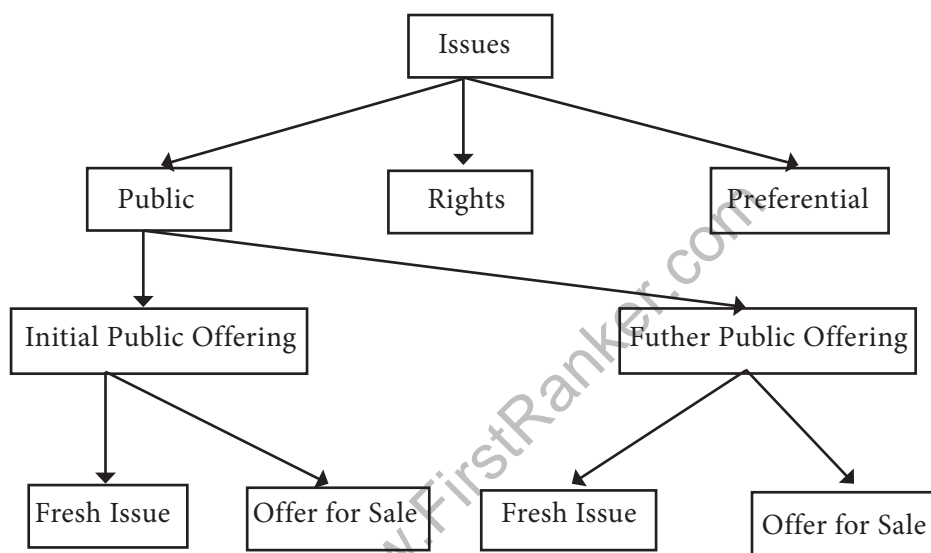


Figure showing the Classification of issues

- i) **Public issues:** Under this method, the issuing company directly offers to the general public/institutions a fixed number of shares at a stated price through a document called prospectus. This is the most common method followed by join stock companies to raise capital through the issues of securities. According to the companies act, 1956 every application form must be accompanied by a prospectus. Now, it is no longer necessary to furnish a copy of the prospectus along with every application forms as per the companies Amendment Act, 1988. Now, an abridged prospectus is being annexed to every share application form.

Merits of Issue Through Prospectus

- Sale through prospectus has the advantage of inviting a large section of the investing public through advertisement.
- It is a direct method and no intermediaries are involved in it.
- Shares, under this method, are allotted to a large section of investors on a non-discriminatory basis. This procedure helps in wide dispersion of shares and to avoid concentration of wealth in few hands.

Demerits of Issue Through Prospectus

- It is an expensive method. The company has to incur expenses on printing of prospectus, advertisement, banks' commission, underwriting commission, legal charges, stamp duty, listing fees and registration charges.
- This method is suitable only for large issues.

ii) **Offer for sale:** The method of offer of sale constitute outright sale of securities through the intermediary of issue houses or share brokers. In other words, the shares are not offered to the public directly. This method consist of two stages: the first stage is a direct sale by the issuing company to the issue house and brokers at an agreed price. In the second stage, the intermediaries resell the above securities to the ultimate investors. The issue houses or stock brokers purchase the securities at a negotiated price and resell at a higher price. The difference in the purchase and sale price is called turn or spread.

Advantages: The advantages of this method are that the company is relieved from the problem of printing and advertisement of prospectus and making allotment of shares. Offer of sale is not common in India. This method is used generally in two instances:

- Offer by a foreign company of a part of it to Indian investors.
- Promoters diluting their stake to comply with requirements of stock exchange at the time of listing of shares.

iii) **Follow on Public Offering (FPO):** When an existing listed company either makes a fresh issue of securities to the public or

makes an offer for sale of securities to the public for the first time, through an offer document, such issues are called as 'Follow on Public Offering'. Such public issue of securities or offer for sale to public is required to satisfy the stock exchange listing obligations along with SEBI guidelines.

- iv) **Rights Issue (RI):** When a listed company proposes to issue securities to its existing shareholders, whose names appear in the register of members on record date, in the proportion to their existing holding, through an offer document, such issues are called 'Rights Issue'. This mode of raising capital is best suited when the dilution of controlling interest is not intended.
- v) **Preferential Issue:** A preferential issue is an issue of equity shares or of convertible securities by listed companies to a select group of persons which is neither a rights issue nor a public issue. The issuer company has to comply with the provisions of the Companies Act, as well as, SEBI's guidelines with reference to preferential issues. A company which makes any public or rights issue or an offer for sale can issue shares only in dematerialized form. A company shall not make a public or rights issue of shares unless all the existing partly paid shares have been fully paid-up or forfeited. A company which is making public issue of securities shall make an application to the stock exchange for listing of those shares.

Book Building

It is a capital issuance process which results towards a price discovery and also to assess demand analysis of the security. It is a process used for marketing equity shares of a company. The book building process includes the following steps

- The Issuer nominates a merchant banker as book runner.
- Specifies issue size and floor price
- Appoints syndicate members
- Investors place orders into the electronic book, termed as the process of bidding • Bids are entered, 'at' or 'above' the floor price
- Retail investors can bid at a cut-off price
- The price opted by majority of bidders shall be decided as the subscription price.

Difference between Fixed Price vs. Book-Building is shown in the table below:

Table showing the difference between fixed price vs. book building	
Fixed Price	Book-Building
i) Offer price is known to investor	i) Only the floor price and price in advance range is known
ii) Demand for the securities known	ii) Demand for the securities is after issue closure visible online as the book is built
iii) Application money credited to issuer	iii) Application money is credited Account. to an escrow account

Eligibility Norms for Public Issue

SEBI has laid down the eligibility norms for entities accessing the primary market through public issues. The entry norms for companies making initial public offer or Follow on Public offer, are summarized as follows (students are advised to refer to SEBI guidelines to have the latest norms):

Entry Norm I

The company shall meet the following requirements:

- Pre-issue net worth of the co. should not be less than ₹1 crore in last 3 out of last 5 years with minimum net worth to be met during immediately preceding 2 years and
- track record of distributable profits for at least three (3) out of immediately preceding five (5) years and
- the issue size (i.e. offer through offer document + firm allotment + promoters' contribution through the offer document) shall not exceed five (5) times its pre-issue net worth.

In case an unlisted company does not satisfy any of the above criteria, it can come out with a public issue only through the Book-Building process. In the Book Building process the company has to compulsorily allot at least

sixty percent (60%) of the issue size to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded

- If change in name, at least 50% revenue for preceding 1 year should be from the new activity.
- The issue size does not exceed 5 times the pre-issue net worth.

To provide sufficient flexibility and also to ensure that genuine companies do not suffer on account of rigidity of the parameters, SEBI has provided two other alternative routes to company not satisfying any of the above conditions, for accessing the primary market.

Entry Norm II

- Issue shall be through book building route, with at least 50% to be mandatorily allotted to the Qualified Institutional Buyers (QIBs).
- The minimum post-issue face value capital shall be ₹10 crores or there shall be a compulsory market-making for at least 2 years or

Entry Norm III

- The 'project' is appraised and participated to the extent of 15% by FIs/Scheduled commercial banks of which at least 10% comes from the appraiser(s).
- The minimum post-issue face value capital shall be ₹10 crores or there shall be a compulsory market-making for at least 2 years In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having at least 1000 prospective allottees in its issue.

Green Shoe Option

Green Shoe Option denotes 'an option of allocating shares in excess of the shares included in the public issue'. It is an option allowing the Issuing Company to issue additional shares when the demand is high for the shares when the flotation is on. SEBI guidelines allows the Issuing company to accept oversubscription, subject to a ceiling, say 15% of the offer made to public. In certain cases, the Green Shoe Option can be even more than 15%. It is extensively used in international IPOs to stabilize the

post listing price of new issued shares. The concept has been introduced in the Indian capital market and is used in initial public offerings through book building process. SEBI has allowed the use of the option with a view to boost the investors' confidence and to put a check for speculative practices causing short-term volatility in post listing price. The Green Shoe Option facility would bring in price stability of initial public offerings.

Kinds of Offer Documents

An offer document means 'prospectus' in case of a public issue or an offer for sale and 'Letter of offer' in case of rights issue, which is required to be filed with the Registrar of Companies (ROC) and Stock Exchanges. An offer document covers all the relevant information to help an investor in making wise investment decisions.

Draft Prospectus

A company before making any public issue of securities shall file a draft prospectus with SEBI, through an eligible merchant banker, at least 21 days prior to the filing of prospectus with the Registrar of Companies. If any specific changes are suggested by SEBI within the said 21 days, the Issuing Company or the lead merchant banker shall carryout such changes in the draft prospectus before filing the prospectus with ROC.

Draft Letter of Offer

A listed company, before making any rights issue for an amount exceeding ₹50 lakhs (including premium) shall file a draft letter of offer with SEBI, at least 21 days prior to the filing of the letter of offer with regional stock exchange and shall carry changes as suggested by SEBI before the filing of the draft letter of offer with regional stock exchange.

Prospectus

A company issuing shares to public must issue a 'prospectus'. The prospectus is an 'invitation' to offer. It is an invitation to the public to take shares or debentures in the company or deposit money in the company. Section 2(36) of the Companies Act, 1956 defines prospectus as "any document described or issued as a 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”.

Abridged Prospectus

Section 2(1) of the Companies Act, 1956 defines abridged prospectus means ‘a memorandum containing such salient features of a prospectus as may be prescribed’. An abridged prospectus means the memorandum as prescribed in Form 2A under sub-section (3) of section 56 of the Companies Act. It contains all the salient features of a prospectus. A company cannot supply application forms for shares or debentures unless the form is accompanied by abridged prospectus.

Shelf Prospectus

Sometimes, securities are issued in stages spread over a period of time, particularly in respect of infrastructure projects where issue size is large as huge funds have to be collected. In such cases, filing of prospectus each time will be very expensive. In such cases, section 60A of the Companies Act, 1956 allows a prospectus called ‘Shelf Prospectus’ to be filed with Registrar of Companies. At subsequent stages only ‘Information Memorandum’ is required to be filed. The shelf prospectus shall be valid for a period of 1 year from the date of opening of first issue of securities under that prospectus.

Information Memorandum

The Information Memorandum shall contain all material facts relating to new charges created, changes in the financial position as have accrued between the first offer, previous offer and the succeeding offer. The Information Memorandum shall be filed with a period of 3 months prior to making of second or subsequent offer of securities under Shelf Prospectus. The Information Memorandum shall be issued to the public along with Shelf Prospectus filed at the first stage of offer. Where an update of Information Memorandum is filed every time an offer of securities is made, such memorandum together with the Shelf Prospectus shall constitute the Prospectus.

Red-Herring Prospectus

A prospectus is said to be a red-herring prospectus which contains all information as per prospectus contents but does not have information on price of securities offered and number of securities (quantum) offered through such document. Thus, a red-herring prospectus lacks price and quantity of the securities offered. This is used in book building issues only. In the case of book built issues, it is a process of price discovery and the price cannot be determined until bidding process is completed. Hence, such details are not shown in Red-herring prospectus filed with ROC in terms of the provisions of the Companies Act. Only on completion of the bidding process, the details of the final price are included in the offer document. The offer document filed thereafter with ROC is called a 'prospectus'.

Secondary Markets

Secondary market, popularly known as stock exchange is the place where the issued shares and other instruments are traded for subsequent sale. One of the criteria in investment management which is considered as very important next to risk assessment is the liquidity. After the investors get the shares allotted through the primary market they need some platform or market place to provide liquidity for their investment. Thus, secondary market offers liquidity to investment made in the primary market. Both, primary and secondary markets co-exist, i.e. to say one depends on the other for its survival and growth.

There are two broad segments of the stock markets

- The organised stock exchanges and
- The Over-the-Counter (OTC) market.

The primary middlemen in the stock market are brokers and dealers. The distinction between them is, the broker acts as an agent, whereas the dealer acts as a principal in the transaction. Stock markets are said to reflect the overall health of the country's economy. On the other hand, major economic indicators determine stock market movements to a large extent. From a thorough analysis of the various economic indicators and its implications on the stock markets, it is known that stock market

movements are largely influenced by broad money supply, inflation, credit/deposit ratio and fiscal deficit apart from political stability.

Besides, fundamentals, factors like corporate performance, industrial growth, etc. always exert a certain amount of influence on the stock markets. Because the stock market involves the trading of securities initially sold in the primary market, it is providing liquidity to the individuals who acquired these securities. The trends in stock market will have impact on the primary market.

The secondary market in India comprises of 23 Stock Exchanges and more than 10000 listed companies out of which BSE has about 4888 and NSE has 1225 companies listed with them as on 29th February 2008. A large volume of transactions on the secondary markets are transacted through BSE and NSE. Presently, the BSE & NSE put together account for more than 99% of the total turnover as compared to less than 1% by the other Stock Exchanges.

Role of Secondary Market

There are two main reasons why individuals transact in the secondary market: **Information Motivated Reasons:** Information motivated investors believe that they have superior information about a particular security than other market participants. This information leads them to believe that the security is not being correctly priced by the market. If the information is good, this suggests that the security is currently under-priced, and investors with access to such information will want to buy the security. On the other hand, if the information is bad, the security will be currently overpriced, and such investors will want to sell their holdings of the security.

Liquidity Motivated Reasons: Liquidity motivated investors, on the other hand, transact in the secondary market because they are currently in a position of either excess or insufficient liquidity. Investors with surplus cash holdings (e.g., as a result of an inheritance or adequate savings of their income) will buy securities, where as investors with insufficient cash (e.g., to purchase a car or any other assets) will sell their securities.

Types of Securities in the Stock Market

The Securities which are traded in the secondary market may be classified as follows.

On the Basis of Issuer

Securities may be classified as Industrial securities, Government securities and financial intermediaries securities.

- a) *Industrial securities* issued by industrial and common undertakings in the private and public sector whereas government securities include securities issued by State governments, municipalities and public utilities.
- b) *Government securities* are generally considered risk-free, low return securities compared to the Industrial securities.
- c) *Financial Intermediaries Securities*: Besides these two classes of issues, the Financial Intermediaries are emerging as the third important group. The securities issued by Financial Institutions and Banks would fall, in terms of risk-return features, somewhere in between the industrial securities and government securities.

On the Basis of Maturity

Securities may be classified into short term and long term or Money Market and Capital Market securities. Treasury bills, commercial bills, commercial papers, certificate of deposits are short- term or money market securities. Equities, Preference shares, Debentures and Bonds are long term or capital market securities.

On the Basis of Settlement of Deals

Securities may be classified into Forward securities and Cash securities. Forward securities are those in which the settlement date can be shifted from one settlement date to other by paying the badla charges. Cash securities are those for which settlement dates cannot be shifted. The Forward securities are known by different names viz. specified shares or group A shares or Forward section. Cash securities are also known as Non-specified shares or group B shares or cash section.

Stock Market in India

From scattered and small beginnings in the 19th Century, India's stock market has risen to great heights. In 1990, we had 19 stock exchanges in the country. There were around 6,000 listed companies and the invested population stood around 15 million. You might be interested in knowing more about the growth of stock market in India. What functions does it perform? What is the form of organization of stock exchange in India? How are they administered? What is the trading system followed on these exchanges? We shall discuss these and other questions in the following sections.

Role and Functions of Stock Exchanges

The history of stock exchanges shows that the development of joint stock enterprise would never have reached its present stage but for the facilities which the stock exchanges provide for dealing with the securities. Stock exchanges have a very important function to fulfill in the country's economy. The stock exchange is really an essential pillar of the private sector corporate economy. It discharges essential functions in the process of capital formation and in raising resources for the corporate sector.

Liquidity and Marketability of Securities

The stock exchange provides a market place for *purchase and sale of securities* viz., shares, bonds, debentures etc. It, therefore, ensures the free transferability of securities which is the essential basis for the stock enterprise system. The private sector economy cannot function without the assurance provided by the exchange to the owners of shares and bonds that they can be sold in the market at any time. At the same time, those who invest their surplus funds in securities for long-term capital appreciation or for speculative purpose can also buy scripts of their choice in the market.

Capital Formation

The stock exchange provides the *linkage between the savings in the household sector and investment in corporate economy*. It mobilizes savings,

and channelizes them in the form of securities into those enterprises which are favoured by the investors on the basis of such criteria as future growth prospects, good returns and appreciation of capital.

Fair Price Determination

By providing a *market quotation of the prices of shares and bonds* (a sort of collective judgement simultaneously reached by many buyers and sellers in the market), the stock exchange serves the role of barometer, not only of the state of health of individual companies, but also of the nation's economy.

The changes in share prices are brought about by a complex set of factors, all operating in the market simultaneously. Share values as a whole are subject to secular trends set by the economic programme of the nation, and governed by factors like general economic situation, financial and monetary policies, tax changes, political environment, international - economic and financial development, etc.

Membership, Organization and Management

Natures of the century-old traditional stock exchanges are a highly organized and smoothly functioning network in the world. The membership of stock exchanges initially comprised of individuals and partnership firms. Later on the corporate entities and financial institutions were also allowed to become members. A number of financial institutions are now members of Indian Stock Exchanges.

Over the years, stock exchanges have been initiated in various forms. For example, while the Ahmedabad Stock Exchange and M.P. (Indore) Stock Exchange were started as Non-profit making association of persons, the Calcutta Stock Exchange, Delhi Stock Exchange, U.P. Stock Exchange, Cochin Stock Exchange, Gauhati Stock Exchange, Bangalore Stock Exchange, Jaipur Stock Exchange and (Mangalore) Stock Exchange were established as public limited companies. Quite a few others have been started as Company limited by guarantee.

The entrance fee is different for different stock exchanges. Membership deposit and annual fees also varies from exchange to exchange. The entrance fee is different for different members among various exchanges based on their status like individual or corporate.

The *internal governance* of exchange rests in a governing board comprising members of the board and Executive Director. The Members of the governing boards include brokers and SEBI Nominees called Public Representatives.

The Chairman is expected to ensure the position of Executive Director can't be expected to be very strong because if he really tries to be may bring him into conflict with influential broker-members who may also be on the exchange's board which determines Executive Director's terms and conditions of service and his re-appointment on this term. It is not human nature to displease one's appointing authorities and it may be too much Executive Director's to be strict under the present scheme of things. Subject to the previous approval of the law, governing bodies of stock exchanges have wide powers to make bye-laws. Governing bodies furnish, censure and also expel any member, and authorized clerk and employee. It has to adjudicate disputes. Above all, it has the power to make, amend, suspend and enforce rules, bye-regulations and supervises the entire functioning of a stock exchange.

To rationalize the functioning of the stock exchanges during the year 2007 all the exchanges in India were de-mutualized under a compulsory scheme brought out by SEBI in the year 2005. Except NSE all other exchanges were managed by the brokers who were members of the exchange by having major stake in the composition of the Governing Board.

After the demutualization, management of the exchange rests with the owners (non-brokers) with more than 50% representation in the board and minority representation of the Trading Members and SEBI nominees. All the exchanges have become from Not-for profit organization to that of for-profit organizations. Those exchanges which have failed to complete the demutualization within the stipulated time frame as given by SEBI were cancelled of their recognition as an exchange and hence, they have lost their identity as exchange and cease to exist.

