



FINANCIAL MARKETS
&
INSTITUTIONS

UNIT-I

Financial Markets and Institutions

BASIC CONCEPTS & TERMS

- ❖ **Market** – Place for trading of goods and services.
- ❖ **Financial market** – Markets in which funds are transferred from people who have an excess of available funds to people who have a shortage of funds.
- ❖ **Security** – A claim on the issuer's future income.
- ❖ **Bond** – Debt security that promises to make payments periodically for a specified period.
- ❖ **Interest rate** – Cost of borrowing or the price paid for the rental of funds.
- ❖ **Common stock/ stock** – A share of ownership in a corporation.
- ❖ **Foreign exchange market** – Funds are converted from one currency into another. It determines the foreign exchange rate.
- ❖ **Financial intermediaries** – institutions that borrow funds from people who have saved and make loans to other people.
- ❖ **E-Finance** – Delivering financial services electronically.
- ❖ **Banks** – Financial institutions that accept deposits and make loans.
- ❖ **ESOP** - A trust established by a corporate which acts as a tax-qualified, defined-contribution retirement plan by making the corporation's employees partial owners. contributions are made by the sponsoring employer, and can grow tax-deferred, just as with an IRA or 401(k). But unlike other retirement plans, the contributions must be invested in the company's stock.

- ❖ **Reverse split** - A stock split which reduces the number of outstanding shares and increases the per-share price proportionately. This is usually an attempt by a company to disguise a falling stock price, since the actual market capitalization of the stock does not change at all. For example, if a company declares a one-for-ten reverse split, then a person who previously held 20 shares valued by the market at \$1 each will then have 2 shares worth \$10 each.
- ❖ **Float** - The number of shares of a security that are outstanding and available for trading by the public. The amount of money or time represented by checks that are in transit between deposit and payment, or credit card purchases that are between the purchase and the payment.
- ❖ **GDR** - A negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country. American Depositary Receipts make it easier for individuals to invest in foreign companies, due to the widespread availability of price information, lower transaction costs, and timely dividend distributions. also called European Depositary Receipt.
- ❖ **Double taxation** - Taxation of the same earnings at two levels. One common example is taxation of earnings at the corporate level and then again at the shareholder dividend level. Another example is taxation of foreign investments in the country of origin and then again upon repatriation, although many countries have signed agreements to prevent this latter type of double taxation.
- ❖ **Market maker** - A brokerage or bank that maintains a firm bid and ask price in a given security by standing ready, willing, and able to buy or sell at publicly quoted prices (called making a market). These firms display bid and offer prices for specific numbers of specific securities, and if these prices are met, they will immediately buy for or sell from their own accounts.

CHAPTER-1

INDIAN FINANCIAL SYSTEM

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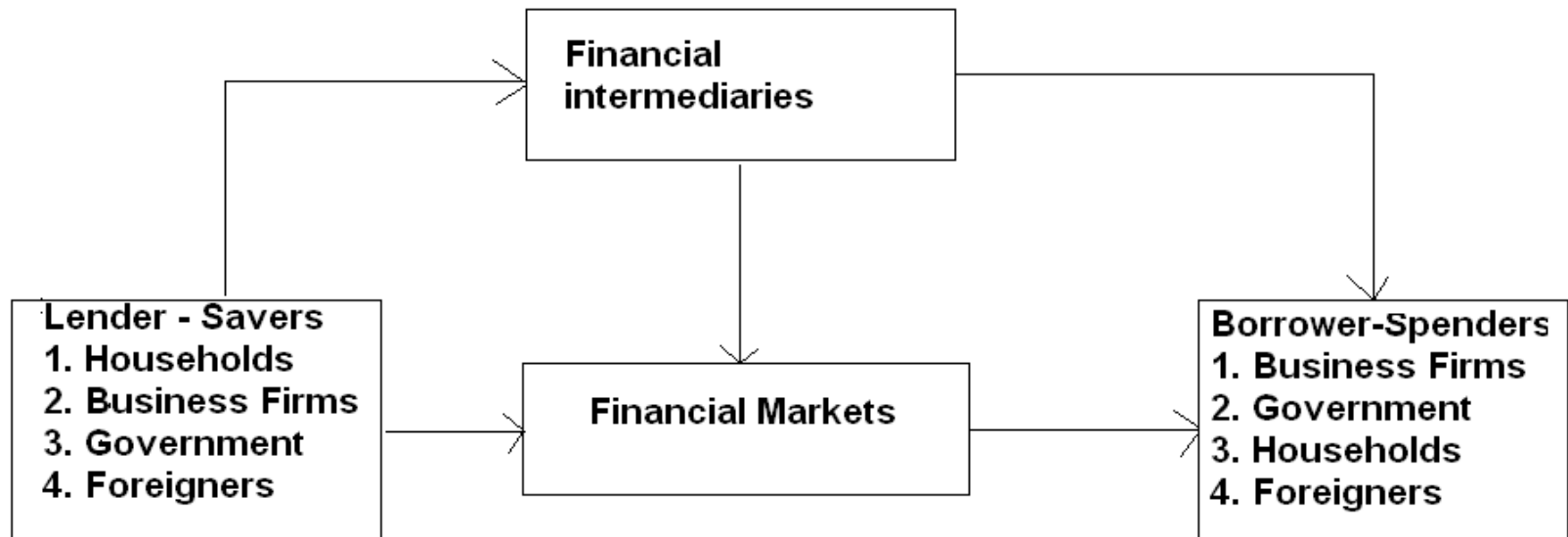
RECENT REFORMS IN THE INDIAN CAPITAL MARKET

Financial System

Financial System of a country consists of a network of an interconnected system of markets, institutions and services.

- This system contributes to the economic development of a country.
- The main function of the financial system are to encourage savings and to transfer them efficiently into investments.
- Various components of financial system are:
 - **Financial Institutions**
 - **Financial Markets**
 - **Financial Instruments**
 - **Financial Services**

Flow of funds in financial system



Functions of a Financial System

Financial System aims at establishing a regular, smooth, efficient and cost effective link between savers and investors.

The financial system performs the following functions:

- ***Efficient transformation of Funds.***
- ***Creating innovative schemes for savings & investments.***



Components of a Financial System

1. Financial Institutions
2. Financial Markets
3. Financial Instruments
4. Financial Services



1. Financial Institutions

Mobilization of savings and transformation of direct claims in indirect are the focus of financial institutions. They can be Classified as

- **Intermediaries**
 - Banks
 - Non Banks
- **Non-intermediaries**
- **Others**



2. Financial Markets: Participants & Instruments

- Financial Markets are an important component
- of financial system in an economy.
- Financial Markets are the centers or arrangements facilitating buying and selling of financial claims, assets, services and securities.
- They aim at establishing a regular, smooth, efficient and cost effective link between savers and investors.
- It may be a specific place or location e.g. stock exchange, or it may be just an over-the-phone market.

Indian Financial Market

Features

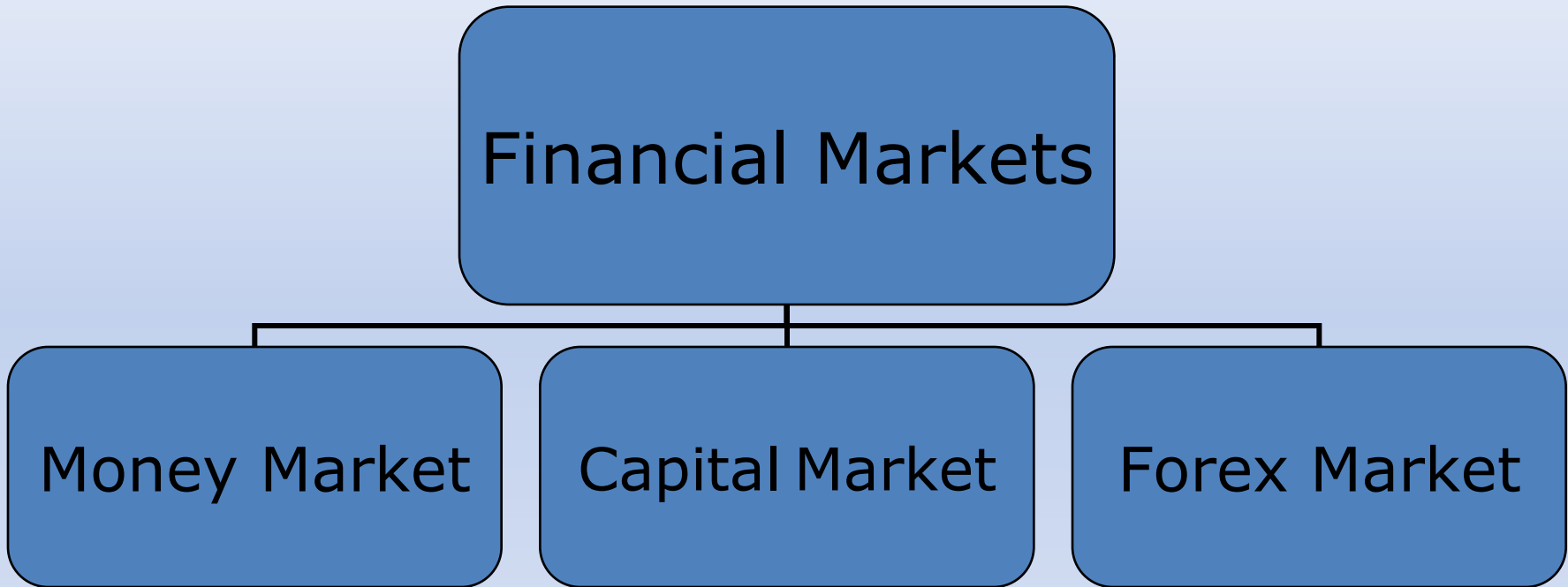
- Real time India Financial Indices – BSE 30 index, Sector Indexes, Stock Quotes, Sensex charts, Bond Prices, Foreign exchange, Rupee and Dollar chart.
- Indian Financial Market News
- Stock news – BSE, BSE 30 closing index, S & P CNX- NIFTY NSE, stock quotes, company information, issue on market capitalization, corporate earning statements, Indian business directory.
- Fixed income : Corporate bond prices, corporate debt details, debt trading activities, interest rates, money market, govt. securities, public sector debt, external debt services.
- Foreign investment : Foreign debt database composed by BIS, IMF, OECD and World Bank, Investments in India and abroad.
- Global Equity Indexes : Dow Jones Global indexes, Morgan Stanley Equity indexes.
- Currency indexes : FX & Gold chart Plotter, J.P. Morgan Currency indexes.
- National and global market relations.

- Mutual Funds
- Insurance
- Loans
- Forex and Bullion

Categorization of Financial Market

- Debt and Equity Market
- Primary and Secondary Market
- Exchanges and Over the Counter Market
- Money and Capital market

Classification of Financial Markets



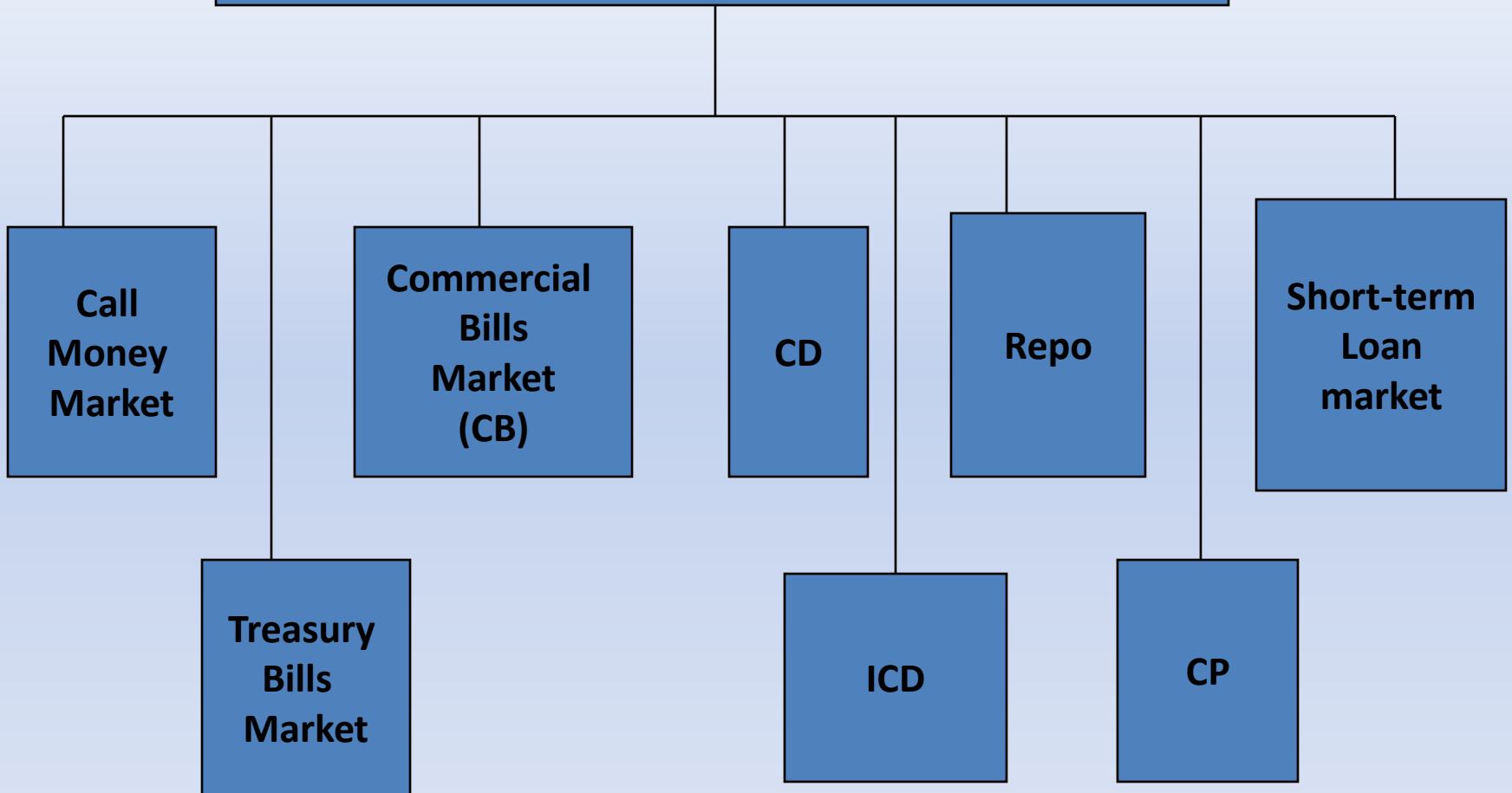
MONEY MARKET

Money market is a specialised market geared to cater to the short term needs. It is a market for short term financial assets which near substitutes for money.

Characteristics

- Over-the-phone market.
- Dealings with or without the help of brokers.
- Short term financial assets that are close substitutes for money.
- Period generally up to one year.
- Financial assets which can be converted into money with ease, speed, without loss and with minimum transactions cost are regarded as close substitutes for money or near-money.
- Consists sub markets such as commercial paper market, treasury bills market, etc.

Types of Money Market



Objectives of money market

- Provides an equilibrating mechanism for evening out short term surpluses and deficits.
- Provides a focal point for central bank intervention for influencing liquidity in the economy.
- Provides reasonable access to users of short term money to meet their requirements at a realistic price.

Prerequisites for an efficient money market

- It should be wide and deep – Large number of participants.
- There should be well diversified mix of money market instruments suited to the requirements of borrowers and lenders.
- Active secondary markets in these instruments.
- Strong central bank for regulation, direction and facilitation is required.
- Well organized commercial banking system.
- Full scope for play of market forces in determining demand and supply of funds and the rate of interest.
- Number of inter related and intra related sub markets like call money market, commercial bill market, etc.
- Competition between each sub-market and between different sub-markets.
- Adequate amount of liquidity in the form of large amounts maturing with in a short period.
- A large demand and supply of funds.

Who Participates in the Money Markets?

TABLE 2 *Money Market Participants*

Participant	Role
U.S. Treasury Department	Sells U.S. Treasury securities to fund the national debt
Federal Reserve System	Buys and sells U.S. Treasury securities as its primary method of controlling the money supply
Commercial banks	Buy U.S. Treasury securities; sell certificates of deposit and make short-term loans; offer individual investors accounts that invest in money market securities
Businesses	Buy and sell various short-term securities as a regular part of their cash management
Investment companies (brokerage firms)	Trade on behalf of commercial accounts
Finance companies (commercial leasing companies)	Lend funds to individuals
Insurance companies (property and casualty insurance companies)	Maintain liquidity needed to meet unexpected demands
Pension funds	Maintain funds in money market instruments in readiness for investment in stocks and bonds
Individuals	Buy money market mutual funds
Money market mutual funds	Allow small investors to participate in the money market by aggregating their funds to invest in large-denomination money market securities

Distinction between Money Market and Capital Market

Money Market

- SHORT DURATION.
- Institutional source of working capital to the industry, financial instruments and other corporate entities.
- Large sized participants.
- Over the phone market.
- Wholesale market.
- Generally on a same day settlement basis.
- Consists of a number of interrelated sub-markets such as call market, treasury bill market, commercial bill market, etc.

Capital Market

- LONGER DURATION
- Financing fixed investments.
- Both large and small sized participants.
- Over the phone, stock exchanges, intermediaries, etc.
- Both whole sale and retail market.
- May involve short term period or long term holding.
- Consists of primary market and secondary market.

Indian Money Market till 1991

- In 1935, RBI was formed.
- Commencement of planning process in 1951.
- Nationalisation of bank in 1969.
- Setting of Sukhmoy Chakraborty committee and Vaghul Working Group in 1982 and 1986 respectively.
- Submission of their report in 1985 and 1987 respectively.
- Setting of Discount and Finance House of India Ltd. (DFHI) in 1988.
- Setting of Securities Trading Corporation of India (STCI) in 1994.
- Commencement of liberalisation and globalisation process in 1991.

Weaknesses of Indian Money Market

- Existence of unorganized Money Market.
- Lack of integration.
- Non-emergence of National Market.
- Disparity in interest rates.
- Limited Bill Market.
- Overall shortage of funds in Money Market.
- Seasonal shortage of funds.
- Interest rate fluctuations.
- Inadequate elasticity and stability.
- Inefficient and inadequate banking facilities.
- Limited supply of short term instruments.
- Limited foreign funds.
- Restricted secondary market.
- Limited number of participants.

Money Market instruments

- Money at call and short notice (Call loans).
- Treasury Bills (TBs) – 14 day TBs (introduced in MAY 1997), 28 day TBs (introduced in October 1997), 91 day TBs, 182 day TBs (auction discounted) and 364 day TBs.
- Bills Rediscounting Scheme (BRS).
- Certificates of Deposits (CDs).
- Commercial Papers (CPs).
- Repurchase Options or Ready Forward (REPOs or RF).
- Inter Bank Participation Certificates (IBPCs) on a risk sharing basis or without risk sharing basis
- Securitized Debts.
- Options.
- Financial Futures.
- Forward Rate Agreements
- Swaps.
- Collateralised Borrowing and Lending Obligations (CBLO).

CAPITAL MARKET

RECENT REFORMS

Capital Market

- Capital Market is generally understood as the market for long term funds.
- However, sometimes the term is used in broad sense to include also the market for short term funds.
- But in most of the cases, the term Capital Market is used to refer to the market for long term loanable funds as distinct from money market.
- Money Market & Capital Market are in fact inter dependent markets

Capital Market: Constituents

- Marketable Securities includes:
 - Government Securities
 - Corporate securities
 - P.S.U. Bonds
 - Mutual Funds
- Non-Marketable securities includes:
 - Bank Deposits
 - Deposit with Companies
 - Loans & advances of Banks and FIs.
 - Post Office Certificates and Deposits

Capital Market: Constitutents

- **New Issues Market Players:
Original**

Promoters & Directors
Associate & Friends
Collaborators
Employees
FIs and Banks
NRIs
Public

- **New Issues Market Players:
For Issues**

Merchant Bankers
Collecting Bankers
Registrars, Brokers
Underwriters
Advertising Agencies
Printers
Solicitors
Sub-Brokers
Sub- Underwriters
Mailing Agents

Capital Market: Constituents

- **Intermediaries are:**

Brokers

Jobbers

Dealers

Badla Financers

Arbitragers

How Trading Mechanisms have changed

- Technology has been a change driver
- Created Virtual market place
- Widened reach
- Increased market efficiencies
- Competitive market structures- ECNs?

Impact of changes

- Reach
 - Geographical
 - Made a distribution framework available
 - Product Diversity
- Efficiencies
 - Better order executions
 - Increased liquidity

Impact of changes(contd.)

- Price transparency
- Cost reduction
- Shorter settlement cycles
- Full line service from order capture to settlement and risk management
- Regulatory issues with each new development

Major Recent Changes

- Rolling settlement
- Derivatives
- Client-level approach

Emerging Trends

- Wider client access to systems
 - Order routing systems
 - Net Trading
 - More access to information
 - Facilitating overseas interest
- Increased emphasis on due risk management
 - Know Your client

Emerging Trends (contd.)