Trading System

Trading on stock exchanges is done through brokers and dealers. All members can act as brokers and for this purpose they have to maintain

a minimum security deposit and additional security deposit also called as base capital which will decide on the trading exposure that the said broker will be allowed to. Brokers act as agents for buying and selling on behalf of their clients, for which they receive brokerage/commission at stipulated rates.

The maximum brokerage that can be charged is restricted to 2.5% of the value of transaction done and there is no minimum stipulated but it cannot be nil, except when the transactions are done for charitable organizations. Dealers act as principals and buy and sell securities on their own accounts. However, members cannot enter into contract with any person other than the member without prior permission of the governing Body.

The Trading system of NSE has enhanced its efficiency, liquidity and transparency, by introducing a nation-wide online fully-automated screen based trading system (SBTS) where a member can input into the computer trading terminal, the quantities of the securities he wanted to buy or sell and the prices at which he likes to transact and the transaction is executed as soon as it finds a matching sale or buy order from a counter party. SBTS electronically matches orders on a strict price/time priority and hence cuts down on time, cost and risk of error, as well as on fraud resulting in improved operational efficiency.

It allows faster incorporation of price sensitive information into prevailing prices, thus increasing the informational efficiency of markets. It enables market participants, irrespective of their geographical locations, to trade with one another simultaneously, improving the depth and liquidity of the market. It provides full anonymity by accepting orders, big or small, from members without revealing their identity, thus providing equal access to everybody. It also provides a perfect audit trail, which helps to resolve disputes by logging in the trade execution process in entirety.

An Overview of Stock Exchanges in India

a) Bombay Stock Exchange of India Ltd.

The Bombay Stock Exchange is known as the oldest exchange in Asia. It traces its history to the 1850s, when stockbrokers would gather under banyan trees in front of Mumbai's Town Hall. The location of

these meetings changed many times, as the number of brokers constantly increased. The group eventually moved to Dalal Street in 1874 and in 1875 became an official organization known as 'The Native Share & Stock Brokers Association'. In 1956, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contracts Regulation Act.

The Bombay Stock Exchange developed the BSE Sensex in 1986, giving the BSE a means to measure overall performance of the exchange. In 2000 the BSE used this index to open its derivatives market, trading Sensex futures contracts. The development of Sensex options along with equity derivatives followed in 2001 and 2002, expanding the BSE's trading platform. Historically an open-cry floor trading exchange, the Bombay Stock Exchange switched to an electronic trading system in 1995. It took the exchange only fifty days to make this transition.

b) National Stock Exchange of India Ltd

The National Stock Exchange of India Limited (NSE) was promoted by IDBI, ICICI, IFCI, GIC, LIC, State Bank of India, SBI Capital Markets Limited, SHCIL and IL & FS as a Joint Stock Company under the Companies Act, 1956, on November 27, 1992. The Government of India has granted recognition with effect from April 26, 1993, initially for a period of five years. The GOI has appointed IDBI as a lead promoter. To form the infrastructure of NSE, IDBI had appointed a Hongkong Bound consulting firm M/s. International Securities Consulting Limited for helping in setting up of the NSE.

The main objective of NSE is to ensure comprehensive nationwide securities trading facilities to investors through automated screen based trading called NEAT and automatic post trade clearing and settlement facilities. The NSE encourages corporate trading members with dealer networks, computerized trading and short settlement cycles. It has three segments, one dealing with wholesale debt instruments, the second to deal with capital market instruments called cash segment and the third for Futures and Options or Derivatives Market. The Clearing Corporation of India Limited (CCIL) an Electronic Clearing and Depository System (ECDS) set up by the Stock Holding Corporation of India Limited (SHCIL) provides the requisite clearing and settlement systems. The

recommendations of the High Power Committee on setting up of the National Stock Exchange, a 'Model Exchange' at New Mumbai to act as a National Stock Exchange (NSE) to provide access to all investors from across the country on an equal footing, and work as Integral component of the National Stock Market System. Hence, NSE is having the following vital features:

- NSE is promoted by Financial Institutions, Mutual Funds, and financed on a self-sustaining basis through levy of membership fees. The capital outlay of 30 crores of rupees was financed by admitting 1,000 members with an entry fee of ₹10 lakhs each. Fees for corporate and Institutional members were at a higher level of ₹25 lakhs.
- NSE is a company incorporated under the Companies Act of 1956. It is constituted by the Board of Directors (Board) and managed by it. 50 per cent of the Managing Board of the Exchange comprise of professionals who are not members. These professionals must be from a cross section of finance and industry, and must actively contribute to ensuring that the stock exchange functions in a balanced and fair manner.
- It is trading on large & medium sized securities of equity shares and debt instruments.
- It is a separate ring altogether. For the first time in our country, debt instruments were traded to become an active part in the secondary market of the nation.
- NSE made its debut with the debt market. The debt market is predominantly a market in Government Securities. The Central Government moving over to auctions at market-related rates of interest, the primary market has become active with the well informed and fine-tuned bidding at the auctions.
- It is having full support from the National Clearing and Settlement divisions, SHCIL and the Securities Facilities Support Corporation. It is using modern computer technology for the clearance and settlement procedures.
- Better transparency system for the securities trading & settlement.

In the very first year of its operation, NSE became the leading stock exchange in the country, impacting the fortunes of other exchanges and forcing them to adopt SBTS also. Today India can boast that almost 100% trading take place through electronic order matching. Technology was used to carry the trading platform from the trading hall of stock exchanges to the premises of brokers. NSE carried the trading platform further to the PCs at the residence of investors through the Internet and to handheld devices through WAP for convenience of mobile investors. This made a huge difference in terms of equal access to investors in a geographically vast country like India.

The trading network is depicted in above. NSE has main computer which is connected through Very Small Aperture Terminal (VSAT) installed at its office. The main computer runs on a fault tolerant STRATUS mainframe computer at the Exchange. Brokers have terminals installed at their premises which are connected through VSATs/leased lines/modems. An investor informs a broker to place an order on his behalf. The broker enters the order through his PC, which runs under Windows NT and sends signal to the Satellite via VSAT/leased line/modem. The signal is directed to mainframe.

Both BSE and NSE have national presence and they dominate the stock markets. All other exchanges have created a platform by having either an alliance with or cross holding with these two premier exchanges or trading facility provided to their members through a subsidiary of the main exchanges.

c) Over The Counter Exchange of India (OTCEI)

Indeed in mid-eighties itself the G.S. Patel Committee on Stock Exchange reforms and the Abid Holi Committee on Capital Markets had recommended for the creation of a second tier stock market that will solve some of the problems of present stock exchanges. Over The Counter Exchange of India (OTCEI) was been promoted by, UTI, IDBI, IFCI, LIC, GIC, SBI Capital Market and Canbank Financial Services as a non profit-making company under Section 25 of the Companies Act, 1956. The OTCEI is a recognized Stock Exchange under section 4 of the Securities Contracts (Regulation) Act, 1956. Hence companies listed on the OTC Exchange enjoy the same status as companies listed on any other stock exchanges in the country.

OTC Exchange of India has picked the model from the NASDAQ system (National Association of Security Dealers-Automated Quotations) prevalent in the United States of America. Modifications suited to Indian conditions been adopted from OTC in America was an offshoot of their government's efforts to regulate the unlisted securities act. The Indian version of NASD National Associations of Securities Dealers is what is called OTC Exchange of India. Unlike in the regular exchange, listing on OTCEI is a national listing from day one.

Wherever and whenever counters start operating in the country they can trade in all the scripts of OTCEI. Separate listing in those regular places is not needed at all. All said and done the OTCEI did not take off and was not successful due to many reasons like lower end technology, low liquidity, less participation by investors in small cap companies, etc.

d) Inter-connected Stock Exchange of India

Inter-connected Stock Exchange of India Limited (ISE), has been promoted by 15 Regional stock exchanges to provide trading linkage/ connectivity to all the participating exchanges to widen their market. Thus, ISE is a national level exchange providing trading, clearing, settlement, risk management and surveillance support to the Inter-Connected Market System (ICMS).

ISE aims to address the needs of small companies and retail investors with the guiding principle of optimizing the infrastructure and harnessing the potential of regional markets to transform these into a liquid and vibrant market through the use of technology and networking. The participating exchange in ISE has in all about 4500 traders.

In order to leverage its infrastructure as also to expand its nation-wide reach, ISE has also appointed dealers across various cities other than the participating exchange centres. These dealers are administratively supported through strategically located regional offices at Delhi, Calcutta, Chennai and Nagpur.

ISE, thus expects to emerge as a low cost national level exchange in the country for retail investors and small intermediaries. ISE has also floated a wholly-owned subsidiary namely, ISE Securities and Services

Limited (ISS) to take membership of NSE and other premier exchanges, so that traders and dealers of ISE can access other markets in addition to the local market and ISE.

This will provide the investors in smaller cities with a solution for cost-effective and efficient trading in securities. Core objectives of the Inter-connected Stock Exchange include creation of single integrated national level solution with access to multiple markets for providing high quality, low cost services to millions of investors across the country, a liquid and vibrant national level market for all listed companies in general and small capital companies in particular and providing trading, clearing and settlement facilities to the traders and dealers across the country at their doorstep with decentralized support system. Some of the features which make ISE a new age stock exchange are as follows:

- ISE is a national level recognised stock exchange having moderate listing fees and granting listing and trading permission to small and medium sized companies having a post public issue paid-up capital of ₹ 3 crore to ₹ 5 crore (subject to the appointment of market makers) besides companies with a capital of above ₹ 5 crore.
- All traders and dealers of ISE have access to NSE through ISE Securities and Services Ltd. (ISS), which ensures continuous attention of investors.
- Proposing to introduce the 'IPO Distribution System' for offering primary market issue.
- ISE has set up an 'Investors Grievance and Service Cell' which looks after all types of complaints of investors located across the country and provides decentralised support.
- Listing of stocks with ISE would give the company an advantage of being identified as a technology-savvy and Investor-friendly company.

Demutualization of Stock Exchanges

Historically stock exchanges were formed as 'mutual' organizations, which were considered beneficial in terms of tax benefits and matters of compliance. They are generally 'not-for-profit' and tax exempted entities.

The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. The ownership rights and trading rights are clubbed together in a membership card which is not freely transferable and hence this card at times carries a premium. In contrast, in a 'demutual' exchange, three separate sets of people own the exchange, manage it and use its services.

The ownership usually vests in management constituting a board of directors which is assisted by a professional team. A completely different set of people use trading platform of the exchange. These are generally 'for-profit' and taxpaying entities. The ownership rights are freely transferable. Trading rights are acquired / surrendered in terms of transparent rules. Membership cards do not exist. These two models of exchanges are generally referred to as 'club' and 'institution' respectively.

The most important development in the capital market is demutualization of the stock exchanges. Demutualization means segregating the ownership from management. This move was necessitated by the fact that brokers in the management of the stock exchange were misusing their position for personal gains. Demutualization would bring in transparency and prevent conflict of interest in the functioning of the stock exchanges. Now, all the stock exchanges in India are demutualised entities.

Lesson 4.3 - Listing Regulations, Mutual Funds and Indian Fiscal System

Learning Objectives

- To understand the Regulations relating to Listing of Securities.
- To understand the meaning of mutual funds and its schemes.
- To understand the framework of the Indian Fiscal System

Listing of Securities (Regulations)

A company, desirous of listing its securities on the Exchange, shall be required to file an application, in the prescribed form, with the Exchange before issue of Prospectus by the company, where the securities are issued by way of a prospectus or before issue of 'Offer for Sale', where the securities are issued by way of an offer for sale. The company shall be responsible to follow all the requirements specified in the Companies Act, the listing norms issued by SEBI from time to time and such other conditions, requirements and norms that may be in force from time to time and included hereafter in these Bye-laws and Regulations to make the security eligible to be listed and for continuous listing on the Exchange.

Applications in Respect of New Issues /Offers for Sale/Book-Building

- Except when otherwise allowed by the Governing Board or Managing Director or Relevant Authority in any particular case and subject to compliance with such conditions as it or he may impose, tenders or applications for subscription or purchase or book-building in respect of any new issue or offer for sale of any security shall not be submitted unless the issuer or offerer offers to all a fair and equal opportunity for subscription or purchase and on the same terms as to brokerage to all the trading members and unless it is provided that all tenders and applications for subscription or purchase or book-building shall rank alike for allotment or sale.

- The issuer or the offerer, prior to issuing further securities or offering securities for sale, shall obtain an in principle approval from the Exchange for listing these securities on the Exchange.

Application for Admission to Dealings

The issuer shall submit an application for admission of its securities to dealings on the Exchange in such form, as may be prescribed by the Exchange from time to time, after ensuring compliance with the applicable provisions in the SCRA, SCRR, Companies Act and the Rules, Regulations and norms as may be issued by SEBI / Exchange in this regard from time to time

Units and Exchange Traded Funds

Units of Mutual Funds may be admitted to dealings on the Exchange subject to such conditions and requirements, as may be prescribed by the Governing Board or Relevant Authority from time to time.

Options or Futures in Securities

Options and futures in securities and in securities index or indices shall be admitted to dealings on the Exchange by the Governing Board or Relevant Authority in accordance with the provisions of SCRA and norms issued by SEBI from time to time and as may be specified in the relevant Bye-laws and Regulations framed in this regard.

Notice of Application for Admission to Dealings

Notice of any application for admission to dealings on the Exchange shall be posted on the notice board or displayed on the ATS or Website of the Exchange for the information of trading members and others, at least one week prior to its consideration by the Exchange.

Underwriting, Placing and Preliminary Arrangements

Except when otherwise allowed by the Relevant Authority in any particular case and subject to compliance with such conditions as it may impose, a trading member shall not enter into an underwriting contract

nor shall he contract either as a principal or agent to subscribe or purchase or to procure, whether through the market or otherwise, nor shall he act or agree to act as broker or underwriter in connection with any floatation or issue of any security, unless the trading member fulfills the capital adequacy requirements, as may be specified by SEBI or the Exchange from time to time, and the issuer conforms or agrees to conform to the listing requirements prescribed in these Bye-laws and Regulations and/or as provided under the SCRA and SCRR and undertakes to apply for admission of such security to dealings on the Exchange.

Listing Conditions and Requirements

- i) The Governing Board or Managing Director or Relevant Authority may not grant admission to dealings on the Exchange to a security of an issuer unless the issuer complies with the listing conditions, requirements and norms, under the SCRA, SCRR, the Companies Act, the Rules, Bye-laws and Regulations of the Exchange and the norms, as may be prescribed by the Exchange and/or SEBI from time to time.
- ii) The Governing Board or Managing Director or Relevant Authority shall ensure that no listing or trading permission is granted unless the issuer complies with all the conditions, requirements or norms, as may be provided in the relevant Regulations from time to time, including dispatch of physical share certificates to, and/or credit of DEMAT shares to the accounts of all the security-holders, maintained with the depositories.
- iii) Where the Exchange is the stock exchange with whose consultation the basis of allotment is decided, the Governing Board or Managing Director or Relevant Authority of the said stock exchange shall intimate the depositories about approval granted for admission to dealings on the Exchange for any security.
- iv) The company shall execute a Listing Agreement, in the prescribed form with the Exchange, prior to approval of the listing application of the company. Any addition or amendment to the provisions of the Listing Agreement, as may be prescribed by SEBI and/or the Exchange shall become applicable to the company as if such addition or amendment was part of the Listing Agreement.

- v) In the case of a new issue or further issue by any issuer the Governing Board or Managing Director or Relevant Authority may grant permission for trading in any security at the Exchange on the same day as on all other stock exchanges where such security admitted to dealings is granted permission for trading.

Securities Issued on Preferential Allotment Basis or Under ESOP

Securities issued on preferential allotment basis or under the Employees Stock Option Scheme by an issuer, whose securities are already admitted to dealings on the Exchange, may be granted admission to dealings on the Exchange on complying with the listing conditions, requirements and norms, under the SCRA, SCRR, the Companies Act, the rules made there under, and these Bye-laws and Regulations, as may be prescribed by the Governing Board or Managing Director or Relevant Authority and/or SEBI from time to time.

Issuers Registered Outside India

Admission to dealings on the Exchange shall not be granted to a security issued by a body corporate or fund or other entity registered or formed outside India unless:

- There is adequate public interest in such securities in India and
- The body corporate, fund or other entity agrees to abide by the applicable statutory provisions, as may be in force and such requirements as may be prescribed in this regard by the Exchange or SEBI or Reserve Bank of India or any other statutory body.

Applicability of Listing Conditions and Requirements

In the case of a body corporate, fund or other entity registered or formed outside India, the Governing Board or Managing Director or Relevant Authority may, for reasons to be recorded in writing, waive or dispense with the strict enforcement of any or all of the listing conditions and requirements prescribed in these Byelaws and Regulations, provided that the securities of such body corporate, fund or other entity are admitted to dealings on any stock exchange outside India and the Governing Board

or Managing Director or Relevant Authority is satisfied that it is in the interest of trade or in the public interest, so to do.

Grant or Refusal of Admission to Dealings

The Governing Board or Managing Director or Relevant Authority may, in its/his discretion, approve subject to such terms as it/he deems proper or defer or reject any application for admission of a security of an issuer to the dealings on the Exchange, without assigning any reason whatsoever, within the time provided under the SCRA, the Companies Act and the Rules, Regulations and norms as may be issued by SEBI / Exchange, that may be in force from time to time.

Listing Approval

The Exchange may grant approval to the issuer for any security sought to be listed on the Exchange on completion of the listing conditions, requirements and norms by the issuer, as may be specified by the Exchange from time to time. Such security shall be called listed security.

Admission to Dealings

Admission to dealings shall mean permission granted by the Exchange to a security for commencement of trading on the ATS of the Exchange as provided in these Bye-laws and the relevant Regulations.

Trading Allowed

Trading in securities admitted to dealings shall be allowed on the ATS of the Exchange as provided in these Bye-laws and the relevant Regulations, and save as otherwise so provided, no other mode of trading shall be allowed.

Explanation

The Exchange shall ensure that the permission for trading in any security at the Exchange is given on the same day as on all other stock exchanges where such security admitted to dealings is granted permission for trading.

Trading in Securities Admitted to Dealings on Other Stock Exchanges

The Governing Board or Relevant Authority may, in its discretion and subject to such conditions as it may deem proper, allow trading in any security or securities, admitted to dealings on any other stock exchange. Such security shall be called permitted security.

Listing Fees

The Board or the Relevant Authority of the Exchange shall fix the listing fees at such rates and in such manner as may be deemed fit from time to time.

Fees or Deposits to be paid by Issuer

Issuers, whose securities are granted admission to dealings on the Exchange, shall pay listing fees and deposits, within such time, as may be determined by the Exchange from time to time.

Trading in Government Securities

Trading shall be allowed in Government Securities, which term for the purposes of these Bye-laws and Regulations, denote securities issued by the Government of India, State Governments, Port Trusts, Municipal Corporations and other similar bodies.

- i) Government Securities shall be deemed to have been admitted to dealings on the Exchange from the date on which they are issued.
- ii) Transactions in Government Securities shall be carried out and settled in accordance with the directions issued by the Reserve Bank of India from time to time.

Governing Board/Managing Director/Relevant Authority May Restrict / Prohibit Trading

- i) The Governing Board or Managing Director or Relevant Authority may, in its/his absolute discretion, impose such restrictions on transactions in any security admitted to dealings, in the interest

of orderly market in securities or in the interest of trade or in the public interest. During the operation of such restrictions, no trading member shall, either on his own account or on account of his sub-brokers or clients, enter into in any transaction in contravention of such restrictions.

- ii) The Governing Board or Managing Director or Relevant Authority may prohibit dealings on the ATS of the Exchange in any security or securities admitted to dealings for reasons to be recorded in writing.

Consequences of Non-Compliance by Issuer

Suspension of Admission to Dealings on the Exchange

- i) Subject to the provisions of SCRA and SCRR, the Governing Board or Managing Director or Relevant Authority may, at any time, for reasons to be recorded in writing, shift trading from normal basis to trade-for-trade basis or suspend the admission to dealings on the Exchange granted to any security for a breach of or non-compliance with any of the conditions of admission to dealings or for manipulation of prices/trading or for any other reason whatsoever, for such period or periods and on such conditions, as it/he may determine. At the expiration of the period of suspension, the Governing Board or Managing Director or Relevant Authority may reinstate the dealings in such security subject to such conditions, as it/he deems fit.
- ii) Intimation of shifting of trading from normal basis to trade-for-trade basis or suspension of trading by the Exchange in any security on account of a violation of any of the provisions of the Listing Agreement or because of a surveillance action or for whatever other reason shall be communicated by the Exchange to other stock exchanges where the security is listed.

Withdrawal of Admission to Dealings or Redemption or Conversion

The Governing Board or Managing Director or Relevant Authority may, if deemed necessary, withdraw admission to dealings granted to a security which is about to be exchanged with some other security

or converted into some other security as a result of any scheme of re-organization or reconstruction of the issuer company or to such security, redeemable or convertible in their nature, which is about to fall due for redemption or conversion.

Liquidation or Merger

If any issuer whose securities have been granted admission to dealings on the Exchange, be placed in final or provisional liquidation or is about to be merged into or amalgamated with another company, the Governing Board or Managing Director or Relevant Authority may withdraw the admission to dealings on the Exchange granted to its securities. The Governing Board or Managing Director or Relevant Authority may accept such evidence as it/he deems sufficient as to such liquidation, merger or amalgamation. If the merger or amalgamation fails to take place or if any company placed in provisional liquidation be reinstated and an application be made by such company for readmission of its securities to dealings on the Exchange, the Governing Board or Managing Director or Relevant Authority shall have the power of considering and of approving, refusing or deferring such application.

Voluntary Delisting by Company

A company may be allowed to get its securities delisted (i.e. withdrawal of admission to dealings) from the Exchange, provided the provisions, guidelines, norms and procedures governing the listing/delisting and trading/suspension of trading in securities that may be stipulated by the SEBI/Central Listing Authority are duly complied with.

Buy-Back of Securities by Company

A company may buy-back securities issued by it earlier, subject to the conditions, requirements and guidelines governing the scheme of buy-back of securities by a company, issued by SEBI and / or Central Government in that behalf. A company, making an offer to buy-back its securities, shall be required to strictly adhere to the conditions, requirements and guidelines in force in that regard and any non-compliance or violation by the company shall render it liable for such action, as may be deemed fit by the Exchange.

Withdrawal of Admission to Dealings or Delisting on the Exchange

Subject to the provisions of SCRA and SCRR, the Governing Board or Managing Director or Relevant Authority may, after giving an opportunity to the company to explain, withdraw the admission to dealings on the Exchange granted to its securities, either for breach of or non-compliance with any of the continuous listing requirements for admission to dealings or for any other reason whatsoever to be recorded in writing, and in such manner, as may be provided in relevant Regulations from time to time.

Right to Appeal against Delisting

Any person, who may be aggrieved or affected by the decision of the Exchange to delist a security of any company admitted to dealings on the Exchange, may appeal in writing, to SEBI, within thirty calendar days from the date the Exchange has notified the decision to the company.

Readmission to Dealings on the Exchange

The Governing Board or Managing Director or Relevant Authority may readmit to dealings on the Exchange the security of a company whose admission to dealings had been previously withdrawn, on the fulfillment of conditions, norms, guidelines or requirements as may be prescribed by the Governing Board or Managing Director or Relevant Authority and / or SEBI from time to time.

Central Listing Authority

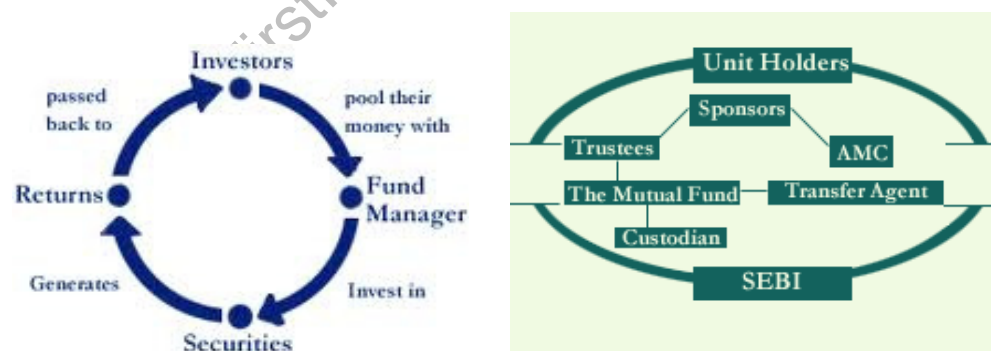
As and when the Central Listing Authority is constituted by SEBI or any authority under the relevant law in relation to listing / delisting and trading / suspension of trading in securities of companies on a stock exchange, the provisions, guidelines, norms and procedures governing the listing / delisting and trading / suspension of trading in securities that may be stipulated by such Central Listing Authority shall then be incorporated in the Bye-laws of the Exchange and shall be made applicable mutatis mutandis by the Exchange.

Mutual Funds

A mutual fund is a type of professionally managed collective investment vehicle that pools money from many investors to purchase securities. While there is no legal definition of the term “mutual fund”, it is most commonly applied only to those collective investment vehicles that are regulated and sold to the general public. They are sometimes referred to as “investment companies” or “registered investment companies.” Most mutual funds are “open-ended,” meaning investors can buy or sell shares of the fund at any time. Hedge funds are not considered a type of mutual fund.

There is a three tier structure in the administration of mutual fund companies, viz., sponsors, trustee and asset management companies (AMCs). The trustee collects money from the investors and the AMCs invest the same in the securities market. The investment decisions are being taken by professionally qualified fund managers. The investments are held in the form of units and the investors are called unit holders. The returns from the investments are distributed to the unit holders after deducting the expenses of AMCs. All the mutual funds are subject to the SEBI guidelines. The following figure explains the operation of mutual fund.

Figures showing the operation of mutual fund



One can make money from a mutual fund in three ways:

- Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all of the income (90%) it receives over the year to the unit holders in the form of a distribution.

- If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
- If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. One can then sell his/her mutual fund shares for a profit.

Benefits of Investing in a Mutual Fund

- **Small investments:** With mutual fund investments, money can be spread in small bits across varied companies. This way you reap the benefits of a diversified portfolio with small investments.
- **Professionally managed:** The pool of money collected by a mutual fund is managed by professionals who possess considerable expertise, resources and experience. Through analysis of markets and economy, they help pick favourable investment opportunities.
- **Spreading risk:** A mutual fund usually spreads the money in companies across a wide spectrum of industries. This not only diversifies the risk, but also helps take advantage of the position it holds.
- **Transparency and interactivity:** Mutual funds clearly present their investment strategy to their investors and regularly provide them with information on the value of their investments. Also, a complete portfolio disclosure of the investments made by various schemes along with the proportion invested in each asset type is provided.
- **Liquidity:** Closed ended funds can be bought and sold at their market value as they have their units listed at the stock exchange. In addition to this, units can be directly redeemed to the mutual fund as and when they announce the repurchase.
- **Choice:** A wide variety of schemes allow investors to pick up those which suit their risk / return profile.
- **Regulations:** All the mutual funds are registered with SEBI. They function within the provisions of strict regulation created to protect the interests of the investor.

Classification of Mutual Funds

Every investor has a different investment objective. Some go for stability and opt for safer securities such as bonds or government securities. Those who have a higher risk appetite and yearn for higher returns may want to choose risk-bearing securities such as equities. Hence, mutual funds come with different schemes, each with a different investment objective. There are hundreds of mutual fund schemes to choose from. Hence, they have been categorized as mentioned below.

- **By structure:** Closed-Ended, Open-Ended Funds, Interval funds.
- **By nature:** Equity, Debt, Balance or Hybrid.
- **By investment objective:** Growth Schemes, Income Schemes, Balanced Schemes, Index funds.

a) Types of Mutual Funds by Structure

- i) **Close ended fund/scheme:** A close ended fund or scheme has a predetermined maturity period (eg. 5-7 years). The fund is open for subscription during the launch of the scheme for a specified period of time. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units on the stock exchanges where they are listed. In order to provide an exit route to the investors, some close ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices or they are listed in secondary market.
- ii) **Open ended fund/scheme:** The most common type of mutual fund available for investment is an open-ended mutual fund. Investors can choose to invest or transact in these schemes as per their convenience. In an open-ended mutual fund, there is no limit to the number of investors, shares, or overall size of the fund, unless the fund manager decides to close the fund to new investors in order to keep it manageable. The value or share price of an open-ended mutual fund is determined at the market close every day and is called the Net Asset Value (NAV).
- iii) **Interval schemes:** Interval schemes combine the features of open-ended and close-ended schemes. The units may be traded on the

stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices. FMPs or Fixed maturity plans are examples of these types of schemes.

b) Types of Mutual Funds by Nature

- i) **Equity mutual funds:** These funds invest maximum part of their corpus into equity holdings. The structure of the fund may vary for different schemes and the fund manager's outlook on different stocks. The Equity funds are sub-classified depending upon their investment objective such as Diversified equity funds, Mid-cap funds, Small cap funds, Sector specific funds and Tax savings funds (ELSS). *Equity investments rank high on the risk-return grid and hence, are ideal for a longer time frame.*
- ii) **Debt mutual funds:** These funds invest in debt instruments to ensure low risk and provide a stable income to the investors. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. Debt funds can be further classified into Gilt funds, Income funds, MIPs, Short term plans and Liquid funds.
- iii) **Balanced funds:** They invest in both equities and fixed income securities which are in line with pre-defined investment objective of the scheme. The equity portion provides growth while debt provides stability in returns. This way, investors get to taste the best of both worlds.

c) Types of Mutual Funds by Investment Objective

- i) **Growth schemes:** Also known as equity schemes, these schemes aim at providing capital appreciation over medium to long term. These schemes normally invest a major portion of their fund in equities and are willing to withstand short-term decline in value for possible future appreciation.
- ii) **Income schemes:** Also known as debt schemes, they generally invest in fixed income securities such as bonds and corporate debentures. These schemes aim at providing regular and steady income to investors. However, capital appreciation in such schemes may be limited.

- iii) **Index schemes:** These schemes attempt to reproduce the performance of a particular index such as the BSE Sensex or the NSE 50. Their portfolios will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weight age. And hence, the returns from such schemes would be more or less equivalent to those of the Index.

Indian Fiscal System

Fiscal system of a country refers to the revenue and capital resources that can be raised by government, the procedure to be observed in raising and spending funds and in case of a federation such as ours the provision that governs the relationship of the constituent unit of federation. It includes within its purview taxation, expenditure, debt management and inter-governmental fiscal relation. **Indian fiscal system** is based on the constitution of India which is federal in character. The constitution envisages two layers of government: the Union of central government and the state government. Local bodies do not find a place in the constitution and the function and resources allotted to them are delegated by the state government.

Division and Functions

The constitution distributes the legislative function and resources into three lists:

- The Union list (defence, foreign relation, railway, currency)
- The state list (education, medical public health, police, law & order)
- The concurrent list (trade union, planning & price policy)

The taxes over which there is legislative jurisdiction of centre extends fall under four groups:

- **Group I:** The taxes which are levied and collected by the union and the proceeds are retained by it. These are corporation tax, custom duties, and taxes on capital value of asset of individual.

- **Group II:** The taxes levied and collected by the union but the proceeds of which are shared with the states. These are Income tax and excise duties.
- **Group III:** The taxes which are levied and collected by the union and the proceeds are assigned to states with in which they are levied. These are succession and estate duties in respect to property other than agriculture land, taxes on goods and passenger carried railway, sea and air.
- **Group IV:** The taxes which are levied by the union but the proceeds are of which are collected and retained by state. These are stamp duties and duties on excise on medicine and toilet preparation containing alcohol.

Expenditure of Government

The total expenditure consists of revenue expenditure (83%) and capital expenditure (27%). **Revenue expenditure** is administrative expenditure, and capital expenditure is spent towards capital or asset formation. The total expenditure may also be classified into plan (26%) and non-plan expenditure (74%).

Non Plan expenditure include Interest payment, Defense expenditure, Subsidies, Grant to state and UT government, Grant to foreign government and Other non plan expenditure

Expenditure of Central Government include General Service, Organ of state, Tax collection, Police + Pension, Write off loan, Others Social Service, Education, Sports & Youth affairs, Health and family welfare, Water supply, Housing, Information and broadcasting, Labour and employment, Welfare of ST,SC & OBC, Others Economic Services, Agriculture & Allied activities, Rural development, Irrigation and flood control, Energy, Industry & minerals, Transport, Communication, Science Technology & Environment and Postal Services Loan, and Advances.

Receipt of Central Government

Receipt of Central Government includes tax revenue, non-tax revenue and capital receipts.

Tax revenue include Corporation tax, Tax on income on other than Corporation Tax, Interest tax, Expenditure Tax, Custom Duty, Union Excise Duties, Wealth Tax, Gift Tax, Other Tax, Taxes on UT, and Service Tax.

Non-tax revenue include Fiscal Service, Interest Receipt, Dividend and profit, Other general service, Social service, Economic Service, UT without Legislature, and Grant-in-aid & contribution.

Capital Receipts include receipts from International debt Market, External assistance, Recovery of Loan, Small saving, State provident fund, Special deposit, Disinvestment and Others.

Deficits

- a) **Budget Deficit:** $\text{Budget Deficit} = \text{Total Expenditure} - \text{Total Revenue}$ (The excess of revenue expenditure over revenue receipts.

It shows the deficit of government on current account).

Revenue Deficit = $\text{Revenue Expenditure} - \text{Revenue Receipts}$. (The excess of all expenditure over all types of receipts including borrowings).

- b) **Fiscal Deficit:** $\text{Fiscal Deficit} = \text{Revenue Deficit} + \text{Capital expenditure}$ (The excess of expenditure over revenue receipts and non debt capital receipts. It represents the total borrowing requirement of the central government).

Primary Deficit = $\text{Gross Fiscal deficit} - \text{Interest Payments}$ (Fiscal deficit net of interest payments. It is the non interest deficit and reflects the current fiscal of the government).

Monetised Deficit: The part of fiscal deficit which is financed by RBI through printing of notes.

Impact of Fiscal Deficit on the Economy

- **The fiscal deficit** measures the shortfall in government ability to fund its expenditure through regular sources. Sources of funds for a government are of kind- revenue and capital.

- **Fiscal Deficit** is important to annual budget. The budget is the government annual report, which differs from corporate annual report in one key area-a budget gives projection or next year's number alongside its performance for a finished year.
- **Fiscal Deficit** represents the extent to which the government needs fund, but does not have them. Government of India is the largest borrower in India. Annual borrowings of Government are probably larger than that of entire corporate sector.
- Besides, borrowing the government has another way of finding funds it does not have. Being the law maker of the land gives the government the power to create money which is simply printing additional notes. This is called monetization.
- Fiscal Deficit to some extent is fine. One typically looks at ratio of FD to gross domestic product. This ratio should ideally remain around 4% for a country like India, says the IMF. A much higher number is bad news. The government has large role to play in the economy in areas like infrastructure, education, social support (India does not have this), defence, civil administration, and so on. Government needs are likely to more than its income in a growing economy.
- Fiscal Deficit has a lot of impact on government policy. For example, if it turns out to be very high in a year, the government will have to either borrow a lot or print a lot of money. Borrowing a lot will push up interest rate there by making the economy costlier and reducing competitiveness of goods produced vis-à-vis those made by other country. Printing lots of money breeds inflation, which is also bad beyond a point.
- Sustained high deficits can lead to very high accumulation of debt by the government leading to what is called internal debt trap.
- Fiscal Deficit can be kept within a limit either through increasing revenue or cutting expenses or both. Revenue can be increased in three fashions - increase tax rate or tax more things or reduce tax evasion. In cutting expenses Government of India has traditionally taken easier route, like cutting infrastructure spending instead harder ones like cutting subsidies or freezing recruitment.

Self Assessment Questions

1. Define financial system. What are the components and functions of Indian Financial System?
2. What are the shortcomings of Indian Financial System?
3. Review the functioning of Indian Financial system.
4. Discuss the role of financial intermediaries.
5. Explain the components of financial market?
6. List and explain the various capital market instruments?
7. What are hybrid instruments?
8. Discuss the role of financial intermediaries in financial markets.
9. Explain the functions of primary markets.
10. Explain how the price is discovered in book building process. How does it differ from fixed price process?
11. Discuss the role of secondary markets.
12. List and explain the various types of securities in stock market.
13. List out the entry norms laid down by SEBI for making public issues.
14. Explain how trading is done in NSE.
15. Give an overview of various important Stock Exchanges in India.
16. What is Demutualization? What is the benefit of demutualisation to various stakeholders?
17. List the various listing conditions and requirements applicable for various issues.
18. Define Mutual funds. Explain the method of its operation.
19. Discuss the various types of mutual funds.
20. Explain the divisions and functions of Indian Fiscal System.
21. Discuss the impact of fiscal deficit on the economy.

CASE STUDY

Failed IPO shows that manipulators have withdrawn from the game

Vaswani Industries Ltd's Initial Public Offering (IPO) was closed for subscription on 3rd May and share allotment details were published on 12th May 2011. After the allotment was published on the registrar's website, retail investors were upset to see that they had received many more shares than what had been allocated. Even though the issue was subscribed 6.83 times in the retail category, investors got share allotment of equivalent to 1.28 times over-subscription in this category. SEBI started its investigation after getting complaints from high net-worth individuals and retail investors.

The market regulator has collected bidding data from the registrar to the issue (Link in time) and has written to the two exchanges - NSE and BSE- to stop listing of the stock till it completes the investigations into the bidding and the subsequent withdrawal of applications. How did this happen?.The game starts when greedy promoters shop for investment bankers who would promise the highest IPO price for their shares. Invariably, the issues get a poor retail response and in the first couple of days after an IPO opens for subscription, panic sets in.