- Services becoming more commoditised
- Need to add value propositions
- Single line of service model to clients right through to Risk Management
- Need to facilitate Technology Leverage by Intermediaries
- Leverage the trading infrastructure

Emerging Trends (contd)

- Customised products and OTC
- Large value investors and OTC
- Standardised products and contracts
- Changing product profile
- Time Horizons changing to span time zones

Emerging Trends (contd.)

- Changing Settlement scenario
- Changing Risk Management scenario
- Straight Through Processing
- Processing oriented to client level
- Interfaces with other settlement Agencies
- Integration emerging across markets

CHAPTER-2

CALL MONEY MARKET

CALL MONEY MARKET

- Call Money Market is the most sensitive segment of financial system. Call money is the money borrowed or lent on demand for a short period.
- Call Money Market is the most visible market as the day-to-day surplus funds, mostly of banks, are traded there.
- Since its inception in 1955-56 it has achieved tremendous growth in the volume of activity.
- Borrowings and lending are for short duration ranging from overnight to a fortnight.
- When money is borrowed or lent for a day, it is known as **Call (Overnight) money**.
- When money is borrowed or lent for more than a day and up to 14 days , it is known as **Notice money**.

Benefits of Call Money Market

1. Commercial banks, primary deposits (PDs) and other authorised institutions are allowed to borrow and lend in call market for adjusting their cash reserve requirement.
2. Banks and other institutions can even out their day to day deficits and surplus of money.
3. Specified FII, Mutual Funds and other specified entities are allowed to operate in Call/ Notice money market as lenders only.
4. Call/ Notice money market is becoming a pure inter-bank market.
5. Both the borrowers and lenders are required to have current accounts with the RBI so that transactions in call market are very speedy and efficient.
6. Interest rates in Call/ Notice money market are fully market determined.
7. Lenders with steady inflow of funds can deploy funds on short-term basis in call market.

Features of Call Money Market

- Part of the national money market.
- Day-to day surplus funds mainly of banks are traded.
- Short term in nature.
- Maturity of these loans vary from 1 to 15 days.
- Lent for 1 day: Call money.
- Lent for more than 1 day but less than 15 days: Notice money.
- Convenient interest rate.
- Highly liquid loan repayable on demand.
- In India, CMM provides facilities for inter-bank lending.
- Surplus suppliers of funds: UTI, SBI, LIC.

Participants in Call Money Market

- Those permitted to operate both as lenders and borrowers:
 - Commercial Banks both Indian & Foreign
 - State Bank of India
 - Co-operative Banks
 - Discount & Finance House of India (DFHI)
 - Securities Trading Corporation of India (STCI)
 - Primary Dealers.
- Those permitted to operate as lenders:
 - LIC
 - UTI
 - GIC
 - IDBI
 - NABARD
 - specified institutions already operating
 - Entities/ corporates/ mutual funds etc.

Location of Call Money Market

- Indian Call Money Market is mainly confined to big industrial and commercial centers like Mumbai, Kolkata, Chennai, Ahemdabad, Delhi and Bangalore.
- The Biggest centre in terms of size and buoyancy of the market are Mumbai and Kolkata.
- Major portion of total transactions take place in Mumbai.

CALL MONEY MARKET IN INDIA

- Commenced in India after the 1st World War.
- Earlier the size was small, few participants from Indian banks and foreign exchange banks. Indian banks started their operations in 1956.
- Market broadened in 1970 as LIC and UTI with huge resources were permitted to operate in call markets.
- In October 1970, State Bank of India (SBI) also entered this market with its subsidiary banks.
- Size of the call market broadened in recent years only.

Working in Call Money Market

- Transactions in this market include:
 - Call loans between banks
 - Borrowings and lending by DFHI & STCI
 - Lending by LIC, UTI, GIC, IDBI, NABARD
 - Call loans to the Bills Market
 - Call loans for dealing in Stock Exchanges and Bullion Market
 - Call loans to the individuals of very high status for trade purposes.
 - Lending by the entities which provide an evidence to RBI that they have bulk lend able resources with no outstanding borrowings.

Working contd.

- Call money market is basically over the telephone market.
- Call money market has small number of large operators. Each operator is financially very sound.
- Despite large volume of transactions, direct deals between lenders & borrowers easily take place.
- Borrowers & lenders contact each other over telephone and arrive at a deal after negotiating the amount of loan and rate of interest.
- After this lender issues RBI cheque in favour of borrowing bank. In return Borrowing Bank issues Call Money Borrowing Receipt.
- On the next day or on the date of reversal of the transaction the lender returns the duly discharged receipt while the borrowing bank repays the amount with interest by issuing RBI cheque.
- Call loans can be renewed with the mutual consent of the borrowers and lenders. Such renewals are at the interest rate mutually agreed. However such renewals are allowed up to a maximum of 14 days from the original transaction after which transaction is to reversed.
- Commercial Banks, primary Dealers and other financial institutions are allowed to operate in this market for adjusting their cash reserve requirement.
- Banks and other institutions can event out their day to day deficits and surpluses of money.
- Call /Notice money market are fully market determined.
- Call /Notice market is becoming a pre inter-bank market.

Volatility in Call Money Market

Reasons:

- Large borrowings by banks on reporting Fridays to meet CRR requirements raise demand for liquid resources and call rates move up.
- When banks extend their credit operations beyond their own resources, they approach call money market for meeting market disequilibrium.
- When institutional lenders are short of liquidity and instead of lending they start selling securities for meeting their loan repayment or maturity of their instruments.
- During the quarter ends when advance tax becomes payable by companies by companies and other institutes, there is a spurt in call rates.
- When stock market is buoyant, call rates goes up and vice versa.
- When subscription to government loans opens, the demand for loans go up and call rates increases. When securities matures and are encashed by the public and private institutions, supply of call loans increases and therefore call rates come down.
- Liquidity crisis also result in soaring call rates.

- The market experiences some regular seasonal changes; it is normally tighter during the busy season (October – April) than during the slack season (May – September). It is much tighter in April.
- By its nature, the call money rate is highly volatile, in 1990-91 was 70 and 85 in 1991-92, 1995-96.

Measures for reducing volatility of Call Rates

- By allowing large number of participants, size of call money market increases, new instruments have been introduced resulting in better competition in the market.
- Setting up of DFHI as market maker and STCI for trading in securities have played an important role in reducing fluctuations in call rates.
- Intervention of RBI in controlling speculation by pumping in money when required daily during recession.
- RBI also provides refinance facility to banks in call market.
- RBI also advises commercial banks against using call loan money in normal banking operations.
- Cash Reserve ratio (CRR) is an important tool with RBI, which has often been used for influencing liquidity in the financial system. If CRR increases credit squeeze and reduces liquidity, thus raising call money rates and vice versa.

CHAPTER-3

TREASURY BILLS MARKET (T-BILLS)

- **Treasury Bills or T-Bills** are the promissory notes or a kind of finance bill issued by the government under discount for a fixed period, not extending beyond one year, with a promise to pay the amount stated therein to the bearer of the instrument.
- Treasury Bills are an important instrument of short term borrowing by the government.
- TBs are the used by the govt. for raising short term funds from institutions or the public for bridging temporary gaps between receipts (both revenue & capital) and expenditure.
- TBs are issued for a minimum of Rs. 25,000 and in multiples thereof.

History of T-Bills

- TBs were first issued by Bank of England.
- In India TBs were first issued in October, 1917 with the twin objectives of raising more resources for the First World War efforts of the Govt. and for mopping up excess liquidity in the economy due to heavy war expenditure.
- Initially TBs were sold by the Govt. by tender for maturities of 3 months, 6 months, 9 months and 12 months.
- Later on, the function of issuing TBs developed on the RBI after it was set up in 1935.
- Sale of TBs to public through auction was suspended in 1965.

Discounting:

When an investor pays less for the security than it will be worth when it matures, and the increase in price provides a return. This is common to short-term securities because they often mature before the issuer can mail out interest checks.

For example:

You pay Rs. 9850 for a 91-day T-bill. It is worth Rs. 10,000 at maturity. What is its annualized yield?

$$i_{yt} = \frac{F - P}{P} \times \frac{365}{n}$$

$$i_{yt} = \frac{\$10,000 - \$9,850}{\$9,850} \times \frac{365}{91} = 0.0611 = 6.11\%$$

Features of T-Bills

- Highly liquid because money can be realised any time by the investor.
- Since TBs are issued by the RBI and on the behalf of the central Government there is absolutely no risk of default.
- Ready Availability : on any day, commercial bank or other institutions can invest their temporary surpluses in TBs.
- The transaction cost is mainly equal to the difference between buying and selling rates of DFHI.
- Discount rate of TBs does not fluctuate much. During 1995-96 and the first half of 1996-97, the yield of TBs remained at around 12-13 percent.
- For measuring Statutory Lending Ratio (SLR) of commercial banks. These are an eligible security.
- Value of a financial instrument depends on its liquidity, safety and yield. TBs are not only highly liquid and highly safe, but the yield on TBs also varies within a very narrow range. As a result, there is very little scope of capital depreciation in case of TBs.

Participants of TB Market

The main participants in 14-day, 28-day, 91-day, and 364-day are:

- The Reserve Bank of India.
- The State Bank of India.
- Commercial Banks.
- State Governments and other approved bodies.
- Discount and Finance House of India (DFHI).
- The Securities Trading Corporation of India (STCI).
- Other Financial institutions such as LIC, UTI, GIC, NABARD, IDBI, IFCI and ICICI, etc.
- Corporate entities.
- General public.
- Foreign Institutional Investors (FIIs) from April 29, 1998.

Types of Treasury Bills

1. Ordinary T- Bills:

These are issued to public, banks and other institutions for enabling the central bank to raise resources for its short term financial needs.

2. Ad Hoc T-Bills:

These are issued in favour of RBI only. These are not sold through tenders or auctions. The RBI is authorized to issue currency notes against it. These are not marketable in India but the investor can sell them back to RBI.

The purpose behind it is:

- Replenish cash balance of the Central Government.
- Provide an investment outlet for the state government, semi government departments and foreign central bank.
- Discount Rate Fluctuations caused by state government intervention are avoided.

Periodicity of T-Bills

- Initially towards First World War, T-Bills of 3,6,9 and 12 months.
- After the commencement of RBI in 1935, 2 types of Bills were there:- TAP Bills and Intermediate bills, both of 91 days maturity.
- In Nov. 1986, Chakraborty Committee recommended 182 days T-Bills because 91 days T-Bills failed to yield.
- In May 1997, RBI introduced 14 days T-Bills.
- On Oct. 21, 1997, 28 days T-Bills were introduced.
- During 1996-97, RBI discounted 91 days Ad Hoc T-Bills issued on the behalf of RBI.
- 14, 91, 182 and 364 days T- Bills are issued on weekly and fortnightly auction basis; 182 T-Bills on Wednesday preceding non-reporting Friday and 364 on Wednesday preceding reporting Friday.
- From April 1, 1998, all T-bills are issued on a fixed notified amount by RBI.

Procedure of issuing T-Bills

- RBI issues 91 days T-Bills on tap basis throughout the week. All the other T-Bills are auctioned on fortnightly basis.
- RBI notifies it with the help of Press Releases in newspapers mentioning the date of auction and the last date of submission of tenders.
- Investors are permitted to submit more than one bid through separate tenders.
- Within 24 hrs. of announcement, the successful bidders are expected to collect letter of acceptance from RBI and deposit back with a cheque on RBI.
- Commercial Banks can also deals on the behalf of investor clients.
- Purchases and sales of TBs take place through the Subsidiary General Ledger (SGL) Account maintained by RBI for investors like Commercial Banks, DFHI, STCI and other financial institutions. Investors who do not enjoy SGL account facility, buy and sell TBs through DFHI.
- Purchaser of TB from DFHI tenders at the DFHI counters, a cheque is drawn on RBI for the purchase price. In return, he collects a duly signed “SGL Transfer Form” from DFHI.

- In case of sale to DFHI, the seller tenders at DFHI counter a duly completed and signed 'SGL Transfer Form' as transferor. In return, he collects from DFHI a cheque drawn on RBI.

Yield on T- Bill or T-Bill Rates

It is the rate of discount at which T-Bills are sold by the RBI. Because of high liquidity and high safety, treasury bill rate is generally the lowest rate of interest in the entire interest rate structure in the country. The effective yield depends on:

- The rate of discount.
- Difference between the price at which they are sold and their redemption value
- Time period of maturity.

Importance of T-Bills

Importance to the Issuer / Government

- For raising short – term funds for meeting temporary budget deficits.
- Govt. can mop up excess liquidity in the economy through issue of TBs.
- Its issuance cannot be monetised and their issue does not lead to inflationary pressure.

Importance to the Purchaser / Investor

- Liquidity at short notice because DFHI offers daily two–way quotes, they can be discounted from RBI.
- Investments are kept in non-earning cash to the minimum and supplementing it with TBs which earn a return.
- Eligible securities for determining statutory liquidity requirement (SLR) of banks. Most investments in TBs is by commercial banks.
- Instrument of meeting mismatch between realisation of assets and payments on account of liabilities.
- Provides complete safety regarding the payment of interest and the repayment of principal.

- TBs are available on tap basis as well as fortnightly auctions, they facilitate proper spread of asset mix with different maturities.
- A hedge against volatility of call loan market and interest rate fluctuations.
- The yield on 364-day TBs is a benchmark for several floating rate bond issues that have been made by various public sector undertakings.

CHAPTER-4

COMMERCIAL BILLS MARKET (C.B. MARKET)

A **bills of exchange** is a written instrument containing an unconditional order, signed by the maker (called drawer), directing a certain person (called drawee) to pay a certain sum of money specified in the instrument, only to, or to the order of, a certain person (called payee), or to the bearer of the instrument on demand or at the expiry of the specified period. It is a negotiable instrument. Its liquidity is next to cash, call loans and treasury bills.

Characteristics of Bills of Exchange:-

- Large number of transactions supported by genuine trade bills.
- Well established and well spread market.
- Both borrowers and lenders must subject them to strict financial disciplines.
- Commercial banks may use Bills of exchange for providing credit to their customers.
- Market has abundant facilities for rediscounting the bills.
- Bills are discounted and rediscounted a large number of times.
- Central bank should be ready to rediscount the bill throughout the year.
- Intermediaries to operate with a fine margin and help in smooth functioning of bills market.
- Efficient credit investigating agencies to investigate the creditworthiness of various parties.

Types of Bills of Exchange

1. **Demand Bill or Sight Bills** – These are the bills which are immediately payable on presentation to the drawee.
2. **Usance bill or time bill** – Bills payable on the date specified on the bill or immediately after the expiry of time period mentioned on the bills.
3. **Clean Bills** – In case documents accompanying the bill are to be delivered against acceptance of the bill by the drawee, it is a clean bill.
4. **Documentary Bill** – Bills accompanied by documents of the title of the bill such as railway receipt, bill of lading, etc.
5. **Inland Bills** – These bills are drawn or made in India and are payable in India and drawn on any person who is resident in India.
6. **Foreign Bills** – It includes bills drawn outside India and payable in India by a party outside India, drawn outside India and payable outside India by a resident or non resident of India and bill drawn in India but made payable outside India.
7. **Export Bill** – Bills drawn by exporters on a party outside India.

8. **Import Bill** – Bills drawn on importers in India by the exporters outside India.
9. **Hundis** – Indigenous bills of exchange and promissory notes for financing agriculture and inland trade.
10. **Genuine Trade Bill** – Bills of exchange by genuine trade or commercial transactions of purchase and sale.
11. **Accommodation Bills or Kite Bills or Wind Bills** – Bills created by borrowers or lenders simply to help each other, without any trading transactions backing the bills.
12. **Supply Bills** – a bill drawn by a supplier or a contractor on the government or semi government departments for the supplies made to such departments.

Process of Bill writing and Discounting

- A genuine trade bill comes into existence when a seller sells goods to buyer.
- The seller needs money on completion of the sale and buyer would like to pay out of the earnings of his purchase.
- To satisfy the requirement of both parties, the seller draws a bill of agreed maturity on buyer who accepts the bill, thus acknowledging his liability to pay on due date.
- The buyer can take the accepted bill to the bank for discounting within his sanctioned limit, or to an NBFC for outside consortium discounting and receives ready cash in return.
- The difference between bill value of the sale transaction and the amount received by seller is known as discount charge which is calculated at a rate percent per annum on the maturity value.

Importance of Commercial Bill Market

- Bill financing is the prevalent method of meeting credit needs of trade and industry.
- These are self liquidating in character because they have a fixed tenure.
- These have high level of liquidity – next only to cash, call loans and treasury bills
- It imposes financial discipline on borrowers as its payment must be made on the due date of the bill.
- Banks can meet their short term liquidity requirements by rediscounting these bills.
- Existence of bill market enables banks and other institutions to invest their surplus funds profitably by selecting appropriate maturities.
- Imparts flexibility to money market by evening out liquidity with bankers.

Yield in Commercial Bills Market

$$\text{Actual Yield} = [(1 + R/100 * P)^P - 1] * 100$$

R = Rate of Discount per annum

P = Period of compounding in one year, e.g. if it is a 3 months bill, then period of compounding is 12 months/3 months = 4

For example, if it is 3 months bill and the discount rate is 15.5% then the yield will be

$$\begin{aligned}\text{Yield} &= [(1 + 15.5/100 * 12/3)^{12/3} - 1] * 100 \\ &= [(1.03875)^4 - 1] * 100 \\ &= (1.1642442 - 1) * 100 \\ &= 16.42442 \%\end{aligned}$$

Bills Rediscounting Scheme (BRS)

In 1968, the Dahejia Committee reiterated that commercial banks, industry and trade should develop the practice of issuing usance bills which should have discounting facilities. In Nov., 1970, the RBI, on recommendation of Narasimhan Committee, introduced the Bills Rediscounting Scheme (BRS) which is also known as New Bills Market Scheme (NBMS). It continues till now. In the beginning, at the time of rediscounting of bills, the banks are required to lodge all such bills with RBI. To minimize these difficulties, the RBI has dispensed with the requirement of lodgment of eligible bills up to the face value of Rs. 10 lakh. RBI has now permitted banks to issue derivative usance promissory notes on the strength of underlying bills.

Objectives of BRS

Objectives :

1. Creation of an instrument of credit linked with the genuine transactions of purchase and sale.
2. Creation of money market instrument for evening out liquidity in the banking system.
3. Developing a subsidiary market in commercial bills and making the money market more deep and wide.
4. Creation of an instrument which banks could get rediscounted with other financial institutions.
5. Creation of an instrument of credit which encourages a more disciplined use of bank credit than that practiced under usual cash credit and book debt loan.

Bills eligible for rediscount

All scheduled commercial banks are eligible to rediscount the eligible bills with the RBI and other approved institutions. Rediscounting can be done with the help of following conditions:

- Genuine trade bill i.e. it should arise out of a genuine transaction of purchase and sale.
- The nature of transaction and the particulars of the documents of title of goods relating to the transaction should be indicated on the face of the bill.
- Bill has to be drawn on, and accepted by, the purchaser's licensed scheduled bank.
- In case the purchaser's bank is not a licensed scheduled bank, the bill has to, in addition, bear an endorsement of a licensed scheduled bank.
- Joint bills i.e. the bills drawn on the buyer and his bank jointly, and bills jointly accepted, are also eligible for rediscounting.

- Eligible bill should have usance of not more than 90 days. In exceptional cases, where the bills has usance upto 120 days, it can be rediscounted only if the remaining maturity period does not exceed 90 days at the time of its presentation for rediscounting.
- Multani and accommodation bills are not eligible for rediscounting.
- Banks enjoy refinance facilities against commercial bills throughout the year.
- The bill should have atleast two good signatures, one of which has to be of a licensed scheduled bank.
- Bills arising out of sale of commodities covered by the RBI under selective credit controls, are not eligible for rediscounting.
- Bills drawn by textile mills, and traders and dealers in textiles are eligible for rediscount provided usance of the bill does not exceed 60 days.

Reasons of slow success of NBMS/ BRS

- Reluctance by businessman in India due to disciplined payment on maturity date.
- Several monopolists regard it against their prestige to accept bills.
- NBMS had limited coverage as sensitive commodities are excluded out of it by RBI.
- Credit rating agencies were non-existing before the set up of CRISIL and ICRA.
- Stamp duty on bills and non-availability of stamp papers. Later stamp duty was removed.
- Essential condition of clearance of bills is not easy for small businessmen.
- Very poor response of public sector undertakings to NBMS.
- Supplies to government departments were not initially covered, though the coverage of NBMS was extended to them in 1971.
- Commercial banks generally did not rediscount the bills but directly reach RBI whenever there was urgent need of funds and/or bill rediscounting proved cheaper than call loans.