The investment bankers then helpfully bring in financiers who demand a 30% to 50% discount to put in applications. These financiers also have the capability of making 4,000 to 5,000 retail applications if required. Yes, the multiple applications scam is thriving, but has only got more sophisticated to evade detection. Our sources say that investment bankers are an integral part of this racket. Another aspect of the scam is pure extortion. Here, some unscrupulous financiers prey on IPOs that get a poor response on opening.

They then put in large applications to corner the retail quota. On issue-closing day, they call the company and its investment bankers and threaten to withdraw their application unless they are given a cash payoff. With little time to rustle up genuine applications, a couple of promoters have succumbed to the blackmail. In either case, with a block of thinly-traded stock in their control, the price manipulators/financiers get to work

once the stock gets listed. They rig the shares up and down, liquidate their entire stake and walk out. With the market in doldrums, the manipulators and financiers have withdrawn from the game. That's why the issue has failed miserably.

Question

1. Discusses the various irregularities happened in the Vaswani IPO to inflate demand and mislead Retail Individual Investors (RIIs) and Non-Institutional Investors (NIIs) into participating in the issue.

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UNIT - V

You know that India is an emerging economy and going to be the global power house. In the process of development, India is developing its social and physical infrastructure. For these developments, more funds are needed. Besides tapping its own debt market, now foreign capital is also tapped for mobilizing funds in various ways. In this unit, let us understand meaning of foreign investment, its various forms, modes and guidelines.

Unit Structure

Lesson 5.1 - Foreign Collaboration & Foreign Direct Investment

Lesson 5.2 - Foreign Institutional Investment

Lesson 5.3 - Offshore Country Funds, Foreign Venture Capital Investments and Other Foreign Investments & International Capital Markets

Lesson 5.1 - Foreign Collaboration & Foreign Direct Investment

Learning Objectives

- To understand the meaning of Foreign Collaboration
- To understand the policy relating to Foreign Technology Agreements.
- To understand the meaning of Foreign Direct Investment, its modes, limits, Prohibited Sectors and investment in MSEs.
- To know about Foreign Currency Account and Escrow Account.

Foreign Collaboration

India's investment policies are designed to attract significant capital inflows into India on a sustained basis and to encourage technology

collaborations between Indian and foreign entities. Foreign investment in India is governed by sub-section (3) of Section 6 of the Foreign Exchange Management Act, 1999 read with Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time. The regulatory framework and instructions issued by the RBI have been compiled in the Master Circular dated July 2, 2012 and that Master Circular is being issued with a sunset clause of one year. That circular will stand withdrawn on July 1, 2013 and be replaced by an updated Master Circular on the subject.

Types of Foreign Collaboration

There are two types of foreign collaborations:

- a) Financial collaboration (foreign equity participation) where foreign equity alone is involved:
- b) Technical collaboration (technology transfer) involving licensing of technology by the foreign collaborator on due compensation. -

There are two approving authorities

- a) Reserve Bank of India, and
- b) Department of Industrial Development in the Ministry of Industry, Government of India.

Areas of Foreign Collaboration

The Government of India issues from time to time a list of industries indicating where foreign investments may be permitted. The Government of India (Foreign Investment Promotion Board) also considers import of technology in Industries listed in Annexure A & Annexure B of Schedule 1 of Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 subject to compliance with the provisions of the Industrial Policy and Procedures as notified by Secretariat for Industrial Assistance (SIA) in the Ministry of Commerce and Industry, Govt. of India, from time to time

Technical Collaboration

The Industrial Policy, 1991, also provides that equity collaboration need not necessarily be accompanied with technical collaborations. The salient features of the Policy relating to Foreign Technology Agreements are outlined below:

A) Standard Conditions Attached to Approvals for Foreign Investment & Technology Agreements

- 1) The total non-resident shareholding in the undertaking should not exceed the percentage(s) specified in the approval letter.
- 2) (a) The royalty will be calculated on the basis of the net ex-factory sales price of the product, exclusive of excise duties, minus the cost of the standard bought-out components and the landed cost of imported components, irrespective of the source of procurement, including ocean freight, insurance, customs duties, etc. The payment of royalty will be restricted to the licensed capacity plus 25% in excess thereof for such items requiring industrial licence or on such capacity as specified in the approval letter. This restriction will not apply to items not requiring industrial licence. In case of production in excess of this quantum, prior approval of Government would have to be obtained regarding the terms of payment of royalty in respect of such excess production.
- (b) The royalty would not be payable beyond the period of the agreement if the orders had not been executed during the period of agreement. However, where the orders themselves took a long time to execute or were executed after the period of agreement, then in such cases the royalty for an order booked during the period of agreement would be payable only after a Chartered Accountant certifies that the orders in fact were firmly booked and execution began during the period of agreement and the technical assistance was available on a continuing basis even after the period of agreement.
- (c) No minimum guaranteed royalty would be allowed.

- 3) The lump sum shall be paid in three instalments as detailed below, unless otherwise stipulated in the approval letter:-
 - i) First 1/3rd after the approval for collaboration proposal is obtained from Reserve Bank of India and collaboration agreement is filed with the Authorized Dealer in Foreign Exchange.
 - ii) Second 1/3rd on delivery of know-how documentation.
 - iii) Third and final 1/3rd on commencement of commercial production, or four years after the proposal is approved by Reserve Bank of India and agreement is filed with the Authorized Dealer in Foreign Exchange, whichever is earlier. The lump sum can be paid in more than three instalments, subject to completion of the activities as specified above.
- 4) All remittances to the foreign collaborator shall be made as per the exchange rates prevailing on the date of remittance.
- 5) The applications for remittances may be made to the Authorized Dealer in Form A2 with the undernoted documents:-
 - i) A No Objection certificate issued by the Income-tax authorities in the standard form or a copy of the certificate issued by the designated bank regarding the payment of tax where the tax has been paid at a flat rate of 30% to the designated bank.
 - ii) A certificate from the Chartered Accountant in Form TCK/TCR (depending upon the purpose of payment).
 - iii) A declaration by the applicant to the effect that the proposed remittance is strictly in accordance with the terms and conditions of the collaboration approved by RBI/Government.
- 6) The agreement shall be subject to Indian Laws.
- 7) A copy of the foreign investment and technology transfer agreement signed by both the parties may be furnished to the following authorities:-
 - i) Administrative Ministry/Department.
 - ii) Department of Scientific and Industrial Research, New Delhi.
 - iii) Concerned Regional Officer of Exchange Control Department, RBI.

- iv) Authorized Dealer designated to service the agreement.
- 8) All payments under the foreign investment and technology transfer agreement including rupee payments (if any) to be made in connection with the engagement/deputation of foreign technical personnel such as passage fare, living expenses, etc. of foreign technicians, would be liable for the levy of cess under the Research and Development Cess Act, 1986 and the Indian Company while making such payments should pay the cess prescribed under the Act.
- 9) A return (in duplicate) in Form TCD should be submitted to Regional Office of the Reserve Bank of India in the first fortnight of January each year.

B) Hiring of Foreign Technicians

No permission is necessary for hiring of foreign technicians and no application need be made to Government for this purpose irrespective of whether the hiring of foreign technician is under an approved collaboration agreement or not. As regards release of foreign exchange either against blanket permits or in free foreign exchange, the Reserve Bank of India/ Authorized Dealers may be approached, as per RBI guidelines.

C) Deputation of Indian Personnel for Training Abroad

For deputing Indian personnel for training and other purposes abroad, the entrepreneur may approach only the RBI/Authorized Dealers as per RBI guidelines.

D) Foreign Testing of Indigenous Raw Materials and Products and Indigenously Developed Technology

Entrepreneurs may approach RBI/Authorized Dealers for authorizing payments either against blanket permits or in free foreign exchange, as per RBI guidelines.

E) Classification System

Entrepreneurs may note that the description of article(s) to be manufactured should be stated according to the Indian Trade Classification

System published by the Ministry of Commerce, Directorate General of Commercial Intelligence and Statistics, Calcutta.

Approval of Collaboration Proposals

Approval for Foreign Collaboration / Joint Venture

At present in India most of the Foreign Collaboration or Joint Venture does not require any approval prior approval from Government of India. However any Joint Venture or Foreign Collaboration where the Foreign Equity Participation exceeds the prescribed limit allowed for automatic route would require prior approval as per the provisions of FEMA and Government Investment Policy.

Approval for Foreign Technology Agreements

The Government now provides for automatic approval most of the technology agreements as subject to FEMA. Applications for automatic approval must be made to the Reserve Bank of India (RBI) and must clearly state the description of the goods to be manufactured in the Indian Trade Classification System. After RBI approval, the entrepreneurs may approach authorized dealers for foreign exchange release along with a copy of the technology agreement. All other proposals must comply with general procedures in force. In order to give Indian industries more freedom in negotiating foreign technology agreements, the government no longer requires the companies to obtain approval for the hiring of foreign technicians and foreign testing of indigenously developed technologies.

Foreign Direct Investment in India

Foreign direct investment is capital invested by corporations in countries other than their places of domicile (their home countries). Direct investment is not nearly as liquid as portfolio investment and is therefore less volatile. Foreign Direct Investment (FDI) in India is undertaken in accordance with the FDI Policy which is formulated and announced by the Government of India. The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India issues a "Consolidated FDI Policy Circular" on an yearly basis on March 31 of each year (since 2010) elaborating the policy and the process in respect

of FDI in India. The latest “Consolidated FDI Policy Circular” dated April 10, 2012 is available in public domain and can be downloaded from the website of Ministry of Commerce and Industry, Department of Industrial Policy and Promotion governed by the provisions of the Foreign Exchange Management Act (FEMA), 1999. FEMA Regulations which prescribe amongst other things the mode of investments i.e., issue or acquisition of shares / convertible debentures and preference shares, manner of receipt of funds, pricing guidelines and reporting of the investments to the Reserve Bank. The Reserve Bank has issued Notification No. FEMA 20 /2000-RB dated May 3, 2000 which contains the Regulations in this regard. This Notification has been amended from time to time. The following figure shows the types of foreign investment in India.

The cumulative FDI flows from 2000- 2013 are shown in the following table:

Cumulative FDI Flows Into India (2000-2013)			
A. Total FDI Inflows (From April, 2000 to January, 2013)			
1.	CUMULATIVE AMOUNT OF FDI INFLOWS (Equity inflows + ‘Re-invested earnings’ + ‘Other capital’)	-	US\$ 284,039 Million
2.	CUMULATIVE AMOUNT OF FDI EQUITY INFLOWS (excluding, amount remitted through RBI’s-NRI Schemes)	₹ 878,429 crore	US\$ 189,962 million

Entry options and Routes for Foreign Investments in India

Entry Options

A foreign enterprise can consider the following routes for doing business in India

1. Corporate entity

- Joint Venture with an Indian partner (JV)
- Wholly Owned Subsidiary (WOS)
- Limited Liability Partnership (LLP)

2. Non-corporate entity

- Project Office (PO)
- Liaison Office (LO)
- Branch Office (BO)

3. Foreign Institutional Investors (FII)

Entry Routes

Under the Foreign Direct Investments (FDI) Scheme, investments can be made in shares, mandatorily and fully convertible debentures and mandatorily and fully convertible preference shares of an Indian company by non-residents through two routes:

- a) Automatic Route:** Under the Automatic Route, the foreign investor or the Indian company does not require any approval from the Reserve Bank or Government of India for the investment.
- b) Government Route:** Under the Government Route, the foreign investor or the Indian company should obtain prior approval of the Government of India, Ministry of Finance, Foreign Investment Promotion Board (FIPB) for the investment.

Eligibility for Investment in India

- i) A person resident outside India (other than a citizen of Pakistan) or an entity incorporated outside India, (other than an entity incorporated in Pakistan) can invest in India, subject to the FDI Policy of the Government of India. A person who is a citizen of Bangladesh or an entity incorporated in Bangladesh can invest in India under the FDI Scheme, with the prior approval of the FIPB.
- ii) NRIs, resident in Nepal and Bhutan as well as citizens of Nepal and Bhutan are permitted to invest in shares and convertible debentures of Indian companies under FDI Scheme on repatriation basis, subject to the condition that the amount of consideration for such investment shall be paid only by way of inward remittance in **free foreign exchange** through normal banking channels.

- iii) Overseas Corporate Bodies (OCBs) have been de-recognized as a class of investors in India with effect from September 16, 2003. Erstwhile OCBs which are incorporated outside India and are not under adverse notice of the Reserve Bank can make fresh investments under the FDI Scheme as incorporated non-resident entities, with the prior approval of the Government of India, if the investment is through the Government Route; and with the prior approval of the Reserve Bank, if the investment is through the Automatic Route. However, before making any fresh FDI under the FDI scheme an erstwhile OCB should through their AD bank take a onetime certification from RBI that it is not in the adverse list being maintained with the Reserve Bank of India.

Authorized Dealers (ADs) should also ensure that OCBs do not maintain any account other than NRO current account in line with the instructions as per A.P. (DIR Series) Circular No. 14 dated September 16, 2003. Further, this NRO account should not be used for any fresh investments in India. Any fresh request for opening of NRO current account for liquidating previous investment held on non-repatriation basis should be forwarded by the AD bank to Foreign Exchange Department, Reserve Bank of India, Central Office, Mumbai. However, ADs should not close other category of accounts (NRE / FCNR / NRO) of OCBs which are in the adverse list of the Reserve Bank of India. These accounts are to be maintained by the respective AD banks in the frozen status.

Type of Instruments

- i) Indian companies can issue equity shares, fully and mandatorily convertible debentures and fully and mandatorily convertible preference shares subject to the pricing guidelines / valuation norms and reporting requirements amongst other requirements as prescribed under FEMA Regulations.
- ii) Issue of other types of preference shares such as, non-convertible, optionally convertible or partially convertible, have to be in accordance with the guidelines applicable for External Commercial Borrowings (ECBs).
- iii) As far as debentures are concerned, only those which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the FDI Policy.

Pricing Guidelines

a) **Fresh issue of shares:** Price of fresh shares issued to persons resident outside India under the FDI Scheme, shall be:

- on the basis of SEBI guidelines in case of listed companies.
- not less than fair value of shares determined by a SEBI registered Merchant Banker or a Chartered Accountant as per the Discounted Free Cash Flow Method (DCF) in case of unlisted companies.

The above pricing guidelines are also applicable for issue of shares against payment of lump sum technical know-how fee / royalty or conversion of ECB into equity or capitalization of pre incorporation expenses/import payables (with prior approval of Government).

b) **Preferential allotment:** In case of issue of shares on preferential allotment, the issue price shall not be less than the price as applicable to transfer of shares from resident to non-resident.

c) **Issue of shares by SEZs against import of capital goods:** In this case, the share valuation has to be done by a Committee consisting of Development Commissioner and the appropriate Customs officials.

d) **Right Shares:** The price of shares offered on rights basis by the Indian company to non-resident shareholders shall be;

- In the case of shares of a company **listed** on a recognized stock exchange in India, at a price as determined by the company.
- In the case of shares of a company **not listed** on a recognized stock exchange in India, at a price which is not less than the price at which the offer on right basis is made to the resident shareholders.

e) **Acquisition / transfer of existing shares (private arrangement):** The acquisition of existing shares from Resident to Non-resident (i.e. to incorporated non-resident entity other than erstwhile OCB, foreign national, NRI, FII) would be at a;

- negotiated price for shares of companies listed on a recognized stock exchange in India which shall not be less than the price

at which the preferential allotment of shares can be made under the SEBI guidelines, as applicable, provided the same is determined for such duration as specified therein, preceding the relevant date, which shall be the date of purchase or sale of shares. The price per share arrived at should be certified by a SEBI registered Merchant Banker or a Chartered Accountant.

- negotiated price for shares of companies which are not listed on a recognized stock exchange in India which shall not be less than the fair value to be determined by a SEBI registered Merchant Banker or a Chartered Accountant as per the Discounted Free Cash Flow(DCF) method.

Further, transfer of existing shares by Non-resident (i.e. by incorporated non-resident entity, erstwhile OCB, foreign national, NRI, FII) to Resident shall not be more than the minimum price at which the transfer of shares can be made from a resident to a non-resident as given above.

- f) The pricing of shares / convertible debentures / preference shares should be decided / determined upfront at the time of issue of the instruments. The price for the convertible instruments can also be a determined based on the conversion formula which has to be determined / fixed upfront, however the price at the time of conversion should not be less than the fair value worked out, at the time of issuance of these instruments, in accordance with the extant FEMA regulations.

Mode of Payment

An Indian company issuing shares /convertible debentures under FDI Scheme to a person resident outside India shall receive the amount of consideration required to be paid for such shares /convertible debentures by:

- i) Inward remittance through normal banking channels.
- ii) Debit to NRE / FCNR account of a person concerned maintained with an AD category I bank.
- iii) Conversion of royalty / lump sum / technical knowhow fee due for payment or conversion of ECB, shall be treated as consideration for issue of shares.

- iv) Conversion of import payables / pre incorporation expenses / share swap can be treated as consideration for issue of shares with the approval of FIPB.
- v) Debit to non-interest bearing Escrow account⁵ in Indian Rupees in India which is opened with the approval from AD Category - I bank and is maintained with the AD Category I bank on behalf of residents and non-residents towards payment of share purchase consideration.

If the shares or convertible debentures are not issued within 180 days from the date of receipt of the inward remittance or date of debit to NRE / FCNR(B) / Escrow account the amount of consideration shall be refunded. Further, the Reserve Bank may on an application made to it and for sufficient reasons permit an Indian Company to refund / allot shares for the amount of consideration received towards issue of security if such amount is outstanding beyond the period of 180 days from the date of receipt.

Foreign Investment Limits, Prohibited Sectors & Investment in MSEs

- a) **Foreign Investment Limits:** The details of the entry route applicable and the maximum permissible foreign investment/sectoral cap in an Indian Company are determined by the sector in which it is operating. The details of the entry route applicable along with the sectoral cap for foreign investment in various sectors are given in the following Table.