Rediscounting procedure by banks

- Commercial banks are allowed to draw derivative usance promissory notes for maturities upto 90 days on the strength of commercial bills discounted by their branches.
- In case of original discounting, the discounter bank issues a derivative promissory note in the favor of approved institutions.
- The discounting bank holds the bill till the date of maturity.
- As the bill matures, the drawer bank should ensure that these bills get deleted from the cover and are replaced by fresh eligible bills.
- The discounting bank maintains a register containing true and complete details of usance bills held in support of derivative promissory notes.

Types of Bill market rates

1. **Bazar Bill rate** : the rate at which shroffs and other money lenders used to discount bills of small traders.
2. **SBI hundi rate** : SBI used to discount hundis to indigenous bankers.
3. **Commercial banks bill finance rate** : rate at which commercial banks can get bills discounted from each other.
4. **SBI discount rate** : At this rate SBI discounts first class usance bills.
5. **Bank rate** : The rate at which the RBI rediscounts eligible bills from commercial banks.
6. **DFHI rate** : the rate at which the DFHI buys and sells eligible bills from commercial banks and other approved institutions. DFHI quotes both for buying and selling rates.

Computation of yield

$$\text{Actual Yield} = [(1 + R/100 * P)^P - 1] * 100$$

R = Rate of discount per annum

P = Period of compounding in one year, e.g. if it is a 3 months bill, then period of compounding in 12 months / 3 months = 4 or 365 / no. of days

For example, if it is a 3 months bill and the discount rate is 15.5 % then yield will be:

$$\begin{aligned} \text{Yield} &= [(1 + 15.5/100 * 12/3)^{12/3} - 1] * 100 \\ &= [(1.03875)^4 - 1] * 100 \\ &= 16.4244 \% \end{aligned}$$

CHAPTER-5

CERTIFICATE OF DEPOSITS (CD)

Certificates of Deposits (CD)

A CD is a negotiable promissory note, secure and short term (up to a year) in nature. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor. It is a receipt given to the depositor by a bank or any other institution entitled to issue CD for funds deposited with it. (DEFINITION)

CDs are issued by Banks, when the deposit growth is sluggish and credit demand is high and a tightening trend in call rate is evident. CDs are generally considered high cost liabilities and banks have recourse to them only under tight liquidity conditions.

- CDs are unsecured, negotiable, short term instruments in bearer form, issued by commercial banks and developmental financial institutions.
- CDs were introduced in June 1989.
- Only scheduled commercial banks excluding RRBs and local area banks were allowed to issue them initially.
- FIs were permitted to issue CDs within umbrella limit fixed by RBI in 1992.
- CDs are time deposits of specific maturity similar to fixed deposits.
- The biggest difference is that CDs are in the bearer form, transferable and tradable while FDs are not.
- CDs are issued by banks during tight liquidity periods, at relatively high interest rates.
- CDs are issued at discount to face value.

Features of CDs

- CDs can be issued to individuals, corporations, companies, trusts, funds, associates, etc.
- NRIs can subscribe to CDs on non-repatriable basis.
- CDs attract stamp duty as applicable to negotiable instruments.
- Banks have to maintain SLR and CRR on the issue price of CDs. No ceiling on the amount to be issued.
- The minimum issue size of CDs is Rs.5 lakhs and multiples thereof.
- CDs are transferable by endorsement and delivery.
- The minimum lock-in-period for CDs is 15 days.

Guidelines issued by Reserve Bank of India

1. These can be issued by scheduled commercial banks and specified All – India Financial Institutions, namely, IDBI, ICICI, IFCI, SIDBI, IRDA, etc.
2. It can be issued to individuals, associations, companies, corporations, trust funds, etc.
3. These attract stamp duty as applicable to negotiable instruments.
4. Banks have to maintain SLR and CRR on issue price of CDs. There is no ceiling on the amount of CDs to be issued.
5. The minimum amount for which a CD was permitted to be issued was also reduced from Rs. 25 lakhs to Rs. 5 lakhs.
6. These can be now transferred to any time after issue, following the prescribed rules.
7. On October 21, 1997, the minimum size of issue of CDs to a single investor was reduced from Rs. 10 lakhs to Rs. 5 lakhs. CDs above Rs. 5 lakhs can be issued in multiples of Rs. 1 lakh.
8. Initially, the maximum amount for which a bank was permitted to issue a CD was fixed at 1% for its fortnightly aggregate average deposits. This limit was raised to 10% in 1992 and was subsequently abolished.

Yield on Commercial Deposits

$$ER = [(1 + QD / 100 * n)^n - 1] * 100$$

ER = Effective rate of interest

QD = Quoted discount rate

n = Maturity period expressed as number of months in a year divided by maturity period in months, e.g. $12/3 = 4$ months.

In case, CDs are issued on rear – end discount, then the effective Rate of interest is:

$$DP = [12 * 100 / (12 * 100 + R * n)] * F$$

DP = Discount price of CDs.

R = Quoted rate of discount

n = maturity period of CD expressed in months or days.

F = Face value of CD

CHAPTER-6

COMMERCIAL PAPER

(CP)

CP-Introduction

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. These are debt instruments issued by corporate for raising short-term resources from the money market. CP was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

Features of CP

- CP can be issued for maturities between a minimum of 15 days and a maximum upto one year from the date of issue. If the maturity date is a holiday, the company would be liable to make payment on the immediate preceding working day.
- CP can be issued only in a dematerialised form through any of the depositories approved by and registered with SEBI. CP can be held only in dematerialised form.
- CP will be issued at a discount to face value as may be determined by the issuer.
- Banks and All-India financial institutions are prohibited from underwriting or co-accepting issues of Commercial Paper.
- On maturity of CP, the holder of the CP will have to get it redeemed through the depository and receive payment from the IPA.
- CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). However, investment by FIIs would be within the 30 per cent limit set for their investments in debt instruments.

Participants of Commercial Paper Market

Participants in Issue of commercial paper

- **Highly rated corporate borrowers, primary dealers (PDs) and satellite dealers (SDs) and all-India financial institutions (FIs)** which have been permitted to raise resources through money market instruments under the umbrella limit fixed by Reserve Bank of India are eligible to issue CP.
- 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 Rs. 4 crore; (b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s.
- CP may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). However, investment by FIIs would be within the 30 per cent limit set for their investments in debt instruments.

Rating and issue requirement

- All eligible participants should obtain the credit rating for issuance of Commercial Paper, from either the Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the Duff & Phelps Credit Rating India Pvt. Ltd. (DCR India) or such other credit rating agency as may be specified by the Reserve Bank of India from time to time, for the purpose. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies. Further, the participants shall ensure at the time of issuance of CP that the rating so obtained is current and has not fallen due for review.
- CP can be issued in denominations of Rs.5 lakh or multiples thereof.

CHAPTER-7

CAPITAL MARKET & ROLE OF SEBI

Structure of capital market



New issue market

It comprises of all individuals, institutions, methods/ practices, services and practices involved in raising fresh capital for both new and existing companies.

Primary market

- Market for new securities
- No fixed geographical location
- Results in raising fresh resources for the corporate sector
- All companies enter through primary market
- No tangible form or administrative set-up. Recognized only by services rendered
- Subjected to outside control by SEBI, stock exchanges and the Companies Act

Secondary market

- Market for existing securities
- Located at a fixed place
- Facilitates transfer of securities from one corporate investor to another
- Securities of only listed companies can trade.
- Has a definite administrative set-up and a tangible form.
- Subjected to control both from within and outside.

Relationship between NIM and stock market

1. Securities are first pass through primary market and only thereafter traded at stock exchange.
2. While issuing prospectus for fresh issue of capital, the companies stipulate in the prospectus that application has been made or will be made in the due course for listing of shares with the stock exchanges.
3. Stock exchanges exercise significant control over regulation of new issue market as a precondition for listing of shares.
4. Stock exchanges provide liquidity to the shares traded through new issue market and thus helps in expanding NIM.
5. A period of rising activities in stock exchanges is accompanied with higher activity in NIM resulting in large number of successful issues and vice versa.
6. In a period of rising prices in stock exchanges, premiums are high in NIM and over subscription becomes a common phenomenon.

TYPES OF ISSUES

1. INITIAL ISSUES/ INITIAL PUBLIC OFFER (IPO).
2. FURTHER ISSUES.

Functions of NIM

- Facilitates transfer of resources from savers to entrepreneurs establishing new companies.
- Helps raising resources for expansion and/ or diversification of activities of existing companies.
- Helps selling existing enterprises to the public as going concerns through conversion of existing proprietorship/ partnership/ private limited concerns into public limited companies.
- Provides origination, underwriting and distribution of securities.

Issue mechanism

1. Public issue through prospectus.
2. Through offer for sale (through intermediaries)
3. Through placement of securities-private placement and stock exchange placing (investor client relationship).
4. Rights issue
5. Issue of bonus shares
6. Book building (Bidding process).
7. Stock option.

Secondary market/ stock exchange

Stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

Stock Broker : these are the members of recognised stock exchanges who buy, sell or otherwise deal in securities.

Sub-broker : He is not the member of stock exchange but act as an agent of stock broker or otherwise assist the investor in buying, selling, or dealing in securities through such stock broker

Role of SEBI (established on April 12,1988)

1. Regulating the business in stock exchanges and any other securities market.
2. Registering and regulating the working of stock brokers, sub brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and other intermediaries.
3. Registering and regulating the working of collective investment schemes including mutual funds.
4. Promoting and regulating self regulatory organizations.
5. Prohibiting fraudulent and unfair trade practices relating to securities market.
6. Promoting investor's education and training of intermediaries of securities market.
7. Prohibiting insider trading in securities.
8. Regulating substantial acquisition of shares and takeovers of companies.
9. Levying fees or other charges for carrying out the above purposes.
10. Conducting research for the above purposes.

CHAPTER-8

**SECURITIES & EXCHANGE BOARD OF
INDIA
(SEBI)**

SECURITIES & EXCHANGE BOARD OF INDIA



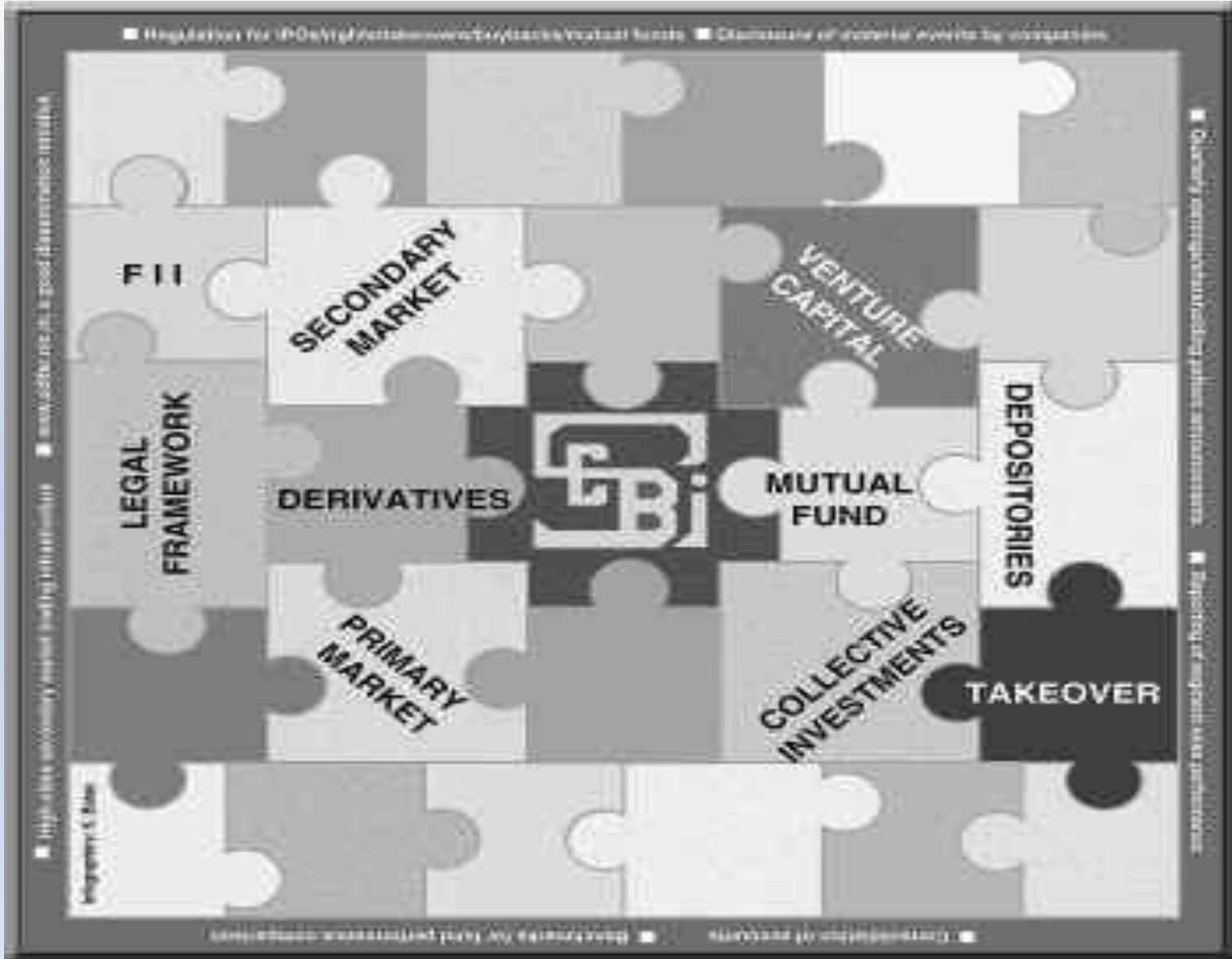
Why do we need a regulatory body for Investor protection in India?

- India is an 'informationally' weak market
- Boosting capital market demands restoring the confidence of lay investors who have been beaten down by repeated scams
- Progressively softening interest rates and an under performing economy have eroded investment options, and require enhanced investing skills.

MISSION OF SEBI

- **Securities & Exchange Board of India (SEBI)** formed under the SEBI Act, 1992 with the prime objective of
 - Protecting the interests of investors in securities,
 - Promoting the development of, and
 - Regulating, the securities market and for matters connected therewith or incidental thereto.’

Focus being the greater investor protection, SEBI has become a vigilant watchdog



FUNCTIONS OF SEBI

- Section 11 of the Securities and Exchange Board of India Act.
- **Regulation Of Business In The Stock Exchanges**
 - A) **review of the market operations, organizational structure and administrative control of the exchange**
 - All stock exchanges are required to be **Body Corporates**
 - The exchange provides a fair, equitable and growing market to investors.
 - The exchange's organisation, systems and practices are in accordance with the Securities Contracts (Regulation) Act (SC(R) Act), 1956

B) Registration And Regulation Of The Working Of Intermediaries

Primary Market	Secondary Market
Merchant Bankers	Stock brokers
Underwriters	Sub- Brokers
Portfolio Managers	

- regulates the working of the depositories [participants], custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries .

C) **Registration And Regulation Of Mutual Funds, Venture Capital Funds & Collective Investment Schemes**

- ✍ AMFI-Self Regulatory Organization-'promoting and protecting the interest of mutual funds and their unit-holders, increasing public awareness of mutual funds, and serving the investors' interest by defining and maintaining high ethical and professional standards in the mutual funds industry'.
- ✍ Every mutual fund must be registered with SEBI and registration is granted only where SEBI is satisfied with the background of the fund.
- ✍ SEBI has the authority to inspect the books of accounts, records and documents of a mutual fund, its trustees, AMC and custodian where it deems it necessary

- SEBI (Mutual Funds) Regulations, 1996 lays down the provisions for the appointment of the trustees and their obligations
- Every new scheme launched by a mutual fund needs to be filed with SEBI and SEBI reviews the document in regard to the disclosures contained in such documents.
- Regulations have been laid down regarding listing of funds, refund procedures, transfer procedures, disclosures, guaranteeing returns etc
- SEBI has also laid down advertisement code to be followed by a mutual fund in making any publicity regarding a scheme and its performance
- SEBI has prescribed norms / restrictions for investment management with a view to minimize / reduce undue investment risks.
- SEBI also has the authority to initiate penal actions against an erring MF.
- In case of a change in the controlling interest of an asset management company, investors should be given at least 30 days time to exercise their exit option.

D) Promoting & Regulating Self Regulatory Organizations

- In order for the SRO to effectively execute its responsibilities, it would be required to be structured, organized, managed and controlled such that it retains its independence, while continuing to perform a genuine market development role

E) Prohibiting Fraudulent And Unfair Trade Practices In The Securities Market

- SEBI is vested with powers to take action against these practices relating to securities market manipulation and misleading statements to induce sale/purchase of securities.

F] Prohibition Of Insider Trading

- **Stock Watch System, which has been put in place, surveillance over insider trading would be further strengthened.**

G] Investor Education And The Training Of Intermediaries

- SEBI distributed the booklet titled “A Quick Reference Guide for Investors” to the investors
- SEBI also issued a series of advertisement /public notices in national as well as regional newspapers to educate and caution the investors about the risks associated with the investments in collective investment schemes
- SEBI has also issued messages in the interest of investors on National Channel and Regional Stations on Doordarshan.

- H) Inspection And Inquiries**
- I) Regulating Substantial Acquisition Of Shares And Take-overs**
- J) Performing Such Functions And Exercising Such Powers Under The Provisions Of The Securities Contracts (Regulation) Act, 1956 As May Be Delegated To It By The Central Government;**
- K) Levying Fees Or Other Charges For Carrying Out The Purposes Of This Section**
- L) Conducting Research For The Above Purposes**

VETTING BY SEBI

- A company cannot come out with public issue unless **Draft Prospectus** is filed with SEBI. Prospectus is a document by way of which the investor gets all the information pertaining to the company in which they are going to invest. It gives the detailed information about the Company, Promoter / Directors, group companies, Capital Structure, Terms of the present issue etc.
- A company cannot file prospectus directly with SEBI. It has to be filed through a merchant banker. After the preparation of prospectus, the merchant banker along with the due diligence certificates and other compliances and sends the same to SEBI for Vetting.
- SEBI on receiving the same scrutinizes it and may suggest changes within 21 days of receipt of prospectus
- The company can come out with a public issue any time within 180 days from the date of the letter from SEBI or if no letter is received from SEBI, within 180 days from the date of expiry of 21 days of submission of prospectus with SEBI
- If the issue size is upto Rs. 20 crores then the merchant bankers are required to file prospectus with the regional office of SEBI falling under the jurisdiction in which registered office of the company is situated.
- ? If the issue size is more than Rs. 20 crores, merchant bankers are required to file prospectus at SEBI, Mumbai office.

Search And Seizure

- To impose penalties of up to Rs 25 crore or three times the amount involved in the violation of a norm, whichever is higher.
- In the cases of some offences, including defaults by brokers, a failure to furnish returns and information by corporates and brokers and other lapses, the market regulator can impose a higher penalty of Rs 1 lakhs a day or a maximum fine of Rs 1 crore, whichever is lower.
- At present, the offences carry penalties ranging between Rs 5,000 and Rs 5 lakhs.

Corporate Governance

The listing requirements, are ensured in two ways.

- Corporates are expected to submit compliance reports as per clause 49 of the listing agreement
- They are also required to provide details of the same in their annual reports.

Delisting

- The exit price to be determined in accordance with the book building process (known as reverse book building) through an electronically-linked transparent facility.
- The offer price shall have a floor price, which will be the average of 26 weeks traded price preceding the date of the public announcement. The final offer price shall be determined as the price at which maximum number of shares has been offered.
- After the final price is determined based on the book-building process, the promoter or the acquirer will have to make a public announcement of the final price and communicate to the exchanges from which the delisting is sought to be made within two working days.
- Further, the number of bidding centres shall not be less than 30, including all the stock exchange centres, which should have at least one electronically-linked computer terminal each.
- In case the promoter does not accept the above price, he should not make an application to the exchange for delisting of the securities, as per the guidelines. Instead, he shall ensure that the public shareholding is brought up to the minimum limits specified under the listing conditions within six months.
- Strict norms for compulsory delisting by stock exchanges

Public Issues

An unlisted company has to satisfy the following criteria to be eligible to make a public issue :-

- Pre-issue networth of the co. should not be less than Rs.1 crore in last 3 out of last 5 years with minimum networth to be met during immediately preceding 2 years
- Track record of distributable profits for at least three (3) out of immediately preceding five (5) years
- 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 networth.
- In case an unlisted company does not satisfy any of the above criterions, 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 (50%) of the issue size to the Qualified Institutional Buyers (QIB's), failing which the full subscription monies shall be refunded.

Initial Public Offer (IPO)

- In case of an Initial Public Offer (IPO) i.e. public issue by unlisted company, the promoters have to necessarily offer at least 20% of the post issue capital.
- In case of public issues by listed companies, the promoters shall participate either to the extent of 20% of the proposed issue or ensure post-issue share holding to the extent of 20% of the post-issue capital.
- In case of any issue of capital to the public the minimum contribution of promoters shall be locked in for a period of 3 years, both for an IPO and Public Issue by listed companies.
- In case of an IPO, if the promoters' contribution in the proposed issue exceeds the required minimum contribution, such excess contribution shall also be locked in for a period of one year.
- In case of a public issue by a listed company, participation by promoters in the proposed public issue in excess of the required minimum percentage shall also be locked-in for a period of one year as per the lock-in provisions as specified in Guidelines on Preferential issue.