Table showing Sector-specific policy for foreign investment

S.No.	Sector/Activity	% of FDI Cap/ Equity	Entry Route
1	Agriculture & Animal Husbandry <ul style="list-style-type: none"> ➤ Floriculture, Horticulture, Apiculture and Cultivation of Vegetables & Mushrooms under controlled conditions; ➤ Development and production of Seeds and planting material; ➤ Animal Husbandry (including breeding of dogs), Pisciculture, Aquaculture, under controlled conditions; and services related to agro and allied sectors 	100%	Automatic
2	Tea Plantation Tea sector including tea plantations	100%	
3	Mining		
3.1	Mining and Exploration of metal and non-metal ores including diamond, gold, silver and precious ores but excluding titanium bearing minerals and its ores; subject to the Mines and Minerals (Development & Regulation) Act, 1957.	100%	Automatic
3.2	Coal and Lignite: Coal & Lignite mining for captive consumption by power projects, iron & steel and cement units and other eligible activities permitted under and subject to the provisions of Coal Mines (Nationalization) Act, 1973 Setting up coal processing plants like washeries	100%	Automatic
3.3	Mining and mineral separation of titanium bearing minerals and ores, its value addition and integrated activities	100%	Government
4	Petroleum & Natural Gas		
4.1	Exploration activities of oil and natural gas fields, infrastructure related to marketing of petroleum products and natural gas, marketing of natural gas and petroleum products, petroleum product pipelines, natural gas/pipelines, LNG Regasification infrastructure, market study and formulation and Petroleum refining in the private sector, subject to the existing sectoral policy and regulatory framework in the oil marketing sector and the policy of the Government on private participation in exploration of oil and the discovered fields of national oil companies	100%	Automatic
4.2	Petroleum refining by the Public Sector Undertakings (PSU), without any disinvestment or dilution of domestic equity in the existing PSUs.	49%	Government

5	FDI in MSEs (as defined under Micro, Small And Medium Enterprises Development Act, 2006 (MSMED, Act 2006)) will be subject to the sectoral caps, entry routes and other relevant sectoral regulations.		
6	Defence	26%	Government
	Services Sector		
7	Broadcasting		
7.1	Terrestrial Broadcasting FM (FM Radio)	26%	Government
7.2	Cable Network	49%	Government
7.3	Direct-to-Home	49%	Government
7.4	FDI limit in Headend-In-The-Sky (HITS) Broadcasting Service	74%	Automatic up to 49%
7.5	Setting up hardware facilities such as up linking, HUB, etc		
	Setting up of Up-linking HUB/Teleports	49%	Government
	Up linking a Non-News & Current Affairs TV Channel	100%	Government
	Up linking a News and Current Affairs TV channel	26%	Government
8	Print Media		
8.1	Publishing of Newspaper and periodicals dealing with news and current affairs	26%	Government
8.2	Publication of Indian editions of foreign magazines dealing with news and current affairs	26%	Government
8.3	Publishing/printing of Scientific and Technical Magazines/ specialty journals/ periodicals,	100%	Government
8.4	Publication of facsimile edition of foreign newspapers	100%	Government
9	Civil Aviation		
9.1	Greenfield projects	100%	Automatic
	Existing Projects	100%	Automatic up to 74%
9.2	Air Transport Services		
	Scheduled Air Transport Service/Domestic Scheduled Passenger Airline	49%	Automatic
	Non-Scheduled Air Transport Service	74%	Automatic up to 49%
	Helicopter services/seaplane services requiring DGCA approval	100%	Automatic
9.4	Other services under Civil Aviation sector		
	Ground Handling Services subject to sectoral regulations and security clearance	74%	Automatic

	Maintenance and Repair organizations; flying training institutes; and technical training institutions	100%	Government
10	Courier services for carrying packages, parcels and other items which do not come within the ambit of the Indian Post Office Act, 1898 and excluding the activity relating to the distribution of letters.	100%	Government
11	Construction Development: Townships, Housing, Built-up infrastructure		
11.1	Townships, housing, built-up infrastructure and construction-development projects	100%	Automatic
12	Industrial Parks – new and existing	100%	Automatic
13	Satellites – Establishment and operation	74%	Government
14	Private Security Agencies	49%	Government
15	Telecom Services	74%	Automatic up to 49%
16	Trading - Cash & Carry Wholesale Trading/ Wholesale Trading(including sourcing from MSEs)	100%	Automatic
16.1	E-Commerce activities	100%	Automatic
16.2	Test Marketing	100%	Government
16.3	Single Brand product retail trading	100%	Government
17	Financial Services		
17.1	Asset Reconstruction Companies	49% of paid up cap of ARC	Government
18	Banking – Private sector	74% including investment by FIIs	Automatic up to 49%
19	Banking – Public sector	20%	Government
20	Commodity Exchanges	49%	Government
21	Credit Information Companies	49%	Government
22	Infrastructure company in the securities market	49%	Government
23	Insurance	26%	Automatic
24	Non-Banking Financing Companies	100%	Automatic
25	Pharmaceuticals		
	Greenfield	100%	Automatic
	Existing companies	100%	Government

Source: RBI/2012-13/15 Master Circular No. 15/2012-13 July 02, 2012. (Updated as on February 12, 2013)

b) Investments in Micro and Small Enterprise (MSE)

A company which is reckoned as Micro and Small Enterprise (MSE) (earlier Small Scale Industrial Unit) in terms of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, including an Export Oriented Unit or a Unit in Free Trade Zone or in Export Processing Zone or in a Software Technology Park or in an Electronic Hardware Technology Park, and which is not engaged in any prohibited activity/sector may issue shares or convertible debentures to a person resident outside India (other than a resident of Pakistan and to a resident of Bangladesh under approval route), subject to the prescribed limits as per FDI Policy, in accordance with the Entry Routes and the provision of Foreign Direct Investment Policy, as notified by the Ministry of Commerce & Industry, Government of India, from time to time.

Any Industrial undertaking, with or without FDI, which is not an MSE, having an industrial license under the provisions of the Industries (Development & Regulation) Act, 1951 for manufacturing items reserved for the MSE sector may issue shares to persons resident outside India (other than a resident/entity of Pakistan and to a resident/entity of Bangladesh with prior approval FIPB), to the extent of 24 per cent of its paid-up capital or sectoral cap whichever is lower. Issue of shares in excess of 24 per cent of paid-up capital shall require prior approval of the FIPB of the Government of India and shall be in compliance with the terms and conditions of such approval.

c) Prohibition on Foreign Investment in India

- i) **Foreign investment in any form** is prohibited in a company or a partnership firm or a proprietary concern or any entity, whether incorporated or not (such as, Trusts) which is engaged or proposes to engage in the activities such as Business of chit fund, or Nidhi company, or Agricultural or plantation activities, or Real estate business, or construction of farm houses, or Trading in Transferable Development Rights (TDRs).
- ii) It is clarified that “real estate business” means dealing in land and immovable property with a view to earning profit or earning income there from and does not include development of town-

ships, construction of residential / commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. It is further clarified that partnership firms / proprietorship concerns having investments as per FEMA regulations are not allowed to engage in print media sector.

iii) In addition to the above, **Foreign investment in the form of FDI** is also prohibited in certain sectors such as:

- (a) Retail Trading (except single brand product retailing)
- (b) Lottery Business including Government /private lottery, online lotteries, etc.
- (c) Gambling and Betting including casinos etc.
- (d) Business of Chit funds
- (e) Nidhi company
- (f) Trading in Transferable Development Rights (TDRs)
- (g) Real Estate Business or Construction of Farm Houses
- (h) Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
- (i) Activities / sectors not open to private sector investment e.g. Atomic Energy and Railway Transport (other than Mass Rapid Transport Systems).

Note: Foreign technology collaboration in any form including licensing for franchise, trademark, brand name, management contract is also prohibited for Lottery Business and Gambling and Betting activities.

Modes of Investment under Foreign Direct Investment Scheme

Foreign Direct Investment in India can be done through the following modes:

A) Issuance of fresh shares by the company: An Indian company may issue fresh shares /convertible debentures under the FDI Scheme to a person resident outside India (who is eligible for investment in India) subject to compliance with the extant FDI policy and the FEMA Regulation.

B) Acquisition by way of transfer of existing shares by person resident in or outside India: Foreign investors can also invest in Indian companies by purchasing / acquiring existing shares from Indian shareholders or from other non-resident shareholders. General permission has been granted to non-residents / NRIs for acquisition of shares by way of transfer in the following manner:

B.I. Transfer of Shares by a Person Resident Outside India

- a) **Non Resident to Non-Resident (Sale / Gift):** A person resident outside India (other than NRI and OCB) may transfer by way of sale or gift shares or convertible debentures to any person resident outside India (including NRIs but excluding OCBs). (**Note:** Transfer of shares from or by erstwhile OCBs would require prior approval of the Reserve Bank of India).
- b) **NRI to NRI (Sale / Gift):** NRIs may transfer by way of sale or gift the shares or convertible debentures held by them to another NRI.
- c) **Non Resident to Resident (Sale / Gift):**
 - i) **Gift:** A person resident outside India can transfer any security to a person resident in India by way of gift.
 - ii) **Sale under private arrangement:** General permission is also available for transfer of shares / convertible debentures, by way of sale under private arrangement by a person resident outside India to a person resident in India **in case where transfer of shares are under SEBI regulations and where the FEMA pricing guidelines are not met**, subject to the following
 - a) The original and resultant investment comply with the extant FDI policy/ FEMA regulations;
 - b) The pricing complies with the relevant SEBI regulations (such as IPO, Book building, block deals, delisting, exit, open offer/ substantial acquisition / SEBI (SAST) and buy back); and
 - c) CA certificate to the effect that compliance with relevant SEBI regulations as indicated above is attached to the Form FC-TRS to be filled with the AD bank.
 - d) Compliance with reporting and other guidelines

Note: Transfer of shares from a Non Resident to Resident other than under SEBI regulations and where the FEMA pricing guidelines are not met would require the prior approval of the Reserve Bank of India.

- iii) **Sale of shares/ convertible debentures on the Stock Exchange by person resident outside India:** A person resident outside India can sell the shares and convertible debentures of an Indian company on a recognized Stock Exchange in India through a stock broker registered with stock exchange or a merchant banker registered with SEBI.

B.II Transfer of Shares/Convertible Debentures from Resident to Person Resident Outside India

A person resident in India can transfer by way of sale, shares / convertible debentures (including transfer of subscriber's shares), of an Indian company under private arrangement to a person resident outside India, subject to the following along with pricing, reporting and other guidelines.

- where the transfer of shares requires the prior approval of the FIPB as per extant FDI policy provided that;
 - the requisite FIPB approval has been obtained; and
 - the transfer of share adheres with the pricing guidelines and documentation requirements as specified by the Reserve Bank of India from time to time.
- where SEBI (SAST) guidelines are attracted subject to adherence with the pricing guidelines and documentation requirements as specified by the Reserve Bank of India from time to time.
- where the pricing guidelines under FEMA,1999 are not met provided that:
 - the resultant FDI is in compliance with the extant FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization,etc.),reporting requirements, documentation, etc.;
 - The pricing for the transaction is compliant with specific/ explicit, extant and relevant SEBI regulations(such as IPO, book

building, block deals, delisting, open/ exit offer, substantial acquisition/SEBI(SAST); and

- CA Certificate to the effect that compliance with relevant SEBI regulations as indicated above is attached to the Form FC-TRS to be filed with the AD bank.
- where the investee company is in the financial services sector provided that a) NOCs are obtained from the respective regulators of the investee company as well as the transferor and transferee entities and such NOCS are filed with the AD Bank; b) The FDI policy and FEMA Regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc), reporting requirements, documentation etc., are complied with.

B. III Transfer of Shares by Resident which Requires Government Approval

The following instances of transfer of shares from residents to non-residents by way of sale or otherwise requires Government approval:

- i) Transfer of shares of companies engaged in sector falling under the Government Route.
- ii) Transfer of shares resulting in foreign investments in the Indian company, breaching the sectoral as applicable.

B. IV Prior Permission of the Reserve Bank in Certain Cases for Acquisition / Transfer of Security

- i) Transfer of shares or convertible debentures from residents to non-residents by way of sale requires prior approval of Reserve Bank in case where the non-resident acquirer proposes deferment of payment of the amount of consideration. Further, in case approval is granted for the transaction, the same should be reported in Form FC-TRS to the AD Category - I bank, within 60 days from the date of receipt of the full and final amount of consideration.
- ii) A person resident in India, who intends to transfer any security, by way of gift to a person resident outside India, has to obtain prior

approval from the Reserve Bank. The Reserve Bank considers the following factors while processing such applications:

- a) The proposed transferee is eligible to hold such security as per FEMA.
 - b) The gift does not exceed 5 per cent of the paid-up capital of the Indian company / each series of debentures / each mutual fund scheme.
 - c) The applicable sectoral cap limit in the Indian company is not breached.
 - d) The transferor (donor) and the proposed transferee (donee) are close relatives as defined in Section 6 of the Companies Act, 1956, as amended from time to time.
 - e) The value of security to be transferred together with any security already transferred by the transferor, as gift, to any person residing outside India does not exceed the rupee equivalent of USD 50,000 per financial year.
 - f) Such other conditions as stipulated by the Reserve Bank in public interest from time to time.
- iii) Transfer of shares from NRI to NR requires the prior approval of the Reserve Bank of India.

B.V - Escrow Account for Transfer of Shares

AD Category – I banks have been given general permission to open and maintain non-interest bearing Escrow account in Indian Rupees in India on behalf of residents and non-residents, towards payment of share purchase consideration and / or provide Escrow facilities for keeping securities to facilitate FDI transactions relating to transfer of shares. It has also been decided to permit SEBI authorized Depository Participant, to open and maintain, without approval of the Reserve Bank, Escrow account for securities.

C. Issue of Rights / Bonus Shares

An Indian company may issue Rights / Bonus shares to existing non-resident shareholders, subject to adherence to sectoral cap, reporting

requirements, etc. Further, such issue of bonus / rights shares have to be in accordance with other laws / statutes like the Companies Act, 1956, SEBI (Issue of Capital and Disclosure Requirements), Regulations 2009, etc.

- **Issue of Right shares to OCBs:** OCBs have been de-recognized as a class of investors with effect from September 16, 2003. Therefore, companies desiring to issue rights share to such erstwhile OCBs will have to take specific prior permission from the Reserve Bank¹⁰. As such, entitlement of rights share is not automatically available to OCBs. However, bonus shares can be issued to erstwhile OCBs without prior approval of the Reserve Bank, provided that the OCB is not in the adverse list of RBI.
- **Additional allocation of rights share by residents to non-residents:** Existing non-resident shareholders are allowed to apply for issue of additional shares / convertible debentures / preference shares over and above their rights share entitlements. The investee company can allot the additional rights shares out of unsubscribed portion, subject to the condition that the overall issue of shares to non-residents in the total paid-up capital of the company does not exceed the sectoral cap.

D. Issue of Shares Under Employees Stock Option Scheme (ESOPs)

An Indian Company may issue shares under ESOPs to its employees or employees of its joint venture or wholly owned subsidiary abroad who are resident outside India, other than to the citizens of Pakistan. Citizens of Bangladesh can invest with the prior approval of the FIPB. The face value of the shares to be allotted under the scheme to the non-resident employees should not exceed 5 per cent of the paid-up capital of the issuing company. Shares under ESOPs can be issued directly or through a Trust subject to the condition that the scheme has been drawn in terms of the relevant regulations issued by the SEBI.

E. Conversion of ECB / Lump Sum Fee / Royalty / Import of Capital Goods by SEZs in to Equity/ Import Payables / Pre Incorporation Expenses

- i) Indian companies have been granted general permission for

conversion of External Commercial Borrowings (ECB) into shares / convertible debentures, subject to the following conditions and reporting requirements:

- a) The activity of the company is covered under the Automatic Route for FDI or the company has obtained Government's approval for foreign equity in the company;
 - b) The foreign equity after conversion of ECB into equity is within the sectoral cap, if any;
 - c) Pricing of shares is determined as per SEBI regulations for listed company or DCF method for unlisted company;
 - d) Compliance with the requirements prescribed under any other statute and regulation in force;
 - e) The conversion facility is available for ECBs availed under the Automatic or Approval Route and is applicable to ECBs, due for payment or not, as well as secured / unsecured loans availed from non-resident collaborators.
- ii) General permission is also available *for issue of shares / preference shares against lump-sum technical know-how fee, royalty*, under automatic route or SIA / FIPB route, subject to pricing guidelines of RBI/SEBI and compliance with applicable tax laws.
- iii) *Units in Special Economic Zones (SEZs) are permitted to issue equity shares to non-residents against import of capital goods* subject to the valuation done by a Committee consisting of Development Commissioner and the appropriate Customs officials.
- iv) *Issue of equity shares against Import of capital goods / machinery / equipment*, is allowed under the Government route, subject to the compliance with the following conditions:
- a) The import of capital goods, machineries, etc., made by a resident in India, is in accordance with the Export / Import Policy issued by the Government of India as notified by the Directorate General of Foreign Trade (DGFT) and the regulations issued under the Foreign Exchange Management Act (FEMA), 1999 relating to imports issued by the Reserve Bank;

- b) There is an independent valuation of the capital goods / machineries / equipments by a third party entity, preferably by an independent valuer from the country of import along with production of copies of documents /certificates issued by the customs authorities towards assessment of the fair-value of such imports;
- c) The application should clearly indicate the beneficial ownership and identity of the importer company as well as the overseas entity; and
- d) Applications complete in all respects, for conversions of import payables for capital goods into FDI being made within 180 days from the date of shipment of goods.
- v) *Issue of equity shares against* Pre-operative / pre - incorporation expenses (including payment of rent etc.) is allowed under the Government route, subject to compliance with the following conditions:
 - a) Submission of FIRC for remittance of funds by the overseas promoters for the expenditure incurred.
 - b) Verification and certification of the pre-incorporation / pre-operative expenses by the statutory auditor.
 - c) Payments being made directly by the foreign investor to the company. Payments made through third parties citing the absence of a bank account or similar such reasons will not be allowed.
 - d) The applications, complete in all respects, for capitalization being made within the period of 180 days from the date of incorporation of the company.
- vi) Issue of shares to a non-resident against shares swap, ie., in lieu for the consideration which has to be paid for shares acquired in the overseas company, can be done with the approval of FIPB.

F. Issue of Shares by Indian Companies under ADR / GDR

Depository Receipts (DRs) are negotiable securities issued outside India by a Depository bank, on behalf of an Indian company, which

represent the local Rupee denominated equity shares of the company held as deposit by a Custodian bank in India. DRs are traded on Stock Exchanges in the US, Singapore, Luxembourg, London, etc. DRs listed and traded in the US markets are known as American Depositary Receipts (ADRs) and those listed and traded elsewhere are known as Global Depositary Receipts (GDRs). In the Indian context, DRs are treated as FDI.

- i) Indian companies can raise foreign currency resources abroad through the issue of ADRs/GDRs, in accordance with the Scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India there under from time to time.
- ii) A company can issue ADRs / GDRs, if it is eligible to issue shares to person resident outside India under the FDI Scheme. However, an Indian listed company, which is not eligible to raise funds from the Indian Capital Market including a company which has been restrained from accessing the securities market by the Securities and Exchange Board of India (SEBI) will not be eligible to issue ADRs/GDR₹
- iii) Unlisted companies, which have not yet accessed the ADR/GDR route for raising capital in the international market, would require prior or simultaneous listing in the domestic market, while seeking to issue such overseas instruments. Unlisted companies, which have already issued ADRs/GDRs in the international market, have to list in the domestic market on making profit or within three years of such issue of ADRs/GDRs, whichever is earlier. ADRs / GDRs are issued on the basis of the ratio worked out by the Indian company in consultation with the Lead Manager to the issue. The proceeds so raised have to be kept abroad till actually required in India. Pending repatriation or utilization of the proceeds, the Indian company can invest the funds in:-
 - a) Deposits with or Certificate of Deposit or other instruments offered by banks who have been rated by Standard and Poor, Fitch or Moody's, etc. and such rating not being less than the rating stipulated by the Reserve Bank from time to time for the purpose;

- b) Deposits with branch/es of Indian Authorized Dealers outside India; and
- c) Treasury bills and other monetary instruments with a maturity or unexpired maturity of one year or less.
- iv) There are no end-use restrictions except for a ban on deployment / investment of such funds in real estate or the stock market. There is no monetary limit up to which an Indian company can raise ADRs / GDR₹
- v) The ADR / GDR proceeds can be utilized for first stage acquisition of shares in the disinvestment process of Public Sector Undertakings / Enterprises and also in the mandatory second stage offer to the public in view of their strategic importance.
- vi) Voting rights on shares issued under the Scheme shall be as per the provisions of Companies Act, 1956 and in a manner in which restrictions on voting rights imposed on ADR/GDR issues shall be consistent with the Company Law provisions. Voting rights in the case of banking companies will continue to be in terms of the provisions of the Banking Regulation Act, 1949 and the instructions issued by the Reserve Bank from time to time, as applicable to all shareholders exercising voting rights.
- vii) Erstwhile OCBs which are not eligible to invest in India and entities prohibited to buy / sell or deal in securities by SEBI will not be eligible to subscribe to ADRs / GDRs issued by Indian companies.
- viii) The pricing of ADR / GDR issues including sponsored ADRs / GDRs should be made at a price determined under the provisions of the Scheme of issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government of India and directions issued by the Reserve Bank, from time to time.
- ix) **Two-way Fungibility Scheme:** A limited two-way Fungibility scheme has been put in place by the Government of India for ADRs / GDR₹ Under this Scheme, a stock broker in India, registered with SEBI, can purchase shares of an Indian company from the market for conversion into ADRs/GDRs based on instructions received from overseas investors. Re-issuance of ADRs / GDRs would be

permitted to the extent of ADRs / GDRs which have been redeemed into underlying shares and sold in the Indian market.

- x) **Sponsored ADR/GDR issue** An Indian company can also sponsor an issue of ADR / GDR. Under this mechanism, the company offers its resident shareholders a choice to submit their shares back to the company so that on the basis of such shares, ADRs / GDRs can be issued abroad. The proceeds of the ADR / GDR issue is remitted back to India and distributed among the resident investors who had offered their Rupee denominated shares for conversion. These proceeds can be kept in Resident Foreign Currency (Domestic) accounts in India by the resident shareholders who have tendered such shares for conversion into ADRs / GDR

G. FDI - through issue/transfer of participating interest/right in oil fields to anon-resident

Foreign investment by way of issue / transfer of 'participating interest/right' in oil fields by Indian companies to a non-resident is treated as an FDI under the extant FDI policy and the FEMA regulations. Accordingly, these transactions have to be reported as FDI transactions.

Foreign Currency Account and Escrow Account

- a) Indian companies which are eligible to issue shares to persons resident outside India under the FDI Scheme will be allowed to retain the share subscription amount in a Foreign Currency Account for bonafide business purpose only with the prior approval of the Reserve Bank.
- b) AD Category - I banks have been given general permission to open and maintain non-interest bearing Escrow account in Indian Rupees in India on behalf of residents and non-residents, towards payment of share purchase consideration and / or provide Escrow facilities for keeping securities to facilitate FDI transactions. It has also been decided to permit SEBI authorized Depository Participant, to open and maintain, without approval of the Reserve Bank, Escrow account for securities. The Escrow account would also be subject to the terms and conditions as stipulated in A.P. (DIR Series) Circular No. 58 dated May 2, 2011. Further, the Escrow

account would be maintained with AD Category I bank or SEBI Authorized Depository Participant (in case of securities account). These facilities will be applicable to both, issue of fresh shares to the non-residents as well as transfer of shares to the non-residents as well as transfer of shares from / to the non-residents.

Acquisition of shares under Scheme of Merger / Amalgamation

Mergers and amalgamations of companies in India are usually governed by an order issued by a competent Court on the basis of the Scheme submitted by the companies undergoing merger/amalgamation. Once the scheme of merger or amalgamation of two or more Indian companies has been approved by a Court in India, the transferee company or new company is allowed to issue shares to the shareholders of the transferor company resident outside India, subject to the conditions that:

- i) The percentage of shareholding of persons resident outside India in the transferee or new company does not exceed the sectoral cap, and
- ii) The transferor company or the transferee or the new company is not engaged in activities which are prohibited under the FDI policy.

Remittances

Remittances of Sale Proceeds

AD Category - I bank can allow the remittance of sale proceeds of a security (net of applicable taxes) to the seller of shares resident outside India, provided the security has been held on repatriation basis, the sale of security has been made in accordance with the prescribed guidelines and NOC / tax clearance certificate from the Income Tax Department has been produced.

Remittance on Winding Up/Liquidation of Companies

AD Category - I banks have been allowed to remit winding up proceeds of companies in India, which are under liquidation, subject to payment of applicable taxes. Liquidation may be subject to any order issued

by the court winding up the company or the official liquidator in case of voluntary winding up under the provisions of the Companies Act, 1956. AD Category - I banks shall allow the remittance provided the applicant submits:

- i) No objection or Tax clearance certificate from Income Tax Department for the remittance.
- ii) Auditor's certificate confirming that all liabilities in India have been either fully paid or adequately provided for.
- iii) Auditor's certificate to the effect that the winding up is in accordance with the provisions of the Companies Act, 1956.
- iv) In case of winding up otherwise than by a court, an auditor's certificate to the effect that there is no legal proceedings pending in any court in India against the applicant or the company under liquidation and there is no legal impediment in permitting the remittance.

Pledge of Shares

- a) A person being a promoter of a company registered in India (borrowing company), which has raised external commercial borrowings, may pledge the shares of the borrowing company or that of its associate resident companies for the purpose of securing the ECB raised by the borrowing company, provided that a no objection for the same is obtained from a bank which is an authorized dealer. The authorized dealer, shall issue the no objection for such a pledge after having satisfied itself that the external commercial borrowing is in line with the extant FEMA regulations for ECBs and that:
 - i) The loan agreement has been signed by both the lender and the borrower,
 - ii) There exists a security clause in the Loan Agreement requiring the borrower to create charge on financial securities, and
 - iii) The borrower has obtained Loan Registration Number (LRN) from the Reserve Bank: and the said pledge would be subject to the following conditions:

- The period of such pledge shall be co-terminus with the maturity of the underlying ECB;
 - In case of invocation of pledge, transfer shall be in accordance with the extant FDI Policy and directions issued by the Reserve Bank;
 - The Statutory Auditor has certified that the borrowing company will utilized / has utilized the proceeds of the ECB for the permitted end use/s only.
- b) Non-resident holding shares of an Indian company, can pledge these shares in favour of the AD bank in India to secure credit facilities being extended to the resident investee company for bonafide business purpose, subject to the following conditions:
- in case of invocation of pledge, transfer of shares should be in accordance with the FDI policy in vogue at the time of creation of pledge;
 - submission of a declaration/ annual certificate from the statutory auditor of the investee company that the loan proceeds will be / have been utilized for the declared purpose;
 - the Indian company has to follow the relevant SEBI disclosure norms; and
 - pledge of shares in favour of the lender (bank) would be subject to Section 19 of the Banking Regulation Act, 1949.
- c) Non-resident holding shares of an Indian company, can pledge these shares in favour of an overseas bank to secure the credit facilities being extended to the non-resident investor / non-resident promoter of the Indian company or its overseas group company, subject to the following:
- loan is availed of only from an overseas bank;
 - loan is utilized for genuine business purposes overseas and not for any investments either directly or indirectly in India;
 - overseas investment should not result in any capital inflow into India;
 - in case of invocation of pledge, transfer should be in accordance

with the FDI policy in vogue at the time of creation of pledge;
and

- submission of a declaration/ annual certificate from a Chartered Accountant/ Certified Public Accountant of the non-resident borrower that the loan proceeds will be / have been utilized for the declared purpose.

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Lesson 5.2 - Foreign Institutional Investment

Learning Objectives

- To understand the meaning of Foreign Investment under Portfolio Investment Scheme (PIS) in India
- To understand the provisions relating to FIIs for exchange traded derivative contracts.
- To understand the role of RBI and AD banks in monitoring of PIS.
- To understand the investment by Qualified Foreign Investors in PIS

Introduction

The Foreign Institutional Investment (FII) is another mode through which a country can tap foreign capital. This is the foreign investment under portfolio investment Scheme. Portfolio debt flows result from foreign investors buying domestic debt securities. A German investor buying bonds in Canada is an example. Commercial bank lending (loans from private financial institutions) is also portfolio debt. Portfolio equity flows occur, similarly, when foreign investors purchase equity securities domestically. A Japanese investor who purchases stock in the Brazilian stock market is creating an equity capital flow into Brazil. ADRs and GDRs also fit into this category. FII is a term commonly used in India to refer to outside companies investing in the financial markets of India. FIIs include institutions such as pension funds, mutual funds, investment trusts, asset management companies or their power of attorney holders (providing discretionary and non-discretionary portfolio management services). The FIIs are invited to invest in all the securities traded in the primary and secondary markets, including the equity and other instruments of companies which are listed or are to be listed on the stock exchanges in India. The FIIs are required to register with SEBI, which shall, while granting registration to the FII, take into account its track record, professional competence, financial soundness, experience, etc.

Eligible Entities for Foreign Investments Under Portfolio Investment Scheme (PIS)

- (i) Foreign Institutional Investors (FIIs) registered with SEBI are eligible to purchase shares and convertible debentures issued by Indian companies under the Portfolio Investment Scheme (PIS).
- (ii) NRIs are eligible to purchase shares and convertible debentures issued by Indian companies under PIS, if they have been permitted by the designated branch of any AD Category - I bank (which have been authorized by the Reserve Bank to administer the PIS).
- (iii) SEBI approved sub accounts of FIIs (sub accounts) have general permission to invest under the PIS.
- (iv) OCBs are not permitted to invest under the PIS with effect from November 29, 2001, in India. Further, the OCBs which have already made investments under the PIS are allowed to continue holding such shares / convertible debentures till such time these are sold on the stock exchange.

Investment in Listed Indian Companies

Foreign Institutional Investors (FIIs)

- a) **An Individual FII/ SEBI approved sub accounts** of FIIs can invest up to a maximum of 10 per cent of the total paid-up capital or 10 per cent of the paid-up value of each series of convertible debentures issued by the Indian company. The 10 per cent limit would include shares held by SEBI registered FII/ SEBI approved sub accounts of FII under the PIS (by way of purchases made through a registered broker on a recognized stock exchange in India or by way of offer/ private placement) as well as shares acquired by SEBI registered FII under the FDI scheme.
- b) **Total holdings of all FIIs / SEBI approved sub accounts of FIIs** put together shall not exceed 24 per cent of the paid up capital or paid up value of each series of convertible debentures. This limit of 24 per cent can be increased to the sectoral cap / statutory limit, as applicable to the Indian company concerned, by passing a resolution of its Board of Directors followed by a special resolution to that

effect by its General Body and should necessarily intimate the same to the Reserve Bank of India immediately as hitherto, along with a Certificate from the Company Secretary stating that all the relevant provisions of the extant Foreign Exchange Management Act, 1999 regulations and the Foreign Direct Policy, as amended from time to time, have been complied with.

Non-Resident Indians (NRIs)

- a) NRIs are allowed to invest in shares of listed Indian companies in recognized Stock Exchanges under the PIS.
- b) NRIs can invest through designated ADs, on repatriation and non-repatriation basis under PIS route up to 5 per cent of the paid-up capital / paid-up value of each series of debentures of listed Indian companies.
- c) The aggregate paid up value of shares / convertible debentures purchased by all NRIs cannot exceed 10 per cent of the total paid up capital of the company / paid up value of each series of debentures of the company. The aggregate ceiling of 10 per cent can be raised to 24 per cent by passing a resolution of its Board of Directors followed by a special resolution to that effect by its General Body and should necessarily intimate the same to the Reserve Bank of India immediately as hitherto, along with a Certificate from the Company Secretary stating that all the relevant provisions of the extant Foreign Exchange Management Act, 1999 regulations and the Foreign Direct Policy, as amended from time to time, have been complied with.

C. Prohibition on investments by FIIs and NRIs

- FIIs are not permitted to invest in the capital of an Asset Reconstruction Company.
- **Both FIIs and NRIs** are not allowed to invest in any company which is engaged or proposes to engage in the following activities:
 - Business of chit fund, or
 - Nidhi company, or
 - Agricultural or plantation activities, or

- Real estate business* or construction of farm houses, or
- Trading in Transferable Development Rights (TDRs).

Accounts with AD Category – I Banks

Foreign Institutional Investors (FIIs)

FIIs/sub-accounts can open a non-interest bearing Foreign Currency Account and / or a **single non-interest bearing** Special Non-Resident Rupee Account (SNRR A/c) with an AD Category – I bank, for the purpose of investment under the PIS. They can transfer sums from the Foreign Currency Account to the **single** SNRR A/c for making genuine investments in securities in terms of the SEBI (FII) Regulations, 1995, as amended from time to time. The sums may be transferred from Foreign Currency Account to SNRR A/c at the prevailing market rate and the AD Category - I bank may transfer repatriable proceeds (after payment of tax) from the SNRR A/c to the Foreign Currency account. The SNRR A/c may be credited with the sale proceeds of shares / debentures, dated Government securities, Treasury Bills, etc. Such credits are allowed, subject to the condition that the AD Category - I bank should obtain confirmation from the investee company / FII concerned that tax at source, wherever necessary, has been deducted from the gross amount of dividend / interest payable / approved income to the share / debenture / Government securities holder at the applicable rate, in accordance with the Income Tax Act. The SNRR A/c may be debited for purchase of shares / debentures, dated Government securities, Treasury Bills, etc., and for payment of fees to applicant FIIs' local Chartered Accountant / Tax Consultant where such fees constitute an integral part of their investment process.

Non-Resident Indians (NRIs)

NRIs can approach the designated branch of any AD Category - I bank (which has been authorized by the Reserve Bank to administer the PIS) for permission to open a single designated account (NRE/NRO account) under the PIS for routing investments. Payment for purchase of shares and/or debentures on **repatriation basis** has to be made by way of inward remittance of foreign exchange through normal banking channels or out of funds held in NRE/FCNR(B) account maintained in India. If the shares are purchased on **non-repatriation basis**, the NRIs can also utilize their funds in NRO account in addition to the above.

Exchange Traded Derivative Contracts

Foreign Institutions Investors (FIIs)

- SEBI registered FIIs are allowed to trade in all exchange traded derivative contracts approved by RBI/SEBI on recognized Stock Exchanges in India subject to the position limits and margin requirements as prescribed by RBI / SEBI from time to time as well as the stipulations regarding collateral securities as directed by the Reserve Bank from time to time.
- The SEBI registered FII / sub-account may open a separate account under their SNRR A/c through which all receipts and payments pertaining to trading / investment in exchange traded derivative contracts will be made (including initial margin and mark to market settlement, transaction charges, brokerage, etc.).
- Further, transfer of funds between the SNRR A/c and the separate account maintained for the purpose of trading in exchange traded derivative contracts can be freely made.
- However, repatriation of the Rupee amount will be made only through their SNRR A/c subject to payment of relevant taxes. The AD Category - I banks have to keep proper records of the above mentioned separate account and submit them to the Reserve Bank as and when required.

Non-Resident Indians (NRIs)

NRIs are allowed to invest in Exchange Traded Derivative Contracts approved by SEBI from time to time out of Rupee funds held in India on non-repatriation basis, subject to the limits prescribed by SEBI. Such investments will not be eligible for repatriation benefits.

Collateral for FIIs

- a) **Derivative Segment:** FIIs are allowed to offer foreign sovereign securities with AAA rating as collateral to the recognized Stock Exchanges in India in addition to the cash for their transactions in derivatives segment of the market. SEBI approved clearing corporations of stock exchanges and their clearing members are

allowed to undertake the following transactions subject to the guidelines issued from time to time by SEBI in this regard:

- to open and maintain demat accounts with foreign depositories and to acquire, hold, pledge and transfer the foreign sovereign securities, offered as collateral by FIIs;
- to remit the proceeds arising from corporate action, if any, on such foreign sovereign securities; and
- to liquidate such foreign sovereign securities, if the need arises.

Clearing Corporations have to report, on a monthly basis, the balances of foreign sovereign securities, held by them as non -cash collaterals of their clearing members to the Reserve Bank. The report should be submitted by the 10th of the following month to which it relates.

b) Equity Segment: The above guidelines are also applicable to the equity segment. Further, Domestic Government Securities (subject to the overall limits specified by the SEBI from time to time; the current limit being USD 20 billion) also can be kept as collateral to the recognized Stock Exchanges in India in addition to the cash for their transactions in cash segment of the market. However, cross-margining of Government Securities (placed as margins by the FIIs for their transactions in the cash segment of the market) shall not be allowed between the cash and the derivative segments of the market.

Custodian banks are allowed to issue Irrevocable Payment Commitments (IPCs) in favor of Stock Exchanges / Clearing Corporations of the Stock Exchanges, on behalf of their FII clients for purchase of shares under the PIS. Issue of IPCs should be in accordance with the Reserve Bank regulations on banks' exposure to the capital market issued by the Reserve Bank from time to time.

Short Selling by FIIs

Foreign Institutions Investors (FIIs)

FIIs registered with SEBI and SEBI approved sub-accounts of FIIs are permitted to short sell, lend and borrow equity shares of Indian companies. Short selling, lending and borrowing of equity shares of Indian

companies shall be subject to such conditions as may be prescribed by the Reserve Bank and the SEBI / other regulatory agencies from time to time. The permission is subject to the following conditions:

- Short selling of equity shares by FIIs shall not be permitted for equity shares of Indian companies which are in the ban list and / or caution list of the Reserve Bank.
- Borrowing of equity shares by FIIs shall only be for the purpose of delivery into short sales.
- The margin / collateral shall be maintained by FIIs only in the form of cash. No interest shall be paid to the FII on such margin/ collateral.

Non-Resident Indians (NRIs)

The NRI investor has to take delivery of the shares purchased and give delivery of shares sold. Short Selling is not permitted.

Private Placement with FIIs

SEBI registered FIIs have been permitted to purchase shares / convertible debentures of an Indian company through offer/private placement, subject to total FII investment viz. PIS & FDI (private placement / offer) being within the individual FII/sub account investment limit 10 per cent and all FIIs/sub-accounts put together - 24 per cent of the paid-up capital of the Indian company or to the sectoral limits, as applicable. Indian company is permitted to issue such shares provided that:

- in the case of public offer, the price of shares to be issued is not less than the price at which shares are issued to residents; and
- in the case of issue by private placement, the issue price should be determined as per the pricing guidelines stipulated under the FDI scheme.