Initial Public Offer

- paid up share capital prior to IPO and shares issued on a firm allotment basis along with issue shall be locked-in for a period of one year from the date of allotment in public issue.
- In case of over-subscription in a fixed price issue the allotment is done in marketable lots, on a proportionate basis
- In case of a book building issue, allotment to Qualified Institutional Buyers and Non-Institutional buyers are done on a discretionary basis. Allotment to retail investors is done on a proportionate basis
- all steps for completion of the necessary formalities for listing and commencement of trading at all stock exchanges where the securities are to be listed are taken within 7 working days of finalization of basis of allotment.

RECOMMENDATIONS ON CORPORATE GOVERNANCE

- If an institution wishes to appoint a director on the board of a company, it should be approved by the shareholders of the company. Such a person is not to be considered an independent director.
- An institutional director, so appointed, shall have the same responsibilities and shall be subject to the same liabilities as any other director.
- companies should lay down a code of conduct for all the board members and the senior management of company.
- Mandatory review by audit committees of listed companies
- Companies raising money through a public issue should disclose to the audit committee, the uses and applications of funds by major category on a quarterly basis.

Evaluation Of SEBI' s Performance

Enhancing disclosures

- In most case only the minimum information required under the Companies Act is made available
- The manner in which the swap ratio is fixed and what the management thinks of the same is largely taken for granted.
- valuation reports are made available for inspection, but access is not easy for all investors.

Inability To Utilize The Existing Powers Effectively

- SEBI could initiate prosecution proceedings on insider trading only in one case and seven cases on fraudulent and unfair practices.
- Only in seven of the 181 cases, SEBI resorted to cancellation of registration during the last four years.
- Though SEBI has the power to impose a penalty of Rs 1.50 lakhs every time a person fails to furnish the requisite information, but rarely has this power has been exercised by it .
- The provision for mandatory punishment of imprisonment in addition to award for penalty has scarcely has been used.

Quality Of Decisions

- What is worrying is the poor rate of conviction in major cases. Virtually every SEBI decision involving major cases — such as Sterlite, BPL, Videocon, Anand Rathi and Associates and Hindustan Lever — has been overturned by the appeals process (or the Securities Appellate Tribunal).

Accounting, audit quality

- The plethora of inter-corporate investments, intra-company and intra-group transactions, guarantees and contingent liabilities are areas where there is room for considerable concern.

Price Manipulation — No Dent:

- Price manipulation, informed trading and insider trading with key operators/investors is now routine. This is an area that is difficult to tackle for any regulator. But over the last ten years, SEBI has taken action on such price manipulation in just two cases (Bayer ABS and Amara Raja Batteries). Here, too, the penal action has hardly been stringent.

Enticing ads and investor risk

- Advertisement sans indication of performance by mutual funds has continued regardless of the SEBI guidelines on this.
- The Securities and Exchange Board of India (Sebi) is being blamed for lack of alertness and poor risk-management measures with regard to the automated lending and borrowing mechanism.

Failures

The shortcomings

- **No dent on price manipulation**
- **Poor rate of conviction and very few cases of exemplary penal action**
- **No due process for framing/changing regulations**
- **Waking up to trouble spots too late in the day**
- **Turning a blind eye in bullish markets**
- **Implementation of existing disclosure norms inadequate**
- **No warnings on US-64, MIPs, collective investment & finance schemes**
- **Regulatory bias towards corporate sector and large investors**
- **Indications of extraneous pressures, including government**
- **No disclosure norms for mergers/demergers/asset sell-offs/inter-corporate transactions**

Change In the Market

- The complete transformation of the trading, clearing and settlement infrastructure
- Dramatic transformation to a paperless market and transparent trading system. All trades on the National Stock Exchange are settled in demat (paperless mode).
- By also moving towards rolling settlement (albeit after a considerable and unnecessary delay), cutting the settlement cycle and now going forward towards a T+1 settlement system, SEBI has made the markets much safer for investors

Takeover Code Failures

- The SEBI has not been given the sweeping powers to directly tackle the wrongdoers (many of whom have surfaced during the five-year timeframe when the committee was deliberating on the issue) on the takeover front.
- The creeping acquisition limit will be applicable for the financial year, against the earlier practice where a company couldn't exceed the creeping acquisition limit in any one-year time frame.
- SEBI has almost always been found lacking in the legal foundations of its action against defaulting corporates.

CHAPTER-9

MERCHANT BANKING

Introduction

➤ **Merchant bank** is a financial institution primarily engaged in international finance and long-term loans for multinational corporations and governments. It can also be used to describe the [private equity](#) activities of banking. It is now obligatory that all public issues are managed by merchant bankers who function like lead managers. (DEFINITION)IMP.

ACTIVITIES DONE BY MERCHANT BANKERS:

- Issues relating to new issues.
- Determination of security-mix to be issued.
- Drafting of prospectus, application forms, allotment letters.
- Host of other documents, appointment of registrars for handling share applications and transfers
- Making arrangements for underwriting, placement of shares, selection and appointment of brokers and bankers to the issue
- Publicity of the issue, etc.

Categories of Merchant bankers

1. **CATEGORY I** : those merchant bankers who can conduct all functions.
2. **CATEGORY II** : who can act as consultants, advisors, portfolio managers and co-managers.
3. **CATEGORY III** : who can act as underwriters, advisors and consultants.
4. **CATEGORY IV** : who can act only as advisers or consultants to an issue.

Responsibilities of merchant bankers

- Enter into a contract with the issuing company clearly specifying their mutual rights, obligations and liabilities relating to the issue, particularly relating to disclosures, allotment and refund.
- Refuse acceptance of appointment as lead manager, if the issuing company is its associate.
- Submit a copy of the above contract to SEBI at least one month before the opening of the issue for subscription.
- Not to associate with a merchant banker who does not hold SEBI registration certificate.
- Accept a minimum underwriting obligation of 5% of total commitment or Rs. 25 lakhs, whichever is less.
- Submit to SEBI various documents such as, particulars of the issue, draft prospectus/letter of offer and other literature to be circulated to the investors/shareholders, etc. at least two weeks before the date of filling them with the registrar of companies and regional stock exchanges.
- Ensure that modifications and suggestions made by SEBI regarding above documents have been duly incorporated.
- Not to acquire securities of any company on the basis of unpublished price sensitive information obtained in the course of discharge of assignment.

Duties of Merchant Banker

- Observe high standards of integrity and fairness in its dealings with the client and other merchant bankers.
- Disclose to the clients possible sources of conflict of duties and interest, if any, while accepting the assignment and while providing the services.
- Try his best to render the best possible advice to the clients having due regard to the client's needs and his own professional skills.
- Provide all professional services to the clients in a prompt, efficient and cost-effective manner.
- Take adequate steps for fair allotment of securities and refund of application money without delay.
- Adequately deal with complaints from the investors.
- Make available to the investors a true and adequate information relating to the issue without making any misguided or exaggerated claims.

SEBI and merchant banking

- SEBI can inspect books of accounts, records, and documents of a merchant banker with an objective of :
 - Ensuring that the books are maintained in the manner required.
 - Ensuring that the provisions of the SEBI Act, rules and regulations are being complied with,
 - Investigating into the complaints from investors, other merchant bankers, or any other person relating to any matter having a bearing on his activities as a merchant banker.
 - Taking up an investigation into the affairs of the merchant banker in the interest of securities business or investors interest.

CHAPTER-10

VENTURE CAPITAL

Introduction

- VC a small (though important) component of the NIS). It is usually defined as money supplied to young, start-up firms. **Venture capital** (also known as **VC** or **Venture**) is a type of private equity capital typically provided to immature, high-potential, growth companies in the interest of generating a return through an eventual realization event such as an IPO or trade sale of the company. Venture capital investments are generally made as cash in exchange for shares in the invested company.
- VC firms raise a series of funds, and invests in a firm that can provide a return of >10 times in <5 years typically in new technology.
- A **venture capital fund** refers to a pooled investment vehicle (often an LP or LLC) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets and bank loans.
- Venture capital Fund may raise moneys from any investor – Indian, foreign and non-resident Indian by way of issue of units provided the money accepted from any investor is not less than Rs. 5 lakhs.

Registration of Venture capital Fund

A venture capital fund may be set up either by a company or a trust, after a certificate of registration is granted by SEBI on an application made to it.

The conditions to fulfill are:

- The MOA of the company must specify, as its main objective, the carrying on of the activity of a venture capital fund.
- It is prohibited by its MOA and AOA from making an invitation to the public to subscribe to its securities.
- Its director or principal officer or employee is not involved in any litigation connected with the securities market.
- Its director, principal officer or employee has not at any time been convicted of any offence involving moral turpitude or economic offence.
- The applicant is a fit and proper person.

Traditional Outlook towards Venture Capital in India

- History of state-directed institutional development
 - Mainly small and medium-sized enterprises
 - Hostility to capitalism
 - Few massive private-sector groups (Tata, Birla).
 - Entrepreneurial capital mainly from family sources/bootstrapping.
- Barriers to entrepreneurship
 - Cultural rigidity
 - Intrusive bureaucracy
 - Rigid labor market

Features of Venture Capital

- **Investment in high-risk, high-returns ventures:** As VCs invest in untested, innovative ideas the investments entail high risks. In return, they expect a much higher return than usual. (Internal Rate of return expected is generally in the range of 25 per cent to 40 per cent).
- **Participation in management:** Besides providing finance, venture capitalists may also provide technical, marketing and strategic support. To safeguard their investment, they may also at times expect participation in management.
- **Expertise in managing funds:** VCs generally invest in particular type of industries or some of them invest in particular type of businesses and hence have a prior experience and contacts in the specific industry which gives them an expertise in better management of the funds deployed.
- **Raises funds from several sources:** A misconception among people is that venture capitalists are rich individuals who come together in a partnership. In fact, VCs are not necessarily rich and almost always deal with funds raised mainly from others. The various sources of funds are rich individuals, other investment funds, pension funds, endowment funds, et cetera, in addition to their own funds, if any.
- **Diversification of the portfolio:** VCs reduce the risk of venture investing by developing a portfolio of companies and the norm followed by them is same as the portfolio managers, that is, not to put all the eggs in the same basket.
- **Exit after specified time:** VCs are generally interested in exiting from a business after a pre-specified period. This period may usually range from 3 to 7 years.

Stages of financing offered in Venture Capital

- Seed Money: Low level financing needed to prove a new idea (Often provided by "angel Investors").
- Start-up: Early stage firms that need funding for expenses associated with marketing and product development.
- First-Round: Early sales and manufacturing funds.
- Second-Round: Working capital for early stage companies that are selling product, but not yet turning a profit.
- Third-Round: Also called Mezzanine financing, this is expansion money for a newly profitable company.
- Fourth-Round: Also called bridge financing, 4th round is intended to finance the going public process.

UNIT-II

SUBJECT: FMI

MBA (IIIrd Semester)

FINANCE SPECIALIZATION

CHAPTER-1

FINANCIAL INSTITUTIONS & BANKS

Introduction

Financial institutions (FI) are companies that act as mediators between surplus and deficit economic agents.

Functions of financial institutions:

- provision of payment mechanism.
- facilitation of lending and borrowing.
- provision of insurance, foreign exchange and other services.

Importance of FIs

- Government
- Investors
- Globalization of financial instruments.
- Public
- Legal framework for the assets
- Inter country transactions.
- Growth of company
- Intra country transactions

Recent changes in global financial markets

Globalisation of financial markets.

- Increase in the amount of money involved in financial transactions.
- Increasing domination of institutional investors.
- Increase of new financial instruments and products.
- Increase use and importance of technology.
- Impact of the internet (online banking online dealing).
- Increase competition between banks (corporate banking decline).
- Trend towards deregulation of the financial sector.
- Emergence of EU and Euro.
- Increasing importance of emerging markets.

List of Financial Institutions and Banks in India

- Central Bank – Reserve Bank of India and its regional offices.
- Financial authorities – Securities and Exchanges Board of India (SEBI), Central Board of Direct Taxes (CBDT), Central Board of Excise and Customs (CBEC).
- Insurance – General Insurance Corporation of India Ltd., Life Insurance Corporation (LIC), New India Assurance Company, United India Insurance Company.
- Specialized Financial Institutions in India – Hibiscus Marketing Pvt. Ltd., Export Credit Guarantee Corporation of India Ltd., Export Import Bank of India (EXIM), Industrial Credit and Investment Corporation of India Ltd. (ICICI), Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI).
- Mutual Funds in India – Kotak Mahindra mutual Fund, Unit Trust of India, etc.
- Merchant Banks/ Venture Capital – VLS Finance Ltd.
- Credit reporting and Debt collection – CRISIL, ICRA, etc.
- Commercial Banks.

Checklist of financial banks and institutions

1. The customer should be provided with all the necessary information about a particular product so that he is able to determine the pros and cons of that particular product.
2. If a customer has applied for a loan, his application should be acknowledged and a time frame should be give within which the bank will take its decision and convey it to the applicant.
3. The banks should decide a time frame within which all the shortcomings regarding a loan application should be communicated to the customer.
4. The banks and financial institutions should clearly communicate the interest rates on different loan products through various popular media like the bank's branches, outlets, website, print and other media.
5. All borrowers should be informed periodically about the interest rates applicable to their loans.
6. Any revision in the interest rates should be communicated to the concerned borrower with in specified time frame by various popular communication methods.
7. The default or penal interest rates should be mentioned clearly to the borrower.
8. The conditions on which the bank will charge a default or penal interest rates and what conditions will revoke the penal interest rate should also be mentioned clearly.
9. Any other charges applicable to loan and other banking products should be communicated to the customer while accepting the applications.

10. All the terms and conditions applicable to the loan should be given in a document format to the borrower and it should contain full details about the amount of loan sanctioned, responsibilities of the borrower, responsibility of the bank and any other terms applicable to the loan.
11. The bank and financial institution should respect the privacy of its customers and follow strict privacy guidelines. The personal information of the customer must be confidential and should not be disclosed to any third party unless agreed to by the customer. Exceptions if any to this privacy policy should be communicated to the customer.
12. The banks and financial institutions should maintain a grievance redressal mechanism, which should receive customer's complaints and suggestions, and provide a suitable time frame for their solutions.

Role of FIs in the new emerging era of globalisation and privatization (IMP.)

- **Investor at multiple levels**
- **Strategic Advisor and Coach**
- **Innovator and Catalyst**
- **Match-maker (Facilitating partnerships between FIs and global leaders in strategies and technologies)**
- **Portfolio managers.**
- **Financial intermediaries.**

CHAPTER-2

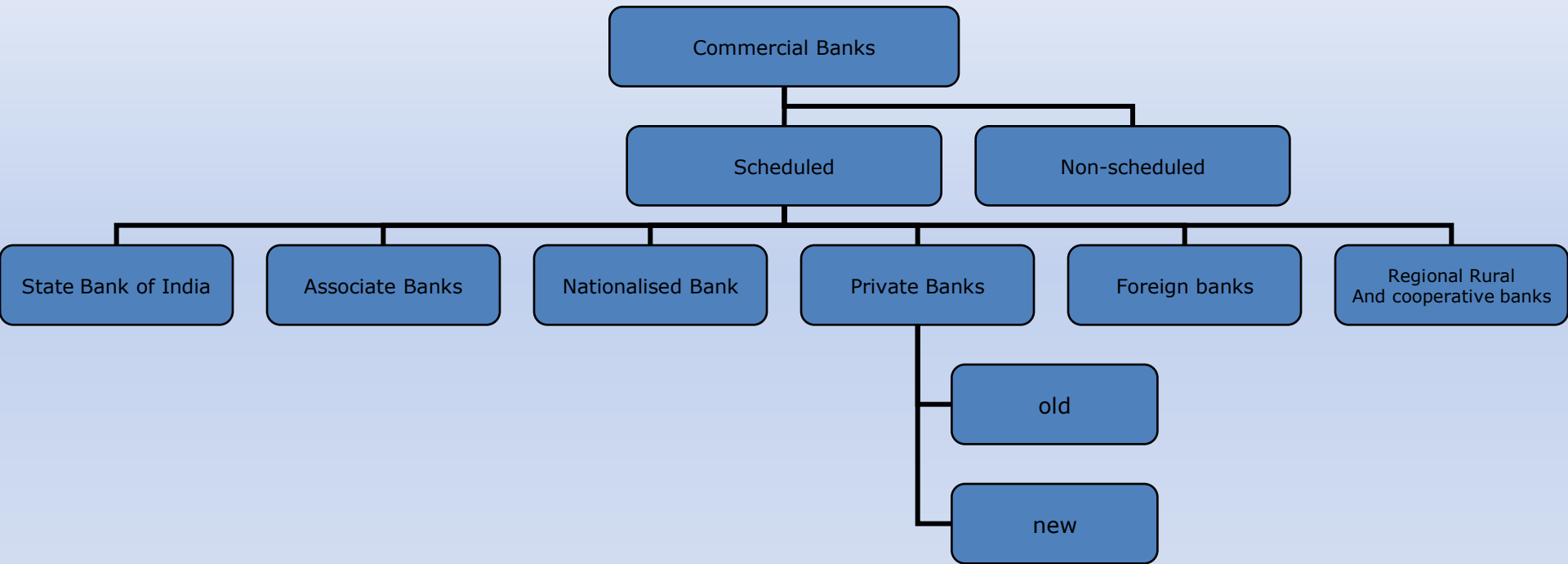
MANAGEMENT OF COMMERCIAL BANKS

Introduction

Bank : An institution which took deposits from the public and lent money. It plays a positive role in the economic development of a country as repositories of community's savings and as providers of credit.

Commercial Banks : It provides short term and medium term financial assistance. The short term credit facilities are granted for working capital requirements. The medium term loans are for the acquisition of land, construction of factory premises and purchase of machinery and equipments.

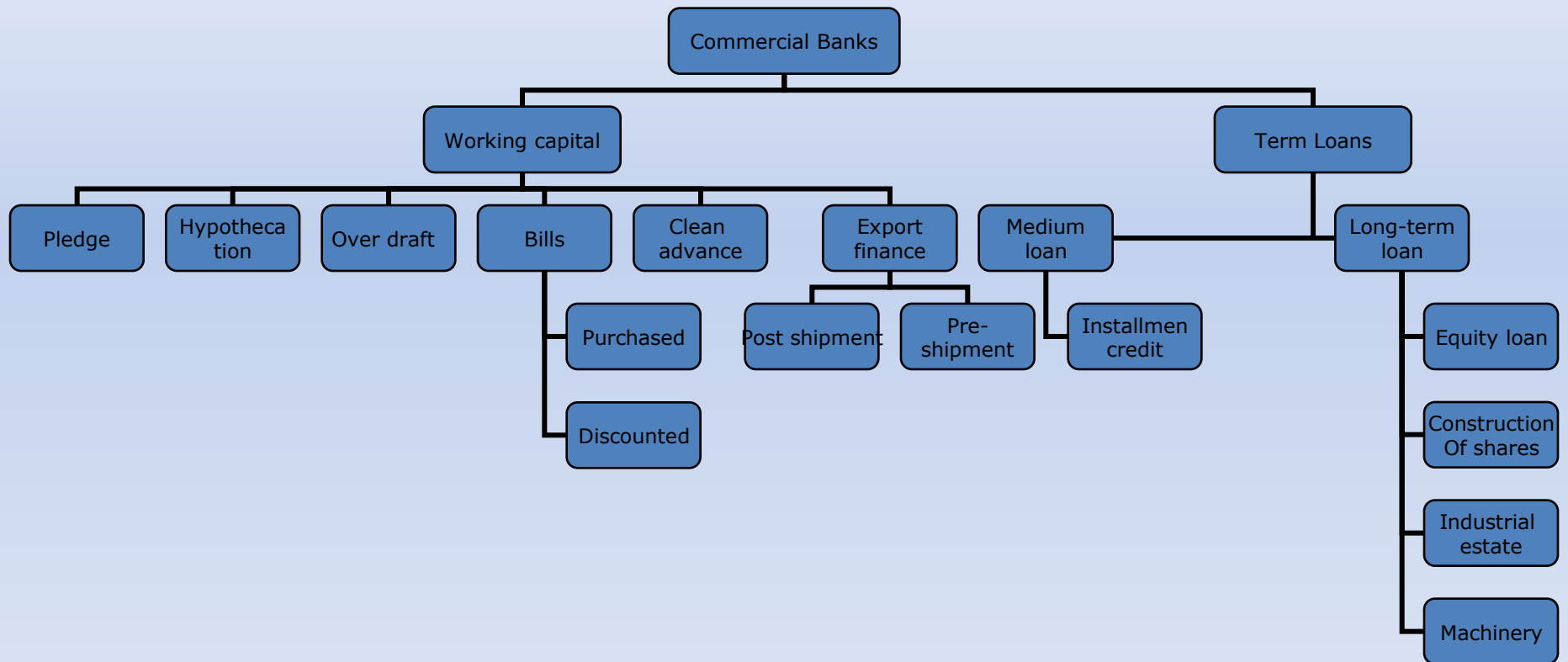
Structure of commercial banks in India



Number of each types of Commercial Banks

• Non- scheduled banks			1
• Scheduled			
– State Bank of India			1
– Associate Banks	7		
– Nationalised Banks			13+6
– Regional Rural Banks	10		
– Cooperative Banks			196
– Foreign Banks			44
– Private Banks			
• OLD			22
• NEW			7

Financial Assistance by commercial banks



Challenges in the way of commercial banking

- Change in ownership pattern of public sector banks.
- Banks and insurance business.
- Move towards universal banking.
- Banks becoming financial super markets.
- Automation and computerization of branches and adoption of new technology.
- Structural issues.
- Management of NPAs.
- Rural Banking.

CHAPTER-3

FUNDS FLOW ANALYSIS

INTRODUCTION

- **FUNDS** : WORKING CAPITAL
- **FLOW OF FUNDS**: THE TERM FLOW MEANS CHANGE AND THEREFORE THE TERM FLOW OF FUNDS MEANS “CHANGES IN FUNDS” OR “CHANGES IN WORKING CAPITAL”. IN OTHER WORDS, ANY INCREASE OR DECREASE IN WORKING CAPITAL MEANS “FLOW OF FUNDS”.

FUNDS FLOW STATEMENT

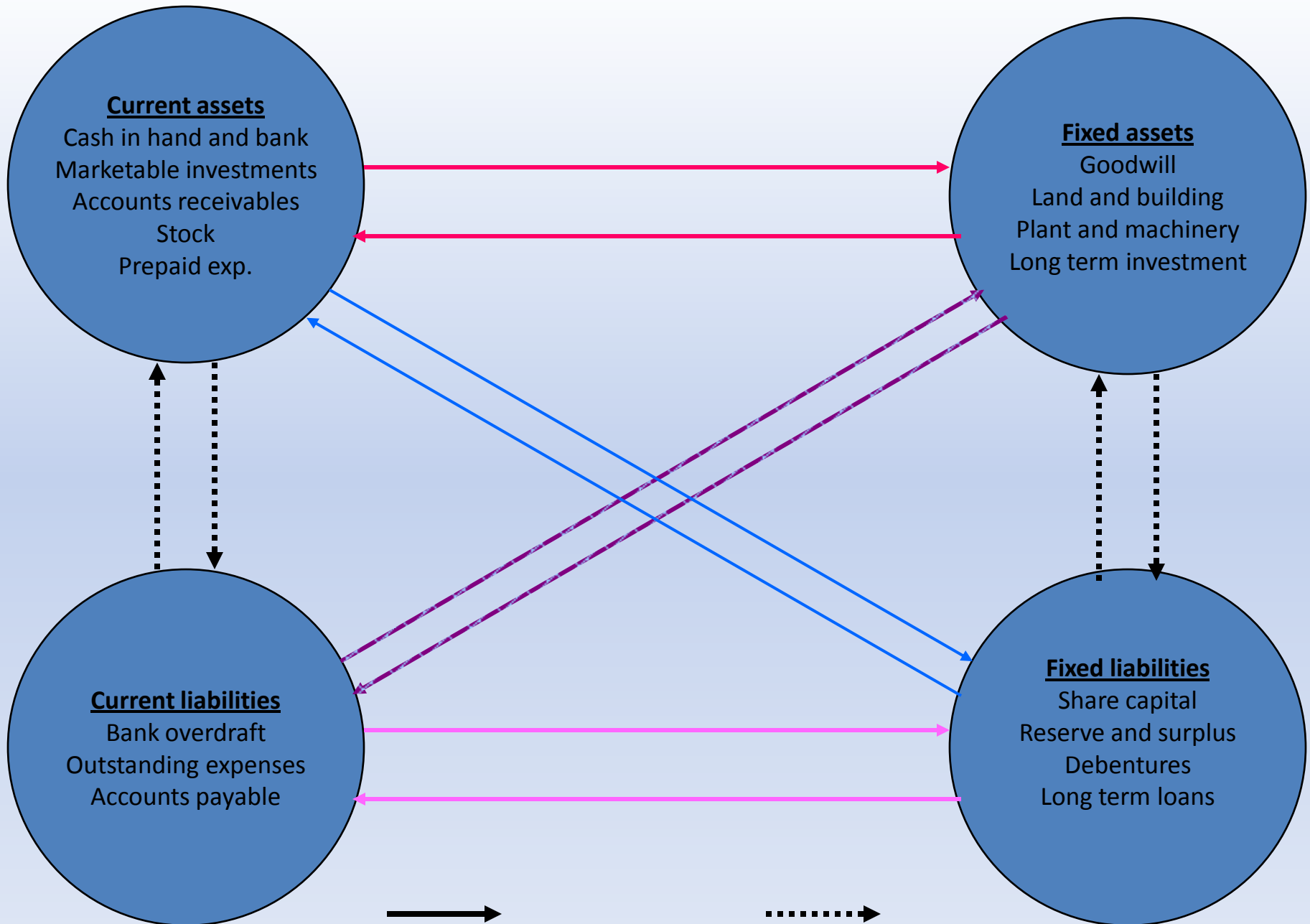
Funds flow statements is dealt by Accounting Standard 7 .

•
Meaning :- It explains changes in funds or changes in working capital . It explains the working capital position of the company which gives an idea to the top management about the liquidity position of the company.

Working capital:- It is the difference between current assets and current liabilities.

Steps in preparation of funds flow statement:-

1. Preparation of working capital statement that explains increase or decrease in working capital.
2. preparation of funds from operation statement in which we find out operating profit.
3. Preparation of funds flow statement that shows various sources and application of fund .



USES OF FUNDS FLOW

- WHY THE LIQUID POSITION OF THE BUSINESS BECOMING MORE AND MORE UNBALANCED IN SPITE OF COMPANY IS MAKING MORE AND MORE PROFITS.
- WHERE HAVE THE PROFIT GONE
- WHAT WILL BE THE SOURCES FOR DIVIDEND IF COMPANY IS NOT EARNING SUFFICIENT PROFIT
- WHAT ARE THE SOURCES OF REPAYMENT OF THE LOAN TAKEN
- HOW MUCH FUNDS GENERATION THROUGH NORMAL BUSINESS OPERATION.
- IN WHAT WAY THE MANAGEMENT HAS UTILIZED THE FUNDS IN THE PAST AND WHAT ARE GOING TO BE LIKELY USES OF FUNDS ?

Funds flow Analysis (FFA)

- This statement is based on the 'working Capital' concept of funds.
- It measures the inflows and outflows of working capital resulting from different transactions.
- Funds flow statement measures and presents in an analytical manner the summarized version of the numerous flows of funds for a specific period.
- 'Funds Flow' is the change in 'Working Capital'

Schedule Of Changes In Working Capital

Current assets	2004	2005	Increase	Decrease
Cash & bank bal.	593.61	555.36	38.25	
Investments	3404.4	2917.5	486.95	
Loans & adv.	9836.5	6696.6	3139.9	
Bills receivables	1522.9	302.3	1220.6	
Total	15357	10472		
Current liabilities				
Other liabilities	1767.5	576.72		1190.75
Short term borrowings	1881	1236		645.02
Bills for collections	4522.2	4477.4		44.85
Total	8170.7	6290.1		
CA - CL	7186.7	4181.7		
Increase In Working Capital		3005		3005.02
TOTAL	7186.7	7186.7	4885.6	4885.64

CALCULATION OF FUNDS FROM OPERATION (FFO)

Closing Balance Of P&L A/c			343.31
(+) Non Fund Items			
	Depreciation On Fixed Assets	2.56	
	Transfer Of R/S	195.23	197.79
			541.1
(-) NON FUND CR.			
	NIL		
OPENING BAL. OF P&L A/C			321.03
FUNDS FROM OPERATION			220.07

Funds Flow Statement (FFS)

SOURCES	AMT.	APPLICATION	AMT.
ISSUE OF CAPITAL	49	Increase In WC	3005.02
FUNDS FROM OPERATION	220.07	Investments	486
SALE OF FIXED ASSET	2.56		
LONG TERM LOANS	2253.02		
BORROWINGS	966.37		
TOTAL	3491.02		3491.02

CHAPTER-4

INTEREST RATE ANALYSIS

Introduction

- **Interest** is a fee, paid on borrowed capital. Assets lent include money, shares, consumer goods through hire purchase, major assets such as aircraft, and even entire factories in finance lease arrangements. The interest is calculated upon the value of the assets in the same manner as upon money. Interest can be thought of as "rent on money".
- The fee is compensation to the lender for foregoing other useful investments that could have been made with the loaned money. These foregone investments are known as the opportunity cost.
- Interest is therefore the price of credit, not the price of money as it is commonly - and mistakenly - believed to be. The percentage of the principal that is paid as a fee (the interest), over a certain period of time, is called the **interest rate**.

Types of interest

- Simple interest

Simple Interest is calculated only on the principal, or on that portion of the principal which remains unpaid. A bank account offering only simple interest and from which money can freely be withdrawn is unlikely, since withdrawing money and immediately depositing it again would be advantageous.

$$SI = p*r*t/100$$

Compound interest

Compound interest is very similar to simple interest, however, as time goes on the difference becomes considerably larger. The conceptual difference is that unpaid interest is added to the balance due. Put another way, the borrower is charged interest on previous interest charges. Loans often include various non interest charges and fees.

One example are points on a mortgage loan in the United States. When such fees are present, lenders are regularly required to provide information on the 'true' cost of finance, often expressed as an annual percentage rate (APR). The APR attempts to express the total cost of a loan as an interest rate *after* including the additional fees and expenses, although details may vary by jurisdiction. Assuming that no part of the principal or subsequent interest has been paid, the debt is calculated by the following formulas:

$$\text{Total} = \text{Principal} * (1 + \text{Interest Rate})^{\text{Period}}$$

Fixed and floating rates

- Commercial loans generally use simple interest, but they may not always have a single interest rate over the life of the loan. Loans for which the interest rate does not change are referred to as fixed rate loans. Loans may also have a changeable rate over the life of the loan based on some reference rate (such as LIBOR and EURIBOR), usually plus (or minus) a fixed margin. These are known as **floating rate, variable rate or adjustable rate loans**.
- Combinations of fixed-rate and floating-rate loans are possible and frequently used. Less frequently, loans may have different interest rates applied over the life of the loan, where the changes to the interest rate are governed by specific criteria other than an underlying interest rate. An example would be a loan that uses specific periods of time to dictate specific changes in the rate, such as a rate of 5% in the first year, 6% in the second, and 7% in the third.

Cumulative interest

This calculation is $(FV/PV)-1$. It ignores the 'per year' convention and assumes compounding at every payment date. It is usually used to compare two long term opportunities.

Nominal interest rate

In economics, interest is considered the price of money, therefore, it is also subject to distortions due to inflation. The nominal interest rate, which refers to the price before adjustment to inflation, is the one visible to the consumer (*i.e.*, the interest tagged in a loan contract, credit card statement, etc). Nominal interest is composed by the real interest rate plus inflation, among other factors.

Nominal interest rate = Real interest rate + Inflation

CHAPTER-5

YIELD CURVE ANALYSIS

Meaning of yield curve

- The yield curve is the relation between the interest rate (or cost of borrowing) and the time to maturity of the debt for a given borrower in a given currency.
- The yield of a debt instrument is the annualized percentage increase in the value of the investment.
- Yield curves are used by fixed income analysts, who analyze bonds and related securities, to understand conditions in financial markets and to seek trading opportunities. Economists use the curves to understand economic conditions.

Types of yield curve

- Normal Yield curve/ current yield/ running yield

Yields rise as maturity lengthens (i.e., the slope of the yield curve is positive).
It is return on investment in the current year. It is the percentage of interest income to the purchase price of the security.

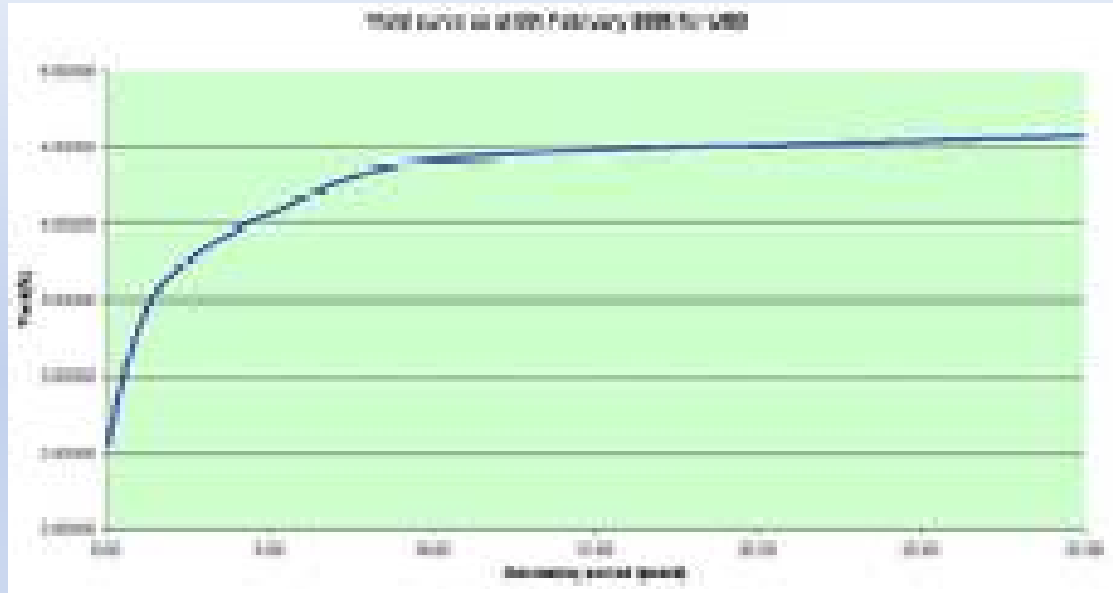
Current yield = $\frac{\text{Yearly coupon payment}}{\text{price of the coupon bond}}$

- **Redemption yield/ yield to maturity**

It resembles internal rate of return (IRR) based on discounted cash flow (DCF) technique. It is calculated as a percentage annual return on the investment up to redemption of the securities based on discounted cash flows.

$$\text{Yield} = (F-P)/F*(360/\text{Days of maturity})$$

Yield curve is usually sloping upwards or positive

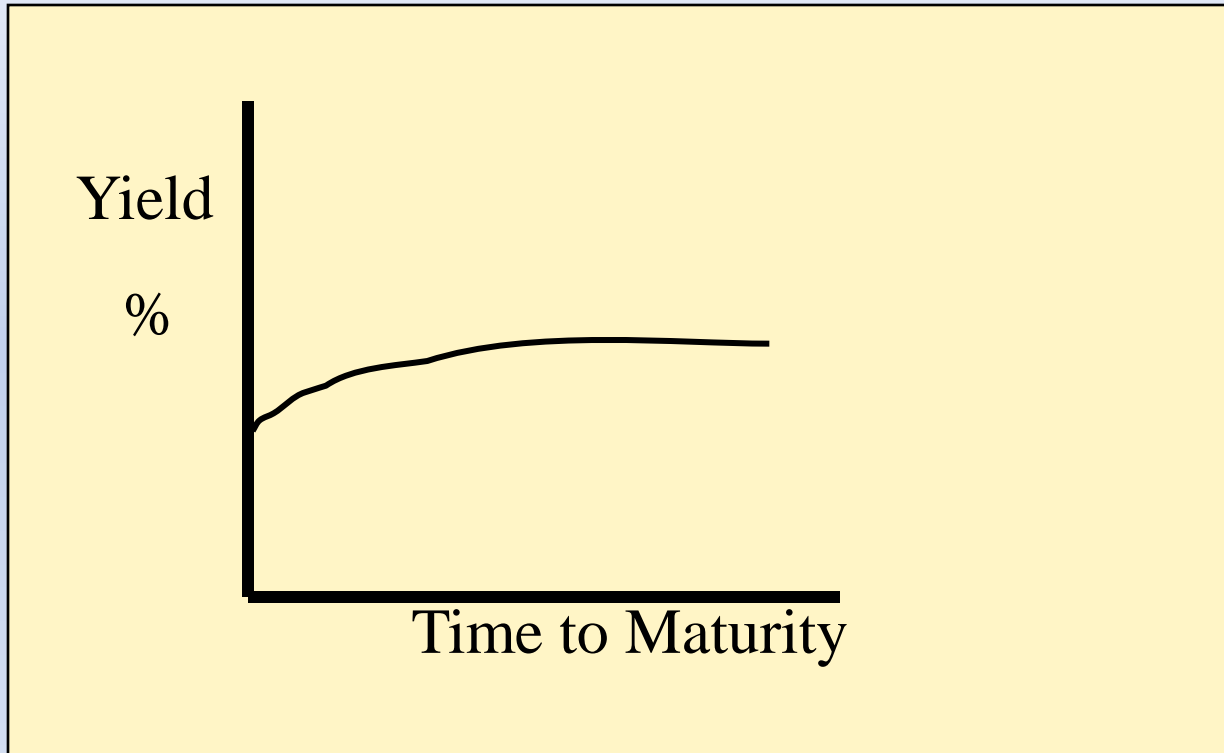


◆ The usual explanation is that longer maturities entail greater risks for the investor (i.e. the lender) and so require higher yields. With longer maturities, more catastrophic events might occur that may impact the investment, hence the need for a risk premium.