Transfer of Shares Acquired Under PIS Under Private Arrangement

Shares purchased by NRIs and FIIs on the stock exchange under PIS cannot be transferred by way of sale under private arrangement or

by way of gift to a person resident in India or outside India without prior approval of the Reserve Bank. However, NRIs can transfer shares acquired under PIS to their relatives as defined in Section 6 of Companies Act, 1956 or to a charitable trust duly registered under the laws in India.

Monitoring of investment position by RBI and AD banks

The Reserve Bank monitors the investment position of FIIs/NRIs in listed Indian companies, reported by Custodian/designated AD banks, on a daily basis, in Forms LEC (FII) and LEC (NRI). However, the respective designated bank (NRIs) / Custodian bank (FIIs) should monitor:

- the individual limit of NRI / FII to ensure that it does not breach the prescribed limits.
- that the trades are not undertaken in the prohibited sectors when the same is reported to them.
- that all trades are reported to them by monitoring the transactions in the designated account.

The onus of reporting of FII and NRI transactions lies on the designated custodian /AD bank, depository participant as well as the FII/ NRI making these investments.

Prior Intimation to Reserve Bank of India

Indian company raising the aggregate FII investment limit of 24 per cent to the sectoral cap/ statutory limit, as applicable to the respective Indian company or raising the aggregate NRI investment limit of 10 per cent to 24 per cent, should necessarily intimate the same to the Reserve Bank of India, immediately, as hitherto, along with a Certificate from the Company Secretary stating that all the relevant provisions of the extant Foreign Exchange Management Act, 1999 regulations and the Foreign Direct Policy, as amended from time to time, have been complied with.

Caution List

When the aggregate net purchases of equity shares of the Indian company by FIIs/NRIs/PIOs reaches the cut-off point of 2 per cent below

the overall limit, the Reserve Bank cautions all the designated bank branches not to purchase any more equity shares of the respective company on behalf of any FIIs/ NRIs/ PIOs without prior approval of the Reserve Bank. The link offices are then required to intimate the Reserve Bank about the total number and value of equity shares/ convertible debentures of the company proposed to be bought on behalf of their FIIs /NRIs /PIOs clients. On receipt of such proposals, the Reserve Bank gives clearances on a first-come-first served basis till such investments in companies reaches the respective limits (such as, 10 / 24 / 30 / 40/ 49 per cent limit or the sectoral caps/statutory ceilings), as applicable.

Ban List

Once the shareholding by FIIs/NRIs/PIO reaches the overall ceiling / sectoral cap / statutory limit, the Reserve Bank places the company in the Ban List and advises all designated bank branches to stop purchases on behalf of their FIIs/ NRIs/ PIO clients. Once a company is placed in the Ban List, no FII / NRI can purchase the shares of the company under the PIS. The Reserve Bank also informs the general public about the 'caution' and the 'stop purchase' in the companies through a press release and an updated list regarding the same is placed on the RBI website

Issue of Irrevocable Payment Commitment (IPCs) to Stock Exchanges on behalf of FIIs

To facilitate the settlement process of the FIIs trades under the portfolio route, custodian banks were permitted to issue Irrevocable Payment Commitments (IPCs) in favour of the Stock Exchanges / Clearing Corporations of the Stock Exchanges, on behalf of their FII clients for purchase of shares under the Portfolio Investment Scheme (PIS).

Investment by Qualified Foreign Investors(QFIs) in Listed Equity Shares

Qualified Foreign Investors (QFIs as defined therein to mean non -resident investors, other than SEBI registered FIIs and SEBI registered FVCIs, who meet the KYC requirements of SEBI) are allowed to purchase on repatriation basis equity shares of Indian companies subject the following terms and conditions:

- i) **Eligible instruments and eligible transactions** – QFIs shall be permitted to invest through SEBI registered Depository Participants (DPs) only in equity shares of listed Indian companies through recognized brokers on recognized stock exchanges in India as well as in equity shares of Indian companies which are offered to public in India in terms of the relevant and applicable SEBI guidelines/regulations. QFIs shall also be permitted to acquire equity shares by way of rights shares, bonus shares or equity shares on account of stock split / consolidation or equity shares on account of amalgamation, demerger or such corporate actions subject to the investment limits as prescribed in para. 2 (iv) below.

QFIs shall be allowed to sell the equity shares so acquired by way of sale

- Through recognized brokers on recognized stock exchanges in India; or
- In an open offer in accordance with the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011; or
- In an open offer in accordance with the SEBI (Delisting of Securities) Guidelines, 2009; or
- Through buyback of shares by a listed Indian company in accordance with the SEBI (Buyback) Regulations, 1998.

- ii) **Mode of payment / repatriation** – For QFI investments under this scheme a non-interest bearing separate single rupee pool bank account would be maintained by the DP with an AD Category- I bank in India for QFI investments under this scheme. The DP will purchase equity at the instruction of the respective QFIs within five working days (including the date of credit of funds to the single rupee pool bank account by way of foreign inward remittances through normal banking channels) failing which the funds would be immediately repatriated back to the QFI's designated overseas bank account. The sale proceeds of the equity shares will also be received in this single rupee pool bank account of the DP and shall be repatriated to the designated overseas bank account of the QFI within five working days (including the date of credit of funds to the single rupee pool bank account by way of sale of equity shares)

of having been received in the single rupee pool bank account of the DP. Within these five working days, the sale proceeds of the existing investment can be also utilized for fresh purchases of equity shares under this scheme, if so instructed by the QFI. Dividend payments on equity shares held by QFIs can either be directly remitted to the designated overseas bank accounts of the QFIs or credited to the single rupee pool bank account. In case dividend payments are credited to the single rupee pool bank account they shall be remitted to the designated overseas bank accounts of the QFIs within five working days (including the day of credit of such funds to the single rupee pool bank account). Within these five working days, the dividend payments can be also utilized for fresh purchases of equity shares under this scheme, if so instructed by the QFI.

- iii) **Demat accounts** - QFIs would be allowed to open a dedicated demat account with a DP in India for investment in equity shares under the scheme. The QFIs would however not be allowed to open any bank account in India.
- iv) **Limits** - The individual and aggregate investment limits for the QFIs shall be 5% and 10% respectively of the paid up capital of an Indian company. These limits shall be over and above the FII and NRI investment ceilings prescribed under the Portfolio Investment Scheme for foreign investment in India. Further, wherever there are composite sectoral caps under the extant FDI policy, these limits for QFI investment in equity shares shall also be within such overall FDI sectoral caps. The onus of monitoring and compliance of these limits shall remain jointly and severally with the respective QFIs, DPs and the respective Indian companies (receiving such investment).
- v) **Eligibility** - Only QFIs from jurisdictions which are FATF compliant and with which SEBI has signed MOUs under the IOSCO framework will be eligible to invest in equity shares under this scheme.
- vi) **KYC** - DPs will ensure KYC of the QFIs as per the norms prescribed by SEBI.

- vii) Permissible currencies** - QFIs will remit foreign inward remittance through normal banking channel in any permitted currency (freely convertible) directly into single rupee pool bank account of the DP maintained with AD Category-I bank.
- viii) Pricing** – The pricing of all eligible transactions and investment in all eligible instruments by QFIs under this scheme shall be in accordance with the relevant and applicable SEBI guidelines only.
- ix) Reporting** – In addition to the reporting to SEBI as may be prescribed by them, DPs will also ensure reporting to the Reserve Bank of India in a manner and format as prescribed by the Reserve Bank of India from time to time.

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Lesson 5.3 - Offshore Country Funds, Foreign Venture Capital Investments, Other Foreign Investments & International Capital Markets

Learning Objectives

- To understand the meaning and advantages of offshore country funds.
- To understand the provisions relating to Foreign Venture Capital Investments.
- To get an insight into the other forms of Foreign Investments
- To understand the phases in internationalization of capital markets.

Offshore Country Funds

An “offshore” investment vehicle is located in a different country than the one where you live. There is another, more informal definition of “offshore”: an investment entity that is located in a country that specializes in hosting “offshore” entities. Some of the best-known examples are Bermuda, the Cayman Islands, the Channel Islands, and Malta. Thus, An **offshore fund** can be defined as a collective investment scheme domiciled in an Offshore Financial Centre such as the British Virgin Islands, Luxembourg, or the Cayman Islands; it is typically sold exclusively to ‘foreign’ investors (those not of the domestic fund sponsor’s country of origin).

Thus, a common example could involve an offshore fund managed or sponsored by a U.S.-based money manager, organized under the laws of the Cayman Islands and sold exclusively to non-U.S. investors. For the purposes of the Income and Corporation Taxes Act 1988 of the UK, an offshore fund is one which is governed by the Offshore Fund Rules set out in that Act. The vast majority of offshore funds are organized under the laws of the Cayman Islands, with the British Virgin Islands being the second most popular domicile.

Advantages

Offshore funds offer eligible investors significant tax benefits compared to many high tax jurisdictions. An offshore fund can be managed similarly however without the high taxes otherwise involved with a similarly managed U.S. organized fund. Where income is repatriated (paid or transferred) to high tax jurisdictions, however, such income is usually taxed at normal rates as foreign sourced or arising income. Many of these tax-haven locations are considered investor-friendly and are internationally regarded as financially secure. Many offshore jurisdictions, notably the British Virgin Islands, offer a zero-tax regime for investment funds which are domiciled there, which allows the fund to reinvest that part of its investment portfolio's gains which would otherwise have been lost to tax. In addition, the regulatory regime in these offshore jurisdictions is deliberately light, with emphasis placed on the importance of balancing effective regulation for the benefit of the protection of investors on the one hand, with the establishment of a regime in which the conduct of investment business is fast and simple. A number of offshore jurisdictions have recently tightened the regulation of offshore funds.

Investments by Foreign Venture Capital Investor

- i) A SEBI registered Foreign Venture Capital Investor (FVCI) with specific approval from the Reserve Bank can invest in Indian Venture Capital Undertaking (IVCU) or Venture Capital Fund (VCF) or in a scheme floated by such VCFs subject to the condition that the domestic VCF is registered with SEBI. These investments by SEBI registered FVCI, would be subject to the respective SEBI regulations and FEMA regulations and sector specific caps of FDI.
- ii) An IVCU is defined as a company incorporated in India whose shares are not listed on a recognized stock exchange in India and which is not engaged in an activity under the negative list specified by SEBI. A VCF is defined as a fund established in the form of a trust, a company including a body corporate and registered under the Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996 which has a dedicated pool of capital raised in a manner specified under the said Regulations and which invests in Venture Capital Undertakings in accordance with the said Regulations.

- iii) FVCIs can purchase equity / equity linked instruments / debt / debt instruments, debentures of an IVCU or of a VCF or in units of schemes / funds set up by a VCF through initial public offer or private placement or by way of private arrangement or purchase from third party. Further, FVCIs would also be allowed to invest in securities on a recognized stock exchange subject to the provisions of the SEBI (FVCI) Regulations, 2000, as amended from time to time. At the time of granting approval, the Reserve Bank permits the FVCI to open a non-interest bearing Foreign Currency Account and/or a non-interest bearing Special Non-Resident Rupee Account with a designated branch of an AD Category – I bank, subject to certain terms and conditions.
- iv) A SEBI registered FVCI can acquire / sale securities (as given in (i ii) above) by way of public offer or private placement by the issuer of such securities and /or by way of private arrangement with a third party at a price that is mutually acceptable to the buyer and the seller.
- v) AD Category–I banks can offer forward cover to FVCIs to the extent of total inward remittance. In case the FVCI has made any remittance by liquidating some investments, original cost of the investments has to be deducted from the eligible cover to arrive at the actual cover that can be offered.

Other Foreign Investments

1) Purchase of other securities by NRIs

i) On Non-Repatriation Basis

- a) NRIs can purchase shares / convertible debentures issued by an Indian company on non-repatriation basis without any limit. Amount of consideration for such purchase shall be paid by way of inward remittance through normal banking channels from abroad or out of funds held in NRE / FCNR (B) / NRO account maintained with the AD Category - I bank.
- b) NRI can also, without any limit, purchase on non-repatriation basis dated Government securities, treasury bills, units of domestic mutual funds, units of Money Market Mutual Funds. Government of

India has notified that NRIs are not permitted to make Investments in Small Savings Schemes including PPF. In case of investment on non-repatriation basis, the sale proceeds shall be credited to NRO account. The amount invested under the scheme and the capital appreciation thereon will not be allowed to be repatriated abroad. NRI can also invest in non-convertible debentures both on repatriation basis and on non-repatriation basis, which has been issued by an Indian Company subject to the other terms and conditions stated under Notification no FEMA 4/2000-RB dated May 3, 2000 (as amended from time to time).

ii) On Repatriation Basis

An NRI can purchase on repatriation basis, without limit, Government dated securities (other than bearer securities) or treasury bills or units of domestic mutual funds; bonds issued by a public sector undertaking (PSU) in India and shares in Public Sector Enterprises being disinvested by the Government of India, provided the purchase is in accordance with the terms and conditions stipulated in the notice inviting bids.

2) Indian Depository Receipts (IDR)

Indian Depository Receipts (IDRs) can be issued by non-resident companies in India subject to and under the terms and conditions of Companies (Issue of Depository Receipts) Rules, 2004 and subsequent amendment made there to and the SEBI (ICDR) Regulations, 2000, as amended from time to time. These IDRs can be issued in India through Domestic Depository to residents in India as well as SEBI registered FIIs and NRIs. In case of raising of funds through issuances of IDRs by financial / banking companies having presence in India, either through a branch or subsidiary, the approval of the sectoral regulator(s) should be obtained before the issuance of ID₹

- a) The FEMA Regulations shall not be applicable to persons resident in India as defined under Section 2(v) of FEMA, 1999, for investing in IDRs and subsequent transfer arising out of transaction on a recognized stock exchange in India.

- b) Foreign Institutional Investors (FIIs) including SEBI approved sub-accounts of the FIIs, registered with SEBI and Non-Resident Indians (NRIs) may invest, purchase, hold and transfer IDRs of eligible companies resident outside India and issued in the Indian capital market, subject to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, as amended from time to time. Further, NRIs are allowed to invest in the IDRs out of funds held in their NRE / FCNR(B) account, maintained with an Authorized Dealer / Authorized bank.
- c) Automatic fungibility of IDRs is not permitted.
- d) IDRs shall not be redeemable into underlying equity shares before the expiry of one year period from the date of issue of the ID₹
- e) At the time of redemption / conversion of IDRs into underlying shares, the Indian holders (persons resident in India) of IDRs shall comply with the provisions of the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations, 2004 as amended from time to time. Accordingly, the following guidelines shall be followed, on redemption of IDRs:
 - Listed Indian companies may either sell or continue to hold the underlying shares subject to the terms and conditions.
 - Indian Mutual Funds, registered with SEBI may either sell or continue to hold the underlying shares subject to the terms and conditions
 - Other persons resident in India including resident individuals are allowed to hold the underlying shares only for the purpose of sale within a period of 30 days from the date of conversion of the IDRs into underlying shares.
 - The FEMA provisions shall not apply to the holding of the underlying shares, on redemption of IDRs by the FIIs including SEBI approved sub -accounts of the FIIs and NRIs.
- f) The proceeds of the issue of IDRs shall be immediately repatriated outside India by the eligible companies issuing such ID₹ The IDRs issued should be denominated in Indian Rupees.

3. Purchase of Other Securities

a) **Corporate bond/Other securities:** FIIs can buy on repatriation basis dated Government securities / treasury bills, listed non-convertible debentures / bonds, commercial papers issued by Indian companies and units of domestic mutual funds, to be listed NCDs/ bonds only if listing of such NCDs/bonds is committed to be done within 15 days of such investment and Security receipts issued by Asset Reconstruction Companies subject to the following terms and conditions:

- The investment by FIIs shall be within the overall limit for investment as prescribed by the Bank from time to time;
- The total holding by a single FII in each tranche of scheme of Security Receipts shall not exceed 10% of the issue and total holdings of all FIIs put together shall not exceed 49% of the paid up value of each tranche of scheme / issue of Security Receipts issued by the ARCs. Further, Sub-account of FIIs are not allowed to invest in the Security Receipts issued by ARCs. The total holding by a single FII / sub-account in each issue of Perpetual Debt Instruments (Tier I) shall not exceed 10% of the issue and total holdings of all FIIs /sub-account put together shall not exceed 49% of the paid up value of each issue of Perpetual Debt Instruments.
- Purchase of debt instruments including Upper Tier II instruments by FIIs are subject to limits notified by SEBI and the Reserve Bank from time to time.

b) **Government Securities**

SEBI registered FIIs may invest in dated Government Securities and Treasury Bills without any residual maturity restrictions subject to limits specified by the Bank from time to time. The present limit stands at USD 25 billion. FIIs along with Long term investors like Sovereign Wealth Funds (SWFs), Multilateral agencies, endowment funds, insurance funds, pension funds and foreign Central Banks to be registered with SEBI will be eligible to invest in dated Government securities (excluding Treasury bills) within the sub-limit of USD 15 billion, within the overall limit of USD 25 billion without any residual maturity restrictions.

The present position of limits, eligible investors and eligible type of instruments is given in table below:

Government Securities – Limits, Investors and Conditions				
Instrument	Limit	Investor	Conditions	Remarks
Government securities	USD 10 billion	FIIIs	No conditions	-
Government dated securities	USD 15 billion	FIIIs and SWF, Multilateral Agencies, Pension/ Insurance/ Endowment Funds, Foreign Central Banks	Investments in short term paper like Treasury Bills not permitted	No residual maturity requirement

4. Investment by Multilateral Development Banks (MDBs)

A Multilateral Development Bank (MDB) which is specifically permitted by the Government of India to float rupee bonds in India can purchase Government dated securities within the limit.

5. Foreign Investment in Tier I and Tier II instruments issued by banks in India

- i) FIIIs registered with SEBI and NRIs have been permitted to subscribe to the Perpetual Debt instruments (eligible for inclusion as Tier I capital) and Debt Capital instruments (eligible for inclusion as upper Tier II capital), issued by banks in India and denominated in Indian Rupees, subject to the following conditions:
 - Investment by all FIIIs in Rupee denominated Perpetual Debt instruments (Tier I) should not exceed an aggregate ceiling of 49 per cent of each issue, and investment by individual FII should not exceed the limit of 10 per cent of each issue.
 - Investments by all NRIs in Rupee denominated Perpetual Debt instruments (Tier I) should not exceed an aggregate ceiling of 24 per cent of each issue and investments by a single NRI should not exceed 5 percent of each issue.