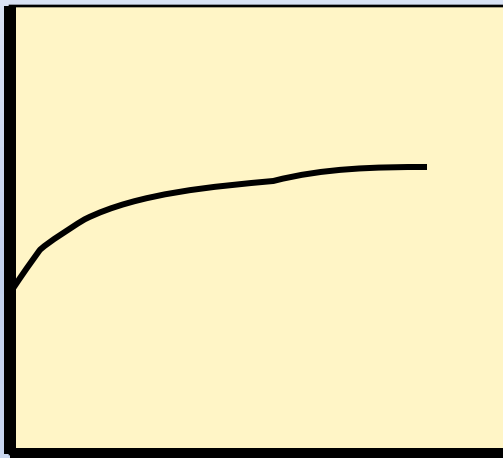
Yield Curve (BASIC)

- o plot of maturity vs. yield
- o slope of curve indicates relationship between maturity and yield

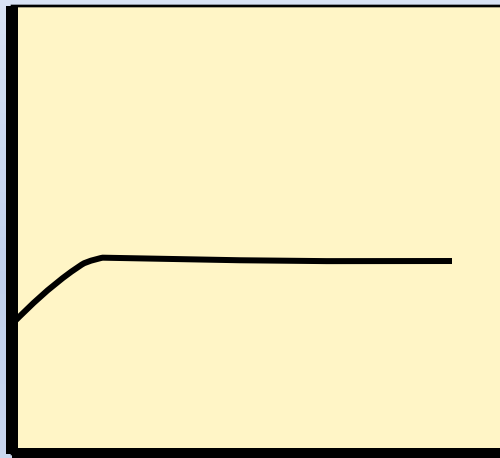
Yield Curve



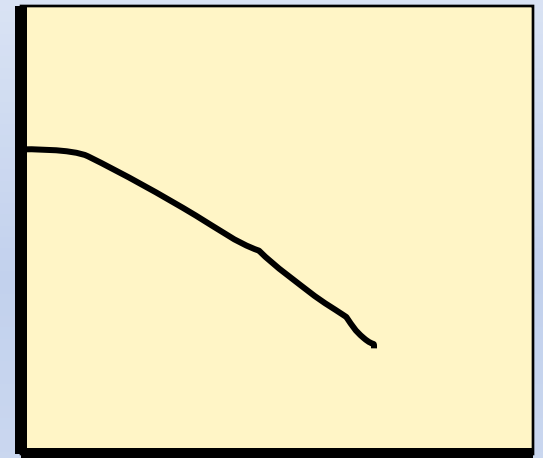
Yield Curve Shapes



Normal

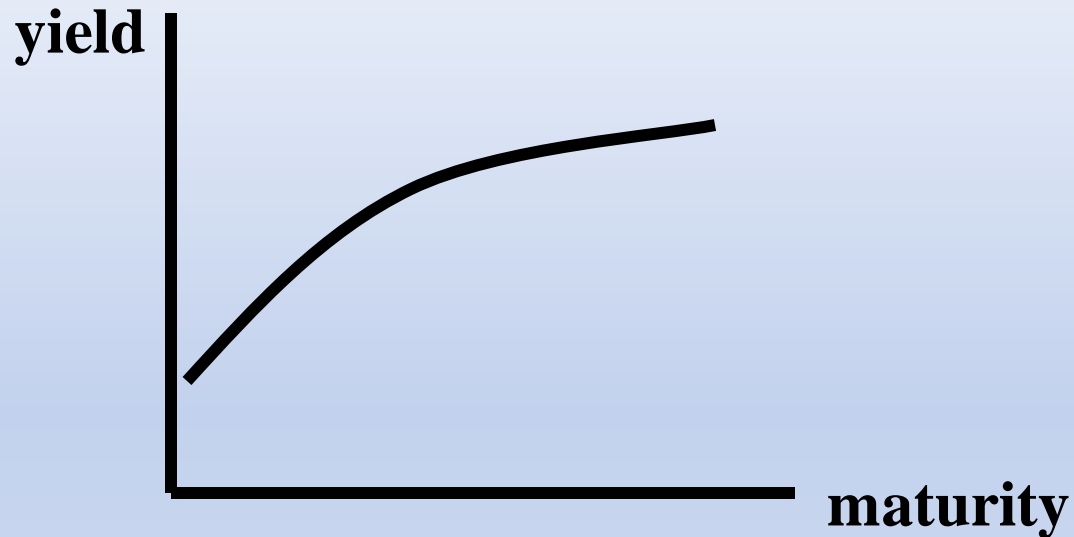


Level or Flat



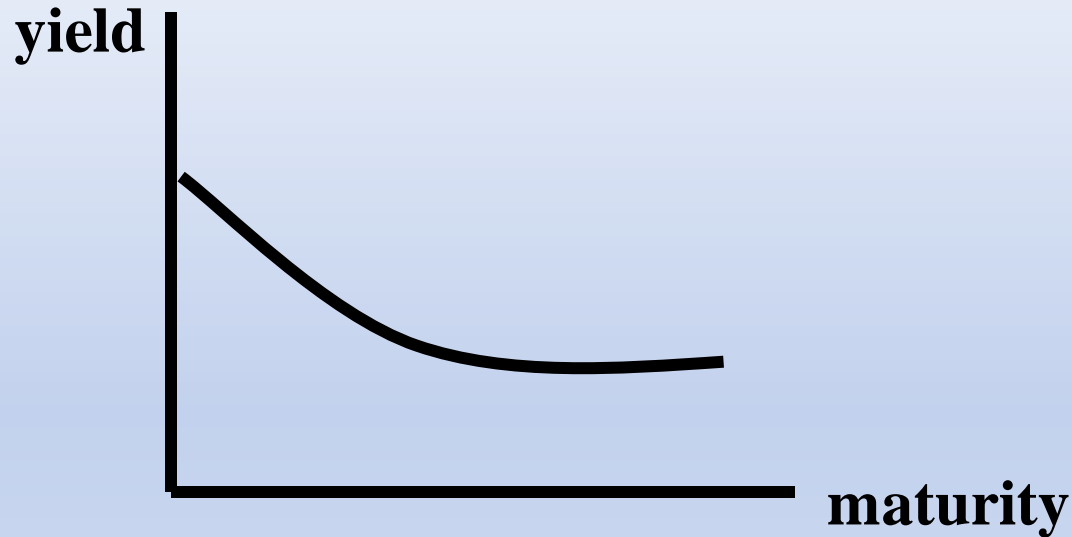
Inverted

upward sloping



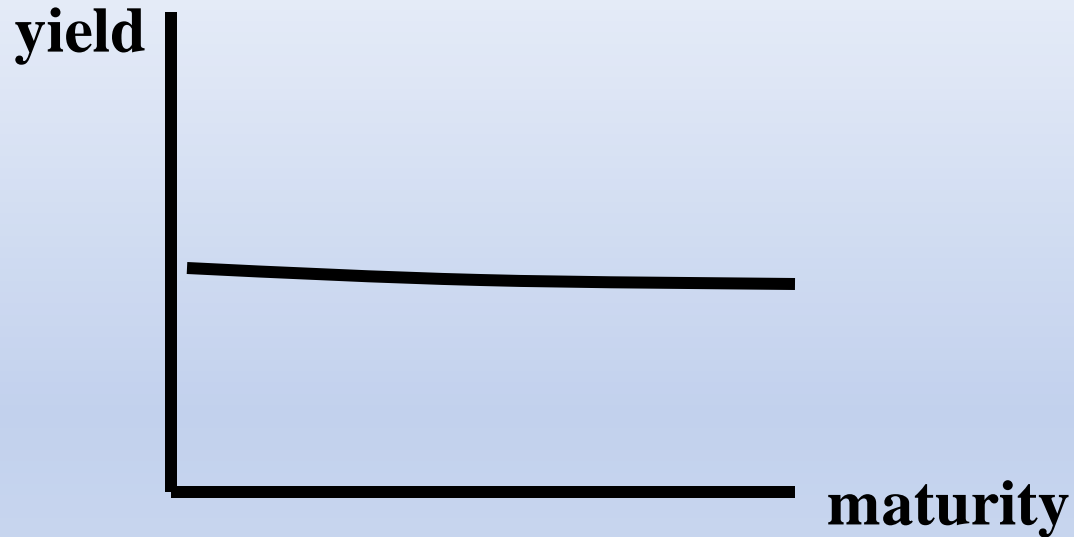
- yields rise w/ maturity (common)

downward sloping (inverted)



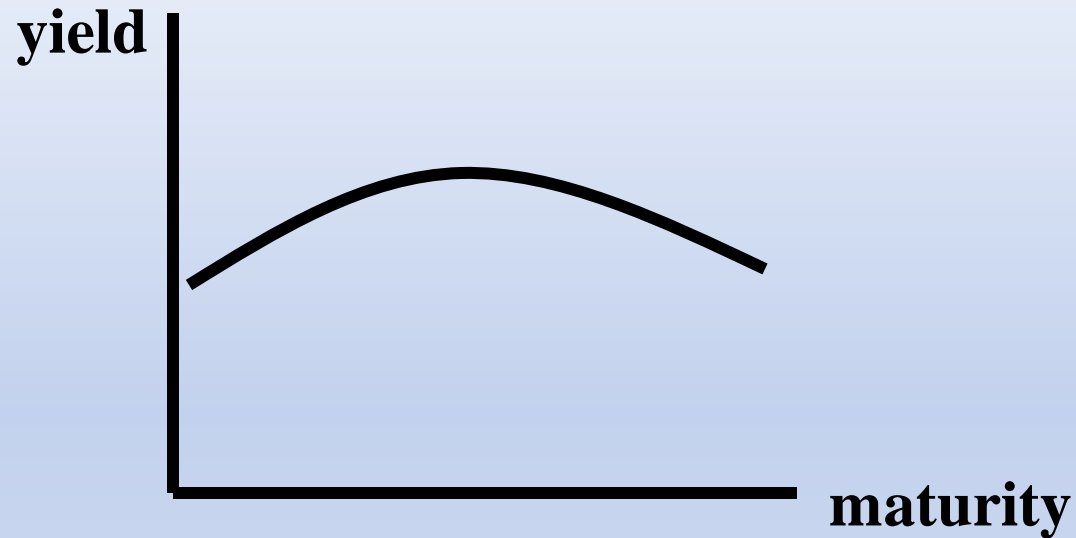
- yield falls w/ maturity (rare)

flat



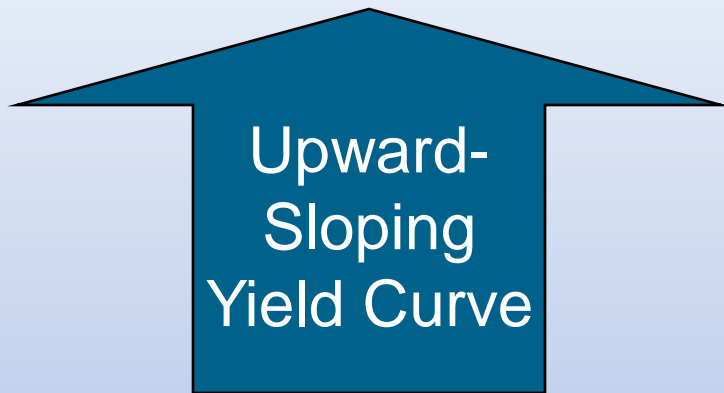
- yields similar for all maturities

humped

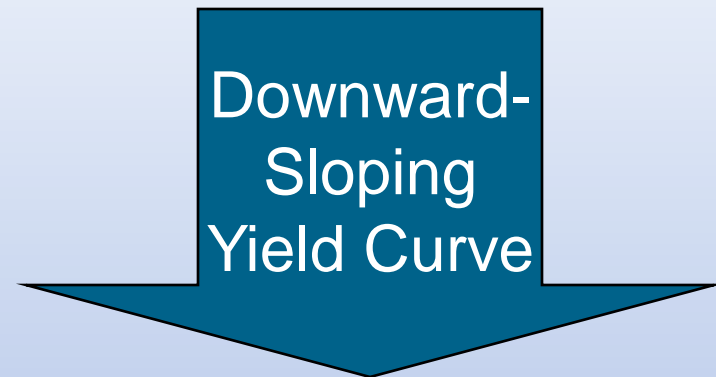


- intermediate yields are highest

The Term Structure of Interest Rates(Yield)



- Expected higher interest rate levels
- Expansive monetary policy
- Expanding economy



- Expected lower interest rate levels
- Tight monetary policy
- Recession soon?

“Nominal” vs. “Real” rates

k = represents any nominal rate

k^* = represents the “real” risk-free rate of interest. Like a T-bill rate, if there was no inflation. Typically ranges from 1% to 4% per year.

k_{RE} = represents the rate of interest on Treasury securities.

Determinants of interest rates

$$k = k^* + IP + DRP + LP + MRP$$

k = required return on a debt security

k^* = real risk-free rate of interest

IP = inflation premium

DRP = default risk premium

LP = liquidity premium

MRP = maturity risk premium

Premiums added to k^* for different types of debt

	IP	MRP	DRP	LP
S-T Treasury	✓			
L-T Treasury	✓	✓		
S-T Corporate	✓		✓	✓
L-T Corporate	✓	✓	✓	✓

Constructing the yield curve: Inflation

- Step 1 – Find the average expected inflation rate over years 1 to n:

$$IP_n = \frac{\sum_{t=1}^n INFL_t}{n}$$

Constructing the yield curve: Inflation

Suppose, that inflation is expected to be 5% next year, 6% the following year, and 8% thereafter.

$$IP_1 = 5\% / 1 = 5.00\%$$

$$IP_{10} = [5\% + 6\% + 8\%(8)] / 10 = 7.50\%$$

$$IP_{20} = [5\% + 6\% + 8\%(18)] / 20 = 7.75\%$$

Must earn these IPs to break even vs. inflation; these IPs would permit you to earn k^* (before taxes).

Constructing the yield curve: Inflation

- Step 2 – Find the appropriate maturity risk premium (MRP). For this example, the following equation will be used find a security's appropriate maturity risk premium.
- $$\text{MRP}(t) = 0.1\% (t - 1)$$

Constructing the yield curve: Maturity Risk

Using the given equation:

$$\text{MRP}_1 = 0.1\% \times (1-1) = 0.0\%$$

$$\text{MRP}_{10} = 0.1\% \times (10-1) = 0.9\%$$

$$\text{MRP}_{20} = 0.1\% \times (20-1) = 1.9\%$$

Notice that since the equation is linear, the maturity risk premium is increasing in the time to maturity, as it should be.

Add the IPs and MRPs to k^* to find the appropriate nominal rates

Step 3 – Adding the premiums to k^* .

$$k_{RF, t} = k^* + IP_t + MRP_t$$

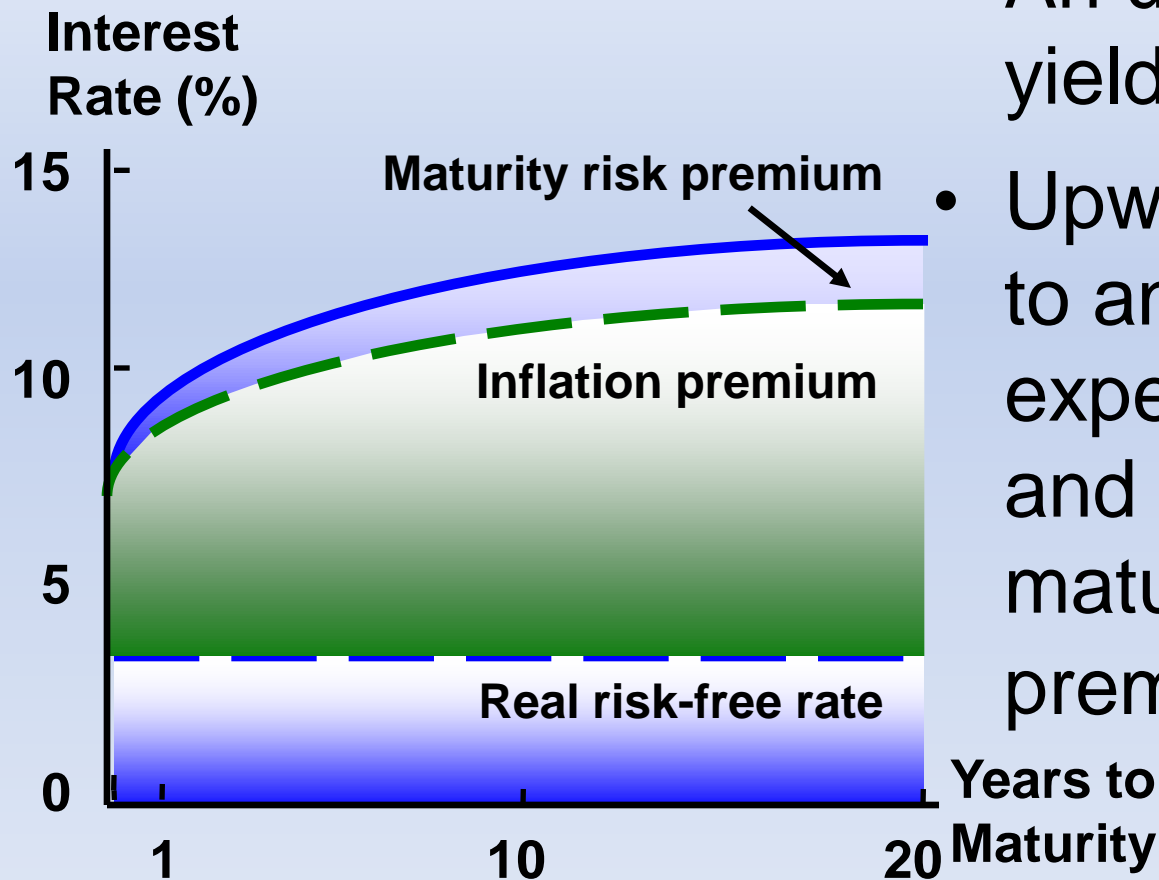
Assume $k^* = 3\%$,

$$k_{RF, 1} = 3\% + 5.0\% + 0.0\% = 8.0\%$$

$$k_{RF, 10} = 3\% + 7.5\% + 0.9\% = 11.4\%$$

$$k_{RF, 20} = 3\% + 7.75\% + 1.9\% = 12.65\%$$

Hypothetical yield curve



- An upward sloping yield curve.
- Upward slope due to an increase in expected inflation and increasing maturity risk premium.

Theories of Yield Curve

- explain relationship between yield and maturity
- what does the yield curve tell us?

THEORIES OF YIELD CURVE(IMP.)

1. Pure Expectations Theory
2. Liquidity Premium Theory
3. Segmented Markets Theory

1. The Pure Expectations

- The interest rate on a long-term bond will equal an average of the short-term interest rates that people expect to occur over the life of the long-term bond.
- Buyers of bonds do not prefer bonds of one maturity over another; they will not hold any quantity of a bond if its expected return is less than that of another bond with a different maturity.
- Bonds like these are said to be perfect substitutes.

Expectations Theory—Example

- Let the current rate on one-year bond be 6%.
- You expect the interest rate on a one-year bond to be 8% next year.
- Then the expected return for buying two one-year bonds averages $(6\% + 8\%)/2 = 7\%$.
- The interest rate on a two-year bond must be 7% for you to be willing to purchase it.

Conclusions about PE

- Some would argue that the $MRP \neq 0$, and hence the PEH is incorrect.
- Most evidence supports the general view that lenders prefer S-T securities, and view L-T securities as riskier.
- Thus, investors demand a MRP to get them to hold L-T securities (i.e., $MRP > 0$).

2. Liquidity Premium Theory

- Investors prefer short-term, more liquid, securities
- Long-term securities and associated risks are desirable only with increased yields
- Explains upward-sloping yield curve
- When combined with the expectations theory, yield curves could still be used to interpret interest rate expectations

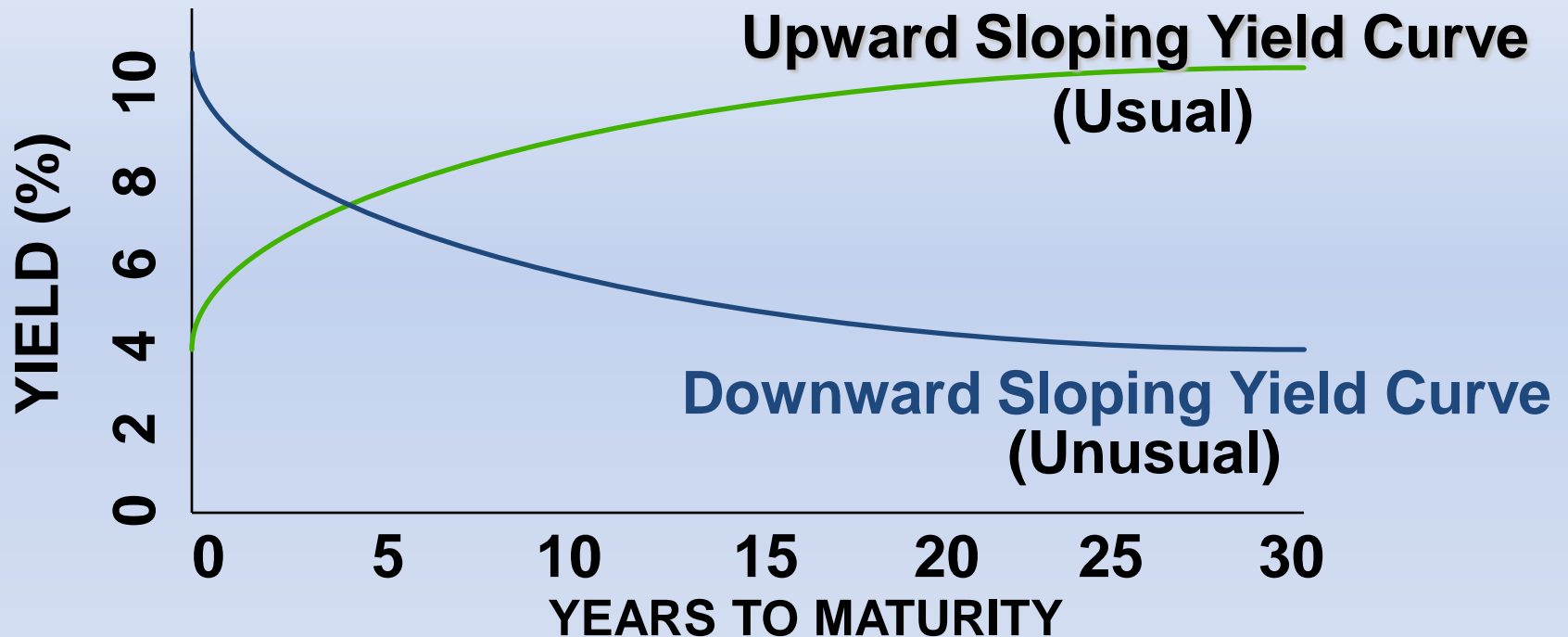
3. Segmented Markets Theory

Assume:

Bonds of different maturities are NOT substitutes at all

- if assumption is true,
 - separate markets for ST and LT bonds
 - slope of yield curves tells us nothing about future ST rates
- unrealistic to assume NO substitution between ST and LT bonds
- unrealistic to assume NO substitution

Term Structure of Interest Rates (Yield)



A [yield curve](#) is a graph of the relationship between yields and term to maturity for particular securities.

Uses of the Yield Curve

- Forecast interest rates
 - The market provides a consensus forecast of expected future interest rates
 - Expectations theory dominates the shape of the yield curve
- Forecast recessions
 - Flat or inverted yield curves have been a good predictor of recessions.
 - Investment and financing decisions
 - Lenders/borrowers attempt to time investment/financing based on expectations shown by the yield curve
 - Riding the yield curve
 - Timing of bond issuance

CHAPTER-6

NON-PERFORMING ASSETS

An advance where interest and/or instalment of principal remains overdue by the borrower for a period of more than 180 days in respect of a term loan.

Non Performing Asset means an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by RBI.