- Investment by FIIs in Rupee denominated Debt Capital instruments (Tier II) shall be within the limits stipulated by SEBI for FII investment in corporate debt instruments.
- Investment by NRIs in Rupee denominated Debt Capital instruments (Tier II) shall be in accordance with the extant policy for investment by NRIs in other debt instruments.
- ii) The issuing banks are required to ensure compliance with the conditions stipulated above at the time of issue. They are also required to comply with the guidelines issued by the Department of Banking Operations and Development (DBOD), Reserve Bank of India, from time to time.
- iii) The issue-wise details of the amount raised as Perpetual Debt Instruments qualifying for Tier I capital by the bank from FIIs / NRIs are required to be reported in the prescribed format within 30 days of the issue to the Reserve Bank.
- iv) Investment by FIIs in Rupee denominated Upper Tier II Instruments raised in Indian Rupees will be within the limit prescribed by SEBI. However, investment by FIIs in these instruments will be subject to a separate ceiling of USD 500 million.
- v) The details of the secondary market sales / purchases by FIIs and the NRIs in these instruments on the floor of the stock exchange are to be reported by the custodians and designated banks respectively, to the Reserve Bank through the soft copy of the Forms LEC (FII) and LEC (NRI).

6. Foreign Investors (QFIs) investment in the units of Domestic Mutual funds

Non- resident investors (other than SEBI registered FIIs/FVCIs) who meet the KYC requirements of SEBI, were permitted to purchase on repatriation basis rupee denominated units of equity schemes of SEBI registered domestic MFs as Qualified Foreign Investors' (QFIs), in accordance with the terms and conditions as stipulated by the SEBI and the RBI from time to time in this regard.

QFIs may invest in rupee denominated units of equity schemes of SEBI registered domestic MFs under the two routes, namely:

- i) **Direct Route** – SEBI registered Qualified Depository Participant (QDP) route - The QDP route will be operated through single non-interest bearing Rupee account to be maintained with an AD Category I Bank in India. The foreign inward remittances in to the single non-interest bearing Rupee account shall be received only in permissible currency.
- ii) **Indirect Route** - Unit Confirmation Receipt (UCR) route - Domestic MFs would be allowed to open foreign currency accounts outside India for the limited purpose of receiving subscriptions from the QFIs as well as for redeeming the UC₹. The UCR will be issued against units of domestic MF equity schemes.
- iii) Investments by the QFIs under both the routes would be subject to a ceiling of USD 10 billion for investment in units of equity based domestic MF and USD 3 billion for investment in units of debt based domestic MF. QFIs can also invest in those MF schemes that hold at least 25 per cent of their assets (either in debt or equity or both) in the infrastructure sector under the USD 3 billion sub-limit for investment in mutual funds related to infrastructure.

7. Infrastructure Debt Funds (IDF)

In order to accelerate and enhance the flow of long term funds to infrastructure projects for undertaking the Government's ambitious programme of infrastructure development, Union

Finance Minister in his budget speech for 2011-12 had announced setting up of Infrastructure Debt Funds (IDFs). Government vide press release dated June 24, 2011 notified the broad structure of the proposed IDFs. The summarized position is given as under:

- i) SWFs, Multilateral Agencies, Pension Funds, Insurance Funds and Endowment Funds registered with SEBI, FIIs, NRIs, HNIs would be the eligible class non - resident investors which will be investing in IDFs.
- ii) Eligible non-resident investors are allowed to invest on repatriation basis in (i) Rupee and Foreign currency denominated bonds issued by the IDFs set up as an Indian company and registered as Non-

Banking Financial Companies (NBFCs) with the Reserve Bank of India and in (ii) Rupee denominated units issued by IDFs set up as SEBI registered domestic Mutual Funds (MFs), in accordance with the terms and conditions stipulated by the SEBI and the Reserve Bank of India from time to time.

- iii) The eligible instruments are Foreign Currency & Rupee denominated Bonds and Rupee denominated Units;
- iv) The residual maturity of the instrument at the time of first purchase by an FII/ eligible IDF investor would be at least fifteen months; and
- v) The facility of Foreign exchange hedging would be available to non-resident IDF investors, IDFs as well as infrastructure project companies exposed to the foreign exchange/ currency risk.

8. Purchase of Other Securities by QFIs

QFIs can invest through SEBI registered Qualified Depository Participants (QDPs) (defined as per the extant SEBI regulations) in eligible corporate debt instruments, viz. listed Non-Convertible Debentures (NCDs), listed bonds of Indian companies, listed units of Mutual Fund debt Schemes and “to be listed” corporate bonds (hereinafter referred to as ‘eligible debt securities’) directly from the issuer or through a registered stock broker on a recognized stock exchange in India.

However, in case of non-listing of “to be listed” corporate bonds, the provisions relating to FIIs would be applicable. Further, QFIs shall also be permitted to sell ‘eligible debt securities’ so acquired by way of sale through registered stock broker on a recognized stock exchange in India or by way of buyback or redemption by the issuer.

QFIs are permitted to invest in corporate debt securities (without any lock -in or residual maturity clause) and Mutual Fund debt schemes subject to a total overall ceiling of USD 1 billion. This limit shall be over and above USD 50 billion for FII investment in corporate debt. The condition of original maturity of 3 years for investment by QFI is applicable. Thus, total limit would be USD 51 billion.

International Capital Markets

A *capital market* is basically a market where long term funds are borrowed and lent. *International capital market* is a market in which governments, companies, and people borrow and invest across national boundaries. In addition to the benefits and purposes of a domestic capital market, international capital markets provide the following benefits:

- a) **Higher returns and cheaper borrowing costs.** These allow companies and governments to tap into foreign markets and access new sources of funds. Many domestic markets are too small or too costly for companies to borrow in. By using the international capital markets, companies, governments, and even individuals can borrow or invest in other countries for either higher rates of return or lower borrowing costs.
- b) **Diversifying risk.** The international capital markets allow individuals, companies, and governments to access more opportunities in different countries to borrow or invest, which in turn reduces risk. The theory is that not all markets will experience contractions at the same time.

Components of International Capital Markets

The structure of the international capital markets falls into two components—primary and secondary. The **primary market** is where new securities (stocks and bonds are the most common) are issued. If a corporation or government agency needs funds, it issues (sells) securities to purchasers in the primary market. Big investment banks assist in this issuing process as intermediaries. The vast majority of capital transactions take place in the **secondary market**. The secondary market includes stock exchanges (the New York Stock Exchange, the London Stock Exchange, and the Tokyo Nikkei), bond markets, and futures and options markets, among others. The important components of international capital markets include:

- i) **International Equity Markets:** Companies sell their stock in the equity markets. International equity market consists of all the stock traded outside the issuing company's home country. Many large global companies seek to take advantage of the global financial

centers and issue stock in major markets to support local and regional operations. For example, Arcelor Mittal is a global steel company headquartered in Luxembourg; it is listed on the stock exchanges of New York, Amsterdam, Paris, Brussels, Luxembourg, Madrid, Barcelona, Bilbao, and Valencia. While the daily value of the global markets changes, in the past decade the international equity markets have expanded considerably, offering global firms increased options for financing their global operations. The key factors for the increased growth in the international equity markets are the following:

- ***Growth of developing markets:*** As developing countries experience growth, their domestic firms seek to expand into global markets and take advantage of cheaper and more flexible financial markets.
- ***Drive to privatize:*** In the past two decades, the general trend in developing and emerging markets has been to privatize formerly state-owned enterprises. These entities tend to be large, and when they sell some or all of their shares, it infuses billions of dollars of new equity into local and global markets. Domestic and global investors, eager to participate in the growth of the local economy, buy these shares.
- ***Investment banks:*** With the increased opportunities in new emerging markets and the need to simply expand their own businesses, investment banks often lead the way in the expansion of global equity markets. These specialized banks seek to be retained by large companies in developing countries or the governments pursuing privatization to issue and sell the stocks to investors with deep pockets outside the local country.
- ***Technology advancements:*** The expansion of technology into global finance has opened new opportunities to investors and companies around the world. Technology and the Internet have provided more efficient and cheaper means of trading stocks and, in some cases, issuing shares by smaller companies.

b) *International Bond Markets:* Bonds are the most common form of debt instrument, which is basically a loan from the holder to the issuer of the bond. The international bond market consists of all the

bonds sold by an issuing company, government, or entity outside their home country. Companies might access the international bond markets for a variety of reasons, including funding a new production facility or expanding its operations in one or more countries. There are several types of international bonds.

- i) **Foreign Bond:** A foreign bond is a bond sold by a company, government, or entity in another country and issued in the currency of the country in which it is being sold. There are foreign exchange, economic, and political risks associated with foreign bonds, and many sophisticated buyers and issuers of these bonds use complex hedging strategies to reduce the risks. For example, the bonds issued by global companies in Japan denominated in yen are called **samurai bonds**. As you might expect, there are other names for similar bond structures. Foreign bonds sold in the United States and denominated in US dollars are called **Yankee bonds**. In the United Kingdom, these foreign bonds are called **bulldog bonds**. Foreign bonds issued and traded throughout Asia except Japan, are called **dragon bonds**, which are typically denominated in US dollars. Foreign bonds are typically subject to the same rules and guidelines as domestic bonds in the country in which they are issued. There are also regulatory and reporting requirements, which make them a slightly more expensive bond than the Eurobond. The requirements add small costs that can add up given the size of the bond issues by many companies.
- ii) **Eurobond:** A Eurobond is a bond issued outside the country in whose currency it is denominated. Eurobonds are not regulated by the governments of the countries in which they are sold, and as a result, Eurobonds are the most popular form of international bond. A bond issued by a Japanese company, denominated in US dollars, and sold only in the United Kingdom and France is an example of a Eurobond.
- iii) **Global Bond:** A global bond is a bond that is sold simultaneously in several global financial centers. It is denominated in one currency, usually US dollars or Euros. By offering the bond in several markets at the same time, the company can reduce its issuing costs. This option is usually reserved for higher rated, creditworthy, and typically very large firms.

Phases in the Internationalization of Capital Markets

One of the most important developments since the 1970s has been the internationalization, and now globalization, of capital markets. The phases in the internationalization of capital markets include the following:

1) The International Capital Market of the Late 1990s was Composed of a Number of Closely Integrated Markets with an International Dimension

Basically, the international capital market includes any transaction with an international dimension. It is not really a single market but a number of closely integrated markets that include some type of international component. The foreign exchange market was a very important part of the international capital market during the late 1990s. Internationally traded stocks and bonds have also been part of the international capital market. Since the late 1990s, sophisticated communications systems have allowed people all over the world to conduct business from wherever they are. The major world financial centers include Hong Kong, Singapore, Tokyo, London, New York, and Paris, among others.

2. The Need to Reduce Risk Through Portfolio Diversification Explains in Part the Importance of the International Capital Market During the Late 1990s

A major benefit of the internationalization of capital markets is the diversification of risk. Individual investors, major corporations, and individual countries all usually try to diversify the risks of their financial portfolios. The reason is that people are generally risk-averse. They would rather get returns on investments that are in a relatively narrow band than investments that have wild fluctuations year-to-year. All portfolio investors look at the risk of their portfolios versus their returns. Higher risk investments generally have the potential to yield higher returns, but there is much more variability. Portfolio diversification looks at the risk versus the return available to get the highest return possible at the lowest possible risk. When an investor or a company invests in many different assets (stocks, bonds, mutual funds, etc.), risk is reduced because there is less reliance on any single asset. By using world markets, risk can be reduced even more.

3. *The Principal Actors in the International Capital Markets of the Late 1990s were Banks, Non-Bank Financial Institutions, Corporations, and Government Agencies*

Commercial banks powered their way to a place of considerable influence in international markets during the late 1990s. The primary reason for this was that they often pursued international activities that they would not have been able to undertake in their home countries. Commercial banks undertook a broad array of financial activities during the late 1990s. Non-bank financial institutions became another fast-rising force in international markets during the late 1990s. Insurance companies, pension and trust funds, and mutual funds from many countries began to diversify into international markets in the 1990s. Together, portfolio enhancement and a widespread increase in fund contributors have accounted for the strength these funds had in the international marketplace.

4. *Changes in the International Marketplace Resulted in a New Era of Global Capital Markets During the Late 1990s, which were Critical to Development*

First, citizens around the world (and especially the Japanese) began to increase their personal savings. *Second*, many governments further deregulated their capital markets since 1980. This allowed domestic companies more opportunities abroad, and foreign companies had the opportunity to invest in the deregulated countries. *Finally*, technological advances made it easier to access global markets. Information could be retrieved quicker, easier, and cheaper than ever before. This allowed investors in one country to obtain more detailed information about investments in other countries, and obtain it quite efficiently. So, in the late 1990s we witnessed the globalization of markets - i.e., the increased integration of domestic markets into a global economy. This differed from the process of internationalization, which connected less integrated domestic markets of the past with offshore markets. The global capital markets became critical to development in an open economy.

Sources of Capital

There are two sources of capital: private sources and public sources. Both sources are very important to the economies of the world. Capital

flows result when funds are transferred across borders; the flows are recorded in the balance of payments account.

- a) **Private Sources of Capital:** Foreign direct investment and portfolio investment (both debt and equity flows) are important sources of private capital. They are already explained in the earlier lessons.
- b) **Public Sources of Capital:** Public sources of capital include official non-concessional loans of both multilateral and bilateral aid and official development assistance (ODA). ODA is made up of grants and concessional multilateral and bilateral loans.
 - **Official non-concessional loans: multilateral & bilateral aid:** Official non-concessional multilateral aid consists of loans from the World Bank, regional development banks, and other intergovernmental agencies such as multilateral organizations. The term “non-concessional” refers to the fact that these loans are based on market rates, must be repaid, and are not partly grants. By contrast, official non-concessional bilateral aid is loans from governments and their central banks or other agencies. Export credit agency loans are also included here. “Bilateral” refers to the fact that the entities providing the funding provide aid only in their home country.
 - **ODA: official grants and concessional loans:** ODA refers in part to official public grants that are legally binding commitments and provide a specific amount of capital available to disburse for which no repayment is required. Concessional bilateral aid refers to aid from governments, central banks, and export credit agencies that contains a partial grant element (25% or more), or partially forgives the loan. Similarly, concessional multilateral aid contains a partial grant, or forgiveness of the loan. Multilateral aid comes from the World Bank, regional development banks and intergovernmental agencies.
- c) **Private Capital Became Very Important to Development in the Late 1990s:** During the 1990s, the sources of capital for developing countries changed drastically. Private funding, however, skyrocketed. Clearly, there was a fundamental change in the sources of funds for developing countries to draw from during the late 1990s. Why did this major change occur? As stated previously,

international portfolio diversification became more prevalent every day. Insurance companies, mutual funds, pension funds, and securities houses were looking to diversify. They also had more funds than ever to invest. Worldwide, portfolios were absorbing an increasing share of aggregate savings. These portfolios were coming more and more under the control of professional fund managers.

As overall international portfolio diversification grew, so too did the share of international portfolio diversification that went to developing countries. Capital flows to developing countries acted as catalysts, propelling the world closer to a seamless global marketplace during the late 1990s. The growth of global institutional investors resulted in capital flows to emerging markets based more on short-term liquidity and performance than long-term business ventures. To protect themselves from the risks of these volatile cash flows, developing countries can take some precautionary measures. The central bank can intervene in foreign exchange markets and capital controls can be imposed.

Conclusion

India has been able to provide an enabling environment to foreign investors in several respects. Deep reforms in capital markets aided by an efficient regulatory architecture have facilitated portfolio investments. Transfer and acquisition of shares are taking place according to investor-friendly guidelines. Foreign exchange regulations have been aligned to global standards through FEMA. In the near future, it is hoped that more foreign capital would flow.

Self Assessment Questions

1. What are the types of Foreign Collaboration? Discuss the salient features of policy relating to foreign technology agreements.
2. Define Foreign Investment. What are the entry routes and options available?
3. What are the types of instruments used in FDI and who are eligible?
4. Write short notes on: a) pricing guidelines for FDI; b) modes of payment used in FDI.
5. Elaborate on the foreign investment limits in India.

6. What are the sectors prohibited for FDI in India?
7. Elaborate on the FDI in MSEs.
8. Discuss the various modes of investment under FDI Scheme.
9. What is foreign currency account and escrow account?
10. Write short notes on remittances of a) sale proceeds and b) winding up/liquidation of companies.
11. What are entities eligible to make Foreign Investment under Portfolio Investment Scheme (PIS) in India?
12. Discuss the provisions relating to Authorized Dealer Category I Banks for PIS.
13. Discuss the provisions relating to exchange traded derivative contracts for PIS.
14. Write short notes on: a) Collaterals for FIIs under PIS; b) Short selling by FIIs; c) Private Placement with FIIs.
15. Explain the role of RBI and AD banks in monitoring investment positions under PIS.
16. Discuss the provisions relating to PIS by Qualified Foreign Investors (QFIs) in listed equity shares.
17. What are offshore country funds? What are its advantages?
18. Discuss the provisions relating to foreign venture capital investment.
19. Explain the various other forms of foreign investments.
20. Discuss the provisions relating to Qualified Foreign Investors Investment in the units of Domestic Mutual funds.
21. Write short notes on:
22. Indian depository Receipts (IDRs)
23. Instruments, limits and investors for Government securities
24. Infrastructure Debt Funds (IDF)
25. What are the important components of international capital markets?
26. Explain the phases in the internationalization of capital markets

CASE STUDY**Clash of the titans: Overlapping and contradictory foreign investment regulations in India**

The SEBI and RBI have been working independently towards rationalising the existing investment regime to make it more investor-friendly. This shift in attitude is evident with the introduction by SEBI of Qualified Foreign Investors (“QFIs”) as a new class of investors, the promulgation of the SEBI (Alternative Investment Fund) Regulations, 2012 and permission granted by RBI to Foreign Venture Capital Investors (FVCIs) to participate in secondary transactions. In addition, RBI has allowed FVCIs to be active participants in stock exchanges which seems to encroach on the monopoly of Foreign Institutional Investors (FIIs) regulated by SEBI. FVCIs were permitted to invest in venture capital funds and Indian venture capital undertakings, which are defined to mean companies not listed on a recognised stock exchange and to invest up to a third of their investible funds in preferential allotment by listed companies. RBI’s circular dated 19 March 2012 extended this, allowing FVCIs to invest in eligible securities by way of private arrangement, purchase from a third party or by investing in securities on a recognised stock exchange. Although the RBI Circular issued in this respect attempts to liberalise investments made by FVCIs in India, it is subject to provisions of SEBI Regulations, which currently don’t allow FVCIs to invest in the manner permitted by RBI’s Circular.

The SEBI’s AIF Regulations, defines an Alternative Investment Fund (AIF) to mean any fund established or incorporated in India which collects funds from domestic and/or foreign investors for investing the funds in accordance with a defined investment policy. However, the consolidated Foreign Direct Investment Policy effective from 10 April 2012 does not permit foreign investments in AIFs. While, the Department of Industrial Policy and Promotion (DIPP) has in the last one year, issued clarifications and made changes to the FDI Policy, none of the press notes issued till date mention the possibility of foreign investments in AIFs. In addition to this, the AIF Regulations created a category of AIFs that would be eligible for tax benefits. However, the government has not announced any benefits or conditions for funds to qualify as such AIFs so far. A similar disconnect is seen in the regime for QFIs who were allowed to invest in the Indian equity

and debt markets to boost foreign investment in the country. However, this route hasn't seen much success due to the skepticism surrounding the tax risk for depositories whose clients are QFIs.

Question

1. What is the problem in this case? Give suggestions to solve the problem.

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