- Classification of asset classification

1. **Gross NPAs** – it reflects the quality of the loans made by banks.
2. **Net NPAs** – it shows the actual burden of banks. Net NPA is obtained by deducting items like interest due but not recovered, part payment received and kept in suspense account etc., from Gross NPA.

Net NPA = Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held)

Causes of NPA

- Quality of the loans
- Quality of the assets.
- Borrowers integrity.
- Intentions of the borrower and the bank management.
- Lapses in supervision and follow up of loans.
- Political interference.
- Managerial incompetence.
- Lack of professionalism.
- Absence of will to recover loans.

Several reasons for an account becoming NPAs

- A. Internal forces
- B. External forces

A. Internal forces

1. Funds borrowed for a particular purpose but not use for the said purpose.
2. Project not completed in time.
3. Poor recovery of receivables.
4. Excess capacities created on non-economic costs.
5. In-ability of the corporate to raise capital through the issue of equity or other debt instrument from capital markets.
6. Business failures.
7. Diversion of funds for expansion\modernization\setting up new projects\ helping or promoting sister concerns.
8. Willful defaults, siphoning of funds, fraud, disputes, management disputes, mis-appropriation etc.,
9. Deficiencies on the part of the banks viz. in credit appraisal, monitoring and follow-ups, delay in settlement of payments\ subsidiaries by government bodies etc.,

B. External sources

1. Sluggish legal system -

Long legal tangles

Changes that had taken place in labour laws

Lack of sincere effort.

2. Scarcity of raw material, power and other resources.

3. Industrial recession.

4. Shortage of raw material, raw material\input price escalation, power shortage, industrial recession, excess capacity, natural calamities like floods, accidents.

5. Failures, non payment\ over dues in other countries, recession in other countries, externalization problems, adverse exchange rates etc.

6. Government policies like excise duty changes, Import duty changes etc.,

Conditions for an asset to be a non - performing asset

- Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where;
 1. interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a Term Loan,
 2. the account remains 'out of order' for a period of more than 90 days, in respect of an overdraft/ cash Credit (OD/CC),
 3. the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted
 4. interest and/ or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purpose, and
 5. any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

CHAPTER-7

ASSET CLASSIFICATION

Classification of Assets

- Standard assets
- Sub standard assets
- Doubtful assets
- Loss assets

Standard assets

These assets do not carry more than normal risk attached to the business and does not disclose any problem.

- Sub standard assets

Assets which have well defined credit weaknesses that may jeopardise the liquidation of a debt and some less may be sustained. It remains NPA for a period not more than 2 years. Since March 31, 2000, such period is reduced to 18 months.

- Doubtful assets

Those sub – standard assets, the recovery of which is highly questionable and impossible. Assets will be treated doubtful if the NPA is more than 18 months.

- Loss assets

The assets where losses have been identified, but the amount have not been written off wholly or partly.

Steps in Asset classification

- Identification of the assets
- Accountability of assets
- Preparing a schema for information classification
- Implementing the classification schema

Identification of assets

- Identifying the critical assets is essential for many reasons. You will come to know what is critical and essential for the business. You will be able to take appropriate decisions regarding the level of security that should be provided to protect the assets. You will also be able to decide about the level of redundancy that is necessary by keeping an extra copy of the data or an extra server that you should procure and keep as a hot standby.
- **Accountability of assets**

A more difficult task is establishing ownership for the information assets. There will be a number of users for these assets. But the prime responsibility for accuracy will lie with the asset owner. Any addition or modification to the information asset will only be done with the consent of the asset owner. For example, any changes to customer information will be done with the knowledge and consent of the marketing head. Information technology staff will probably make the changes, physically. But ownership clearly lies with the business head who has the prime responsibility for the content in the customer database.

Preparing a schema for classification

- The criteria for the classification of assets could be:
- Confidentiality: Can the information be freely distributed? Or do we need to restrict it to certain identified individuals?
- Value: What is the asset value? Is it a high value item, costly to replace or a low value item?
- Time: Is the information time sensitive? Will its confidentiality status change after some time?
- Access rights: Who will have access to the asset?
- Destruction: How long the information will be stored? How can it be destroyed, if necessary?
- Implementation of classification schema

Information is a fluid resource. It keeps changing its form. The implementation should lead to a uniform way of identifying the information so that a uniform protection could be provided.

Provisioning in asset classification

- Standard assets - .25% of total outstanding standard assets.
- Sub – standard assets – 10% of total outstanding advances
- Doubtful assets (a) Secured – 20% to 50% depending upon the period for which the advance has been considered doubtful.
- (b) Unsecured – 100% of such assets
- Loss assets – written off completely or upto the time lag between when it was seeming to be doubtful and when it was good.

CHAPTER-8

CAPITAL ADEQUACY NORMS

Pillars of Basel Committee

1. Minimum capital requirement –
 - To cover credit risk
 - Risk weights to the risk categories like operational risk, interest rate risk.
2. Supervisory Review of Capital Adequacy –
 - Proactive role for the regulator.
 - Review of bank – specific internal capital assessment processes.
 - On-site inspection, off-site surveillance and external auditing.
 - The potential for serious erosion of the bank's capital position.
3. Effective use of market discipline
 - Conduct their business in a safe, sound and efficient manner.
 - Disclosure of all the losses and the capital used as a cushion for these losses to the public.
 - It enables the user to assess whether the available capital is sufficient to meet the credit risk and market risk and other risk requirements.

Risks weight attached to various assets of financial institutions

Particulars	Before revision	After revision
Government securities	0	2.5
Other approved securities guaranteed by Central/ State Government	0	2.5
Other securities where payment of interest and repayment of principal are guaranteed by Central/State Government	0	2.5
Government guaranteed securities of government undertakings which do not form part of approved market borrowing programmes	0	20
Other approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Government	0	20
Claims on banks and public financial institutions.	20	20
Bonds issued by other banks and public financial institutions	100	20
Securities which are guaranteed by banks or PFIs as to repayment of interest and principal	100	20
Sub-ordinated debt in the form of Tier – II bonds issued by other banks/ FIs	100	100
All other investments	100	100

Division of Capital Funds

- Tier I – Paid up capital, statutory reserves, other disclosed free reserves, capital reserves representing surplus arising out of sales proceeds of assets.
- Tier II – Undisclosed reserves and cumulative perpetual preference shares, revaluation of reserves (up to 55% of book value), general provisions and loss reserves, hybrid debt capital instruments and subordinated debts (To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the Reserve Bank of India).

Capital funds of foreign banks operating in India

Elements of Tier I capital

1. Interest-free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.
2. **Statutory reserves kept in Indian books.**
3. Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

Notes:

1. **The foreign banks are required to furnish to Reserve Bank, (if not already done), an undertaking to the effect that the banks will not remit abroad the remittable surplus retained in India and included in Tier I capital as long as the banks function in India.**
2. **These funds may be retained in a separate account titled as 'Amount Retained in India for Meeting Capital to Risk-weighted Asset Ratio (CRAR) Requirements' under 'Capital Funds'.**
3. **An auditor's certificate to the effect that these funds represent surplus remittable to Head Office once tax assessments are completed or tax appeals are decided and do not include funds in the nature of provisions towards tax or for any other contingency may also be furnished to Reserve Bank.**
4. **Foreign banks operating in India are permitted to hedge their Tier I capital held in Indian books. These banks are free to make their own decision as regards the timing of the hedge transactions subject to compliance with all other terms and conditions contained in Exchange Control Department's circular No.EC.CO.FMD.6/02.03.75/2002-2003 dated November 20, 2002.**
4. **Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.**
5. **Interest-free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.**
6. **The net credit balance, if any, in the inter-office account with Head Office/overseas branches will not be reckoned as capital funds. However, any debit balance in Head Office account will have to be set-off against the capital.**

Elements of Tier II capital

To the extent relevant, elements of Tier II capital as indicated above in paragraph 2.1.4 in respect of Indian banks will be eligible.

1. The elements of Tier I & Tier II capital do not include foreign currency loans granted to Indian parties.
2. Minimum requirement of capital funds - Banks were required to maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) norm of 8 percent on an ongoing basis up to the year ending 31 March 1999. With effect from the year ending 31 March 2000, banks are required to maintain a minimum CRAR of 9 percent on an ongoing basis.

Issue of subordinated debt for raising Tier II capital

1. The Reserve Bank has given autonomy to Indian banks to raise rupee subordinated debt as Tier II capital, subject to the terms and conditions given in the *Annexure 1*. It should be ensured that the terms & conditions are strictly adhered to.
2. Foreign banks also would not require prior approval of RBI for raising subordinated debt in foreign currency through borrowings from Head Office for inclusion in Tier II capital.

To ensure transparency and uniformity, detailed guidelines in this regard are given at *Annexure 1A*.

3. The banks should submit a report to Reserve Bank of India giving details of the Subordinated debt issued for raising Tier II capital, such as, amount raised, maturity of the instrument, rate of interest together with a copy of the offer document, soon after the issue is completed.

Risk adjusted assets and off-balance sheet items:

1. Risk adjusted assets would mean weighted aggregate of funded and non-funded items. Degrees of credit risk expressed as percentage weightings, have been assigned to balance sheet assets and conversion factors to off-balance sheet items.
2. Banks' investments in all securities should be assigned a risk weight of 2.5 percent for market risk. This will be in addition to the risk weights assigned towards credit risk since, in line with best practices, some capital cushion should also be provided for market risk in addition to credit risk.
3. The value of each asset/ item shall be multiplied by the relevant weights to produce risk adjusted values of assets and off-balance sheet items. The aggregate will be taken into account for reckoning the minimum capital ratio.
4. The risk-weights allotted to each of the items of assets and off-balance sheet items are furnished in the *Annexure 2*.

Capital Adequacy for Subsidiaries:

1. **The Basel Committee on Banking Supervision has proposed that the New Capital Adequacy Framework should be extended to include, on a consolidated basis, holding companies that are parents of banking groups. On prudential considerations, it is necessary to adopt best practices in line with international standards, while duly reflecting local conditions.**
2. Accordingly, banks may voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk weights applicable to the bank's own assets. Banks should earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switchover to unified balance sheet for the group as a whole is adopted after sometime. The additional capital required may be provided in the bank's books in phases, beginning from the year ended March 2001.
3. A Consolidated bank defined as a group of entities which include a licensed bank should maintain a minimum Capital to Risk-weighted Assets Ratio (CRAR) as applicable to the parent bank on an ongoing basis from the year ended 31 March 2003. While computing capital funds, parent bank may consider the following points :
 - (i) Banks are required to maintain a minimum capital to risk weighted assets ratio of 9%. Non-bank subsidiaries are required to maintain the capital adequacy ratio prescribed by their respective regulators. In case of any shortfall in the capital adequacy ratio of any of the subsidiaries, the parent should maintain capital in addition to its own regulatory requirements to cover the shortfall.
 - (ii) Risks inherent in deconsolidated entities (i.e., entities which are not consolidated in the Consolidated Prudential Reports) in the group need to be assessed and any shortfall in the regulatory capital in the deconsolidated entities should be deducted (in equal proportion from Tier 1 and Tier 2 capital) from the consolidated bank's capital in the proportion of its equity stake in the entity.**

CHAPTER-9

MAXIMUM PERMISSIBLE BANKING FINANCE (MBFCs)

TANDON COMMITTEE

Tandon Committee Report

Reserve Bank of India setup a committee under the chairmanship of Shri P.L. Tandon in July 1974.

The terms of reference of the Committee were:

1. To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end use of funds and keeping a watch on the safety of advances;
2. To suggest the type of operational data and other information that may be obtained by banks periodically from the borrowers and by the Reserve Bank of India from the leading banks;
3. To make suggestions for prescribing inventory norms for the different industries, both in the private and public sectors and indicate the broad criteria for deviating from these norms ;
4. To make recommendations regarding resources for financing the minimum working capital requirements ;
5. To suggest criteria regarding satisfactory' capital structure and sound financial basis in relation to borrowings ;
6. To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc., requires to be modified, if so, to suggest suitable modifications.

The committee was of the opinion that:

- i. Bank credit is extended on the amount of security available and not according to the level of operations of the customer
- ii. Bank credit instead of being taken as a supplementary to other sources of finance is treated as the first source of finance. Although the Committee recommended the continuation of the existing cash credit system, it suggested certain modifications so as to control the bank finance.

The banks should get the information regarding the operational plans of customer in advance so as to carry a realistic appraisal of such plans and the banks should also know the end use of bank credit so that the finances are used only for purposes for which they are lent.

The recommendations of the committee regarding lending norms have been suggested under alternatives. According to the first method, the borrower will have to contribute a minimum of 25% the working capital gap from long-term funds, i.e., owned funds and term borrowing; this will give minimum current ratio of 1.17 : 1

Under the second method of the borrower will have to provide a minimum. of 25% of the total current assets from long-term funds; this will give a minimum current ratio of 1.33:1.

In the third method, the borrower's contribution from long-term funds will be to the extent of the entire core current assets and a minimum of 25% of the balance current assets, thus strengthening the current further.

Illustration:

Total current assets required Rs.40,000

Current liabilities other than bank borrowings Rs.10,000

Core current assets Rs.5,000

1st Method

Total current assets required Rs.40,000

Less current liabilities Rs.10,000

Working Capital Gap Rs.30,000

Less 25% from Long term sources Rs.7,500

Maximum permissible bank borrowings Rs.22,500

2nd Method

Current Assets required Rs.40,000

Less 25% to be provided from long term funds Rs.10,000

Less Current Liabilities Rs.10,000

Maximum permissible bank borrowings Rs.20,000

3rd Method

Current assets Rs.40,000

Less Core Current assets Rs.5,000

Rs.35,000

Less 25% to be provided from long term funds Rs.8,750

Rs.26,250

Less current liabilities Rs.10,000

Maximum permissible bank borrowings Rs.16,250

Computation of Maximum Permissible

Bank Finance(MPBF):

The Tandon Committee had suggested three methods for determining the maximum permissible bank finance (MPBF).

They are

Method 1: $MPBF=0.75(CA-CL)$

Method 2: $MPBF=0.75(CA)-CL$

Method 3: $MPBF=0.75(CA-CCA)-CL$

Where CCA=Core Current Assets- this represents the permanent component of working capital.

Illustration

The following are the data of Mercury Company Limited

Current Assets Rs.(in millions)

Raw material 18

Work in process 5

Finished goods 10

Receivables (including bills Discounted) 15

Other current assets 2

Current Liabilities

Trade Creditors 12

Other current liabilities 3

Bank borrowings (including Bills discounted) 25

MPBF for Mercury Company Limited as per above methods are:

Method 1: $0.75(CA-CL) = 0.75(50-15) = \text{Rs.}26.25$ million

Method 2: $0.75(CA)-CL = 0.75(50)-15 = \text{Rs.}22.5$ million

Method 3: $0.75(CA-CCA)-CL = 0.75(50-20)-15 = \text{Rs.}75$ million

Method 2 is adopted and the minimum current ratio works out to be 1.33.

Under special consideration, within the MPBF so arrived at in terms of the present guidelines, banks/consortia/syndicates are required to restrict sanction of cash credit limits to borrowers up to a certain portion (25% of the MPBF). Where borrowers desire to avail of bank credit for the balance portion (75% of the MPBF), or any part thereof, this will be considered on merit by banks/consortia/syndicates in the form of a short term loan repayable on demand for working capital purpose for a stipulated period.

CHAPTER-10

INFLATION & RISK

Inflation risk

- Inflation occurs from an excess of money being created by a government and spent by its citizens and businesses without an equal amount of trade and goods being created.
- It is a potential risk in purchasing securities.
- It decreases time value of money.
- This is the risk that inflation will undermine the performance of your investment. General price level are expected to increase more than expectation in future.
- Inflation risk is also referred to as purchasing power risk. This term just means that your money doesn't buy as much as it used to.
- Inflation Risk exposure reflects a stock's sensitivity to unexpected changes in the inflation rate. Unexpected increases in the inflation rate put a downward pressure on stock prices, so most stocks have a negative exposure to Inflation Risk.
- For example, a dollar that bought you a sandwich in 1980 barely bought you a candy bar a few years later. For you, the investor, this risk means that the value of your investment (a bond, for example) may not keep up with inflation.

How does it works? Its effects

- Increase in inflation – lower purchasing power of earnings on securities
- Interest rate on bonds increase suddenly resulting in potentially large price decline.
- Securities held for sale suffer losses, could diminish bank liquidity as well as lower trading profits.
- Such losses increase with the increase in the average maturity of the investment portfolio.
- Banks will become cautious about long term investments subject to substantial price risk in the period of inflation.

Steps to prevent interest rate risk

- If you are adverse to riskier investments and just want to shield your savings from inflation, go to your local bank and buy up some I-Bonds. I-bonds are “inflation resistant” (hence the “I”) bonds that the US government backs.
- Gold prices have, for obvious reasons, increased with inflation and decreased with deflation. An ounce of gold has the same “actual” buying power it did back in ancient times.... meaning you could buy the same amount of goods and services, for say an ounce of gold, as you could buy today.
- A third option would be to invest in stocks or bonds issued from other nations around the world.
- A fourth option, that is inherently riskier, is trading dollars for other currencies. This can be done on the Forex, but is incredibly risky if you don't know what you are doing.
- Providers of necessary goods and services (agricultural products, tire and rubber goods, etc.) are relatively less harmed by inflation surprises, and their stocks have a smaller (less negative) exposure.

CHAPTER-11

LOAN PRICING

General features of Loan pricing

- Most banks price commercial loans off of base rates, which serve as indexes of a bank's cost of funds.
 - Common base rate alternatives include the federal funds rate, CD rate, commercial paper rate, the London Interbank Offer Rate (LIBOR), the LIBOR swap curve, Wall Street prime, and a bank's own weighted cost of funds.
- The contractual loan rate is set at some mark-up over the base rate, so that interest income varies directly with movements in the level of borrowing costs.
 - The magnitude of the mark-up reflects differences in perceived default and liquidity risk associated with the borrower.
- Floating-rate loans are popular at banks because they increase the rate sensitivity of loans in line with the increased rate sensitivity of bank liabilities.
- In each case, the contractual rates should reflect the estimated cost of bank funds, perceived default risk, and a term liquidity and interest rate risk premium over the life of the agreement.

Pricing new commercial loans

- The approach is the same, equating revenues with expenses plus target profit, but now the loan officer must forecast borrower behavior.
- For loan commitments this involves projecting the magnitude and timing of actual borrowings, compensating balances held, and the volume of services consumed.
- The analysis assumes that the contractual loan rate is set at a markup over the bank's weighted marginal cost of funds and thus varies coincidentally.

Risk-adjusted returns on loans

- When deciding what rate to charge, loan officers attempt to forecast default losses over the life of the loan.
- Credit risk, in turn, can be divided into expected losses and unexpected losses.
 - Expected losses might be reasonably based on mean historical loss rates.
 - In contrast, unexpected losses should be measured by computing the deviation of realized losses from the historical mean.

Factors affecting loan pricing

- Credit profile/ outstanding credit report.
- Mortgaged property
- Loan to value ratio : Higher LTV, higher the interest rate and cost.
- Income/Debt Ratio : Higher ratio, higher risk, higher charges.
- Other factors : Previous bankruptcies, foreclosures or unpaid judgments; and the type of loan product applied for, such as adjustable rate versus fixed rate, or cash out refinance versus rate and term refinance.

CHAPTER-12

DISINVESTMENT

Disinvestment-Meaning

- A reduction in capital investment reflected by a decrease in capital goods and a company's decision not to replace depleted capital goods.
- The action of an organization or government selling or liquidating an asset or subsidiary. Also known as "divestiture".
- A company or government organization will divest an asset or subsidiary as a strategic move for the company, planning to put the proceeds from the divestiture to better use that garners a higher return on investment.
- Disinvestment process was started in 1991-92 with the sale of minority stakes in some public sector undertakings (PSUs).

Reasons of disinvestment

- low productivity,
- unsatisfactory quality of goods,
- excessive manpower utilization,
- inadequate human resource development
- low rate of return on capital
- Corruption level.

Disinvestment in public sector undertakings

Year	Target	Achievement
1993-94	3,500	-
1991-92	2,500	3038
1992-93	2,500	1913
1993-94	3,500	-
1994-95	4,000	4,843
1995-96	7,000	362
1996-97	5,000	380
1997-98	4,800	902
1998-99	5,000	5,371
1999-00	10,000	1,860
2000-01	10,000	1,871
2001-02	12,000	# 5,632
2002-03	12,000	3,348
2003-04	14,500	15,547
2004-05	4,000	@ 2,765

Figures inclusive of amount realised by way of control premium, dividend/dividend tax transfer of surplus cash reserves prior to disinvestment etc.

@ Up to December 2004.

Source : Department of Disinvestment, Ministry of Finance

Current policy on disinvestment in India

- In May 2004, Government adopted the National Common Minimum Programme (NCMP), which outlines the policy of the Government with respect to the public sector. The relevant extracts of NCMP are given hereinunder:
- “ The UPA Government is committed to a strong and effective public sector whose social objectives are met by its commercial functioning. But for this, there is need for selectivity and a strategic focus. The UPA is pledged to devolve full managerial and commercial autonomy to successful, profit-making companies operating in a competitive environment. Generally profit-making companies will not be privatized.
- All privatizations will be considered on a transparent and consultative case-by-case basis. The UPA will retain existing “navratna” companies in the public sector while these companies raise resources from the capital market. While every effort will be made to modernize and restructure sick public sector companies and revive sick industry, chronically loss-making companies will either be sold-off, or closed, after all workers have got their legitimate dues and compensation. The UPA will induct private industry to turn around companies that have potential for revival.
- The UPA Government believes that privatization should increase competition, not decrease it. It will not support the emergence of any monopoly that only restrict competition. It also believes that there must be a direct link between privatization and social needs – like, for example, the use of privatization revenues for designated social sector schemes. Public sector companies and nationalized banks will be encouraged to enter the capital market to raise resources and offer new investment avenues to retail investors”

Calling off of the ongoing cases of Strategic Sale

- In conformity with the policy enunciated in NCMP, it was decided in February 2005 to formally call off the process of *disinvestment through Strategic Sale* of profit making Central Public Sector Undertakings (CPSUs), as enumerated below:

- **List of Strategic Sale cases called off**

S. No.	Name of the CPSU	Percentage of equity which was earlier proposed to be sold through Strategic	Sale
1	Manganese Ore India Limited	51%	
2	Sponge Iron India Limited	100%	
3	Shipping Corporation of India Limited	54.12% (51% through Strategic Sale and 3.12% to employees)	
4	National Aluminium Company Limited	61.15% (10% Domestic Issue, 20% ADR Issue, 29.15% Strategic Sale, 2% to Employees)	
5	National Building Construction Corporation Limited	74%	
6	National Fertilizers Limited	53% (51% through Strategic Sale and 2% to Employees)	
7	Rashtriya Chemicals and Fertilizers Limited	53% (51% through Strategic Sale and 2% to Employees)	

8	Hindustan Petroleum Corporation Limited	39.01% (34.01% through Strategic Sale and 5% to Employees)
9	Engineers India Limited	61% (51% through Strategic Sale and 10% to Employees)
10	Balmer Lawrie and Company Limited	61.8%
11	Engineering Projects India Limited	74%
12	Hindustan Paper Corporation Limited	74%
13	State Trading Corporation of India Limited	75% (65% through Strategic Sale and 10% to Employees)

Recent developments in disinvestment : Sale of minority shareholding through Initial Public Offerings (IPO), and Follow on Public Offerings (FPO)

- 1.3.1 On 27th January, 2005, Government decided, in principle, to list large, profitable CPSUs on domestic stock exchanges and to selectively sell a minority stake in listed, profitable CPSUs while retaining at least 51% of the shares along with full management control so as not to disturb the Public Sector character of the companies. Government also decided to constitute a National Investment Fund (NIF) into which the realisation from sale of minority shareholding of the Government in profitable CPSUs would be channelised. NIF is to be maintained outside the Consolidated Fund of India. The income from NIF would be used for the following broad investment objectives: -
- a) Investment in social sector projects which promote education, health care and employment;
 - b) Capital investment in selected profitable and revivable Public Sector Enterprises that yield adequate returns in order to enlarge their capital base to finance expansion/ diversification.
- 1.3.2 On 25th November, 2005 Government decided, in principle, to list large, profitable CPSUs on domestic stock exchanges and to selectively sell small portions of equity in listed, profitable CPSUs (other than the Navratnas)”
- 1.3.3 On 6th July, 2006, Government decided to keep all disinvestment decisions and proposals on hold, pending further review.

Evolution of the Disinvestment Policy

- 2.1 The Statement of Industrial Policy dated July 24, 1991 stated that in the case of selected enterprises, part of Government holdings in the equity share capital of these enterprises will be disinvested in order to provide further market discipline to the performance of public enterprises. Thus, disinvestment of the Government's equity in CPSUs started in 1991-92, when minority shareholding of the Central Government in 30 individual CPSUs was sold to selected financial institutions (LIC, GIC, UTI) in bundles, in order to ensure that along with the attractive shares, the not so attractive shares also got sold. Subsequently, shares of individual CPSUs were sold and the category of eligible buyers was gradually expanded to include individuals, NRIs and registered FII's. By 1997, sale through the GDR route was also initiated and MTNL (1997-98), VSNL (1998-99) and GAIL (1999-2000) all used the opportunity to access the GDR market. The number of listed CPSUs on domestic stock exchange stood at 42 as on 31.3.2006.
- 2.2 The policy on disinvestment has evolved through statements of Finance Ministers in their budget speeches. In the interim budget 1991-92, it was announced that the Government would disinvest up to 20 per cent of its equity in selected public sector undertakings in favour of mutual funds and financial or investment institutions in the public sector to broaden the shareholding, improve management, enhance availability of resources for these CPSUs and yield resources for the exchequer.
- 2.3 The Rangarajan Committee recommended in April 1993 that the percentage of equity to be disinvested should be generally under 49% in industries reserved for the public sector and over 74% in other industries. As per statement of Industrial Policy dated 24th July 1991 the following industries were proposed to be reserved for the public sector:-

Arms and ammunition and allied items of defence equipment, Defence aircraft and warships.

- Atomic Energy.
- Coal and lignite
- Mineral oils.
- Mining of iron ore, manganese ore, chrome ore, gypsum, sulphur, gold and diamond.
- Mining of copper, lead, zinc, tin, molybdenum and wolfram.
- Minerals specified in the Schedule to the Atomic Energy (Control of Production and Use) Order, 1953.
- Railway transport.

In the budget speech of 1996-97, the proposal to establish a Disinvestment Commission was announced. It was also stated that the revenues generated from such disinvestment will be utilised for allocation to education and health sectors and for creating a fund to strengthen CPSUs.

Public Sector Disinvestment Commission

- 2.5 The Public Sector Disinvestment Commission was established on 23rd August 1996, for a period of three years, as an independent, non-statutory, advisory body with Shri G.V. Ramakrishna as full time Chairman, four other Members (part time) and a full time Member Secretary. 72 CPSUs were referred to the Commission. Subsequently, 8 cases were withdrawn. The Commission submitted 12 reports for 58 CPSUs, recommending strategic sale in 28 cases, trade sale in 8 cases, closure of 4 units, equity sales in 6 cases and no change (disinvestment deferred) in 12 cases. The Commission did not take up examination of the cases of six CPSUs, which were registered with the Board for Industrial & Financial Reconstruction (BIFR). The tenure of the Chairman of the Commission was extended till 30th November 1999.
- 2.6 In the budget speech of 1998-99, it was announced that, in the generality of cases, the Government's shareholding in CPSUs would be brought down to 26%. In the case of CPSUs involving strategic considerations, the Government would continue to retain majority shareholding. The interest of workers would be protected in all cases.
- 2.7 In the budget speech of 1999-2000, it was announced that Government's strategy towards the CPSUs would continue to encompass a judicious mix of strengthening strategic units, privatising non-strategic ones through gradual disinvestment or strategic sale and devising viable rehabilitation strategies for weak units.

2.8 On 16th March 1999, the Government classified the CPSUs into strategic and non-strategic areas for the purpose of disinvestment. It was decided that the strategic CPSUs would be those functioning in the areas of:

- Arms and ammunition and the allied items of defence equipment, defence aircrafts and warships;
- Atomic energy (except in the areas related to the generation of nuclear power and applications of radiation and radio-isotopes to agriculture, medicine and non-strategic industries);
- Railway transport.

All other CPSUs were to be considered as being non-strategic. For the non-strategic CPSUs, it was decided that reduction of the Government's shareholding to 26% would not be automatic and the manner and pace of doing so would be decided on a case-by-case basis on the following considerations:

- a) Whether the industrial sector required the presence of the public sector as a countervailing force to prevent concentration of power in private hands, and
- b) Whether the industrial sector required a proper regulatory mechanism to protect the consumer interests before Public Sector Enterprises were privatised.

It was also decided to establish a new Department for Disinvestment to systematize the policy approach to disinvestment and privatisation and to give a fresh impetus to this programme. The Department came into being on 10th December 1999.

2.10 In the budget speech of 2000-2001, it was announced that the main elements of the Government's policy were to restructure and revive potentially viable CPSUs; close down CPSUs which cannot be revived; bring down Government's shareholding in all non-strategic CPSUs to 26% or lower, if necessary; and fully protect the interests of workers. The receipts from disinvestment and privatisation will be used for meeting expenditure on social sectors, restructuring of CPSUs and for retiring public debt.

Reconstituted Public Sector Disinvestment Commission

- 2.11 The Public Sector Disinvestment Commission was re-constituted on 24th July 2001 for a period of two years with Dr. R.H. Patil as Chairman (part time) along with four other Members (part time) and a full time Member Secretary. The then Ministry of Disinvestment had informed the Commission on 23rd January 2002 that all non-strategic CPSUs, including subsidiaries, but excluding IOC, ONGC and GAIL, stood referred to the Commission for it to prioritize, examine and make recommendations in the light of the Government policies articulated earlier on 16th March 1999 and the budget speeches of Finance Ministers from time to time. The Disinvestment Commissions in 25 reports submitted between February 1997 – March 2004 disinvestment through strategic sale in 59 cases; disinvestment other than strategic sale in 32 cases and closure was recommended in 4 cases. The term of the Commission was subsequently extended till 31st October 2004. The Commission ceased to exist from 1st November, 2004.
- 2.12 In the budget speech of 2001 – 2002, it was announced that CPSUs must be strengthened to compete and prosper in the new environment. A receipt of Rs. 12,000 crore was budgeted from disinvestment. Out of this, an amount of Rs. 7,000 crore was to be used for providing restructuring assistance to CPSUs, safety net to workers and reduction of debt burden and a sum of Rs. 5,000 crore for providing additional budgetary support for the Plan, primarily in the social and infrastructure sectors. This additional allocation for the Plan would be contingent upon realisation of the anticipated receipts.
- 2.13 The Government decided in September 2002 that CPSUs and Central Government owned cooperative societies (where Government's ownership is 51% or more) should not be permitted to participate as bidders in the disinvestment of other CPSUs unless specifically approved by the Core Group of Secretaries on Disinvestment (CGD). In December 2002 on the basis of a proposal of the Department of Fertilizers, it was decided that Multi State Cooperative Societies under the Department of Fertilizers be allowed to participate in the disinvestment of fertilizer CPSUs including National Fertilizers Limited.

2.14 In a suo motu statement made in both Houses of Parliament on 9th December, 2002, by the then Minister of Disinvestment, the Government reiterated the policy as

“The main objective of disinvestment is to put national resources and assets to optimal use and in particular to unleash the productive potential inherent in our public sector enterprises. The policy of disinvestment specifically aims at:

- Modernization and upgradation of Public Sector Enterprises;
- Creation of new assets;
- Generating of employment; and
- Retiring of public debt.

Government would continue to ensure that disinvestment does not result in alienation of national assets, which, through the process of disinvestment, remain where they are. It would also ensure that disinvestment does not result in private monopolies. In order to provide complete visibility to the Government’s continued commitment of utilisation of disinvestment proceeds for social and infrastructure sectors, the Government would set up a Disinvestment Proceeds Fund. This Fund would be used for financing fresh employment opportunities and investment, and for retirement of public debt. For the disinvestment of natural asset companies, the Ministry of Finance and the Ministry of Disinvestment would work out guidelines. The Ministry of Finance would also prepare for consideration of the Cabinet Committee on Disinvestment a paper on the feasibility and modalities of setting up an Asset Management Company to hold, manage and dispose the residual holding of the Government in the companies in which the Government’s equity has been disinvested to a strategic partner.”

2.15 The then Ministry of Disinvestment issued guidelines regarding Management-Employee Bids in Strategic Sale on 25th April 2003 to encourage and facilitate the participation of employee participation in strategic sales.

2.16 In the budget speech for 2003-04, the Government announced that details regarding the already announced Disinvestment Fund and Asset Management Company, to hold residual shares post disinvestment, would be finalized early in 2003-04.

Recent Cases

1. DISINVESTMENT OF VIDESH SANCHAR NIGAM LIMITED

- Government had decided to disinvest in VSNL in January 2001 and the advertisement for inviting Expression of Interest was issued in February 2001 is owned by TATA Communication now.

2. DISINVESTMENT OF MARUTI UDHYOG LIMITED

- Recently, 18.28% of the company was owned by the Indian government, and 54.2% by Suzuki of Japan. The Indian government held an initial public offering of 25% of the company in June 2003. As of May 10, 2007, Govt. of India sold its complete share to Indian financial institutions. With this, Govt. of India no longer has stake in Maruti Udyog.

Recent Case of Disinvestment (to be happened)

- Govt. to divest 20% in SAIL.
 - ON FPO (follow-on-public) basis.
 - 5% dilution of govt. equity.
 - 5% issue of additional shares in each phase.
 - SAIL will then inform SEBI about it.

CHAPTER-13

NARASIMHAM COMMITTEE REPORTS

- The Advisory Group has set out a inter-lined package of recommendations to enable India to move towards attaining internationally accepted best practices on transparency in monetary and financial policies. These recommendations would need to be properly sequenced and implemented over time.

Overall Concept and Context of Transparency

1. For purposes of this Report, transparency refers to an environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information relating to monetary and financial policies and the specifics of accountability of different agencies are provided to the public in an unequivocal and understandable manner and accessible on a timely basis. Transparency should not be viewed as an end in itself but a necessary prerequisite of good governance as policy actions pass through the test of public scrutiny (Paragraph 2.3).
2. The government, while setting out the framework of objectives, should, in the first instance, set out these objectives before the legislature and after endorsement by the legislature entrust to the central bank the task of attaining these objectives (Paragraph 2.4).
3. The Advisory Group is of the view that greater transparency would compel the authorities to bring about a greater degree of rigour in the formulation of strategies and choice of instruments and there are distinct advantages in a well-informed public debate on the objectives and instruments (Paragraph 2.5).
4. The Advisory Group recognises that there may be good reason for central banks not to disclose certain internal deliberations and documentation and near-term monetary and exchange rate policy implementation strategies. The authorities have to display considerable finesse while drawing the line on disclosures (Paragraph 2.7).
5. Monetary policy is only an aspect of overall economic policy and, therefore, there is need for convergence in policies as also transparency in other aspects of economic policy (Paragraph 2.9).

Critical Evaluation of India's Compliance

With International Codes

6. The RBI's policies and operations largely conform to the IMF Code, but there are clearly a number of areas where improvements need to be made before India can be said to be fully compliant with the IMF Code. In the area of dissemination of information and the rationale of policies the RBI could be considered as being in accord with international best practices though there could be scope for further improvement, especially in providing precision to the monetary policy mandate and revealing of the process of monetary policy formulation. The Advisory Group recommends that the process of communicating the policy process, albeit on a post facto basis, needs to be institutionalised (Paragraphs 3.1 and 3.2).
7. The Advisory Group hopes that the National Commission to Review the Working of the Constitution would address the relevant constitutional issues as they apply to the RBI (Paragraph 3.3).
8. The Advisory Group is of the view that there is need for a transparent setting of objectives of monetary policy by the government and if the government finds these objectives as having certain adverse effects it can always alter the objectives, but it should be done in a transparent manner and made public and placed on the Table of the House and the government should seek Parliamentary deliberation of the objectives. This would then reduce the possibility of counterproductive conflict between the government and the RBI (Paragraph 3.6).
9. The Advisory Group emphasises that the present RBI Act is anachronistic and there should be an early move to amend the RBI Act to give sharper focus to the objectives of monetary policy. Transparency in monetary policy and greater responsibility and accountability for the RBI will be meaningful only if there is legislative amendment of the RBI Act to provide the necessary autonomy to the RBI to fulfil its responsibilities. The objectives of monetary policy should be set out by the government, as part of its overall economic policy package, and the government should seek Parliamentary debate on these objectives as also any changes in these objectives thereafter, which should be in the public domain (Paragraph 3.7).

10. The Advisory Group is of the view that it would be necessary to provide, through legislative amendments, reasonable security of tenure to the Top Management of RBI. This is essential if the RBI is to be clearly assigned specific responsibilities in the conduct of monetary policy and be accountable for the same to the wider public (Paragraph 3.9).

11. The Finance Minister Shri Yashwant Sinha in his Budget Speech for 2000-01 has said :

'In the fast changing world of modern finance it has become necessary to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system. Accordingly, I intend to bring to Parliament proposals for amending the relevant legislation.'

The Advisory Group is gratified to note this commitment and urges that early action should be taken on the intention set out in the Budget Speech to amend the relevant legislation to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system (Paragraph 3.10).

Process of Monetary Policy Formulation

12. The Advisory Group recommends that the determination of interest rates should be exclusively a monetary policy function. There should be well calibrated legislative measures to separate debt management and monetary policy functions. The government should set up its own independent Debt Management Office to take over, in a phased manner, the present debt management functions discharged by the RBI. The Advisory Group recognises that separation of debt management and monetary policy is a necessary but not a sufficient condition for an effective monetary policy which would also require a reasonable degree of fiscal responsibility (Paragraphs 4.2, 4.4 and 4.5).
13. The Advisory Group is of the view that what the RBI needs, by way of autonomy is headroom to operate monetary policy and this it would have once debt management is separated from monetary policy and the fisc is in reasonable balance. Over a phased period, as debt management is gradually distanced from monetary policy, the government and RBI should progressively work towards greater clarity in publicly setting out the objectives of monetary policy. The RBI should evolve a move to greater transparency in setting out the process of monetary policy formulation so that accountability of the RBI can be properly assessed (Paragraphs 4.6 and 4.7).
14. The Advisory Group recommends that with a view to moving towards a more transparent system it would be best to veer towards prescribing to the RBI a single objective while the government could have for itself a clearly set out hierarchy of objectives for which it could use its other instruments of policy. There is much merit in the authorities clarifying issues in monetary and financial policies in simple language intelligible to the general public (Paragraph 4.8).

15. Illustratively, the government can unequivocally set out to the RBI a medium-term inflation objective, say over a prospective three year period, and while fixing this objective the government can take cognizance of other objectives and the government can retain the right, with Parliamentary endorsement, to reset the single objective in the light of evolving developments. The initial statement and consequent resetting of the objective should be done transparently and the rationale of the change should be fully explained. For purposes of credibility, frequent resetting of the objective, for a particular period, should be the exception rather than the rule (Paragraph 4.9).

Transparency in Policy Formulation

16. The Advisory Group recommends that the RBI should set up a seven member *Monetary Policy Committee* (MPC) as a Committee of the RBI Central Board. MPC consisting of the Governor, the three Deputy Governors and three other members drawn from the RBI Central Board. The members of the MPC should be knowledgeable in the areas of macro economics, monetary analysis, central banking policy and operations and banking and finance. More importantly, to ensure against any conflict of interest, the three Board members on the MPC should be independent professionals. The Advisory Group recommends that the MPC be set up early so as to give the MPC some time to work out its modalities and to undertake a few trial runs before the formal procedures are put in place starting from say the next financial year (Paragraph 5.2).
17. The Government of India should consider setting out to the RBI a single objective for monetary policy viz. the inflation rate. Once the single objective is set out the remit of the MPC would be clear and the RBI should be given unfettered *instrument* freedom and held fully accountable for attaining this objective. There is some merit in having an overriding provision under which the government can give a directive on monetary policy to the RBI but this should be in writing and in specific terms and applicable for a specific period; this should require Parliamentary endorsement after being placed on the Table of the House (Paragraphs 5.3, 5.4 and 5.6)
18. The Advisory Group recommends that there should be a monthly meeting of the MPC on a predetermined date, such as the last Wednesday of the month. A convention should develop wherein the RBI should time its measures immediately after the MPC meeting. A short statement should be issued immediately after the meeting of the MPC even when no measures are envisaged. The minutes of the meetings of the MPC should be made public with progressively increased details over time. The RBI should develop a healthy tradition of accepting the recommendations of the MPC save in very exceptional circumstances and in such cases the RBI should publicly justify its actions (Paragraph 5.7, 5.8, 5.9 and 5.11).

Transparency in other financial policies

19. Banks and other financial institutions owe it to their depositors to provide relevant information on performance in simple language easily understood by depositors. While stressing the need for greater disclosure the Advisory Group recognises the need for legitimate protection of proprietorial information (Paragraph 5.14).
20. The Advisory Group stresses that where there is regulatory forbearance it should be undertaken transparently. The regulatory regime should be rule based with minimum of discretion. Such a regime would obviously reinforce transparency (Paragraph 5.15).
21. The Advisory Group commends the recent RBI initiative to release a *Discussion Paper on Prompt Corrective Action (PCA)* and it is hoped that after receiving appropriate feedback the RBI would put in place a PCA regime as part of a commitment to adopt the international best practices and comply fully with the *Core Principles of Supervision* (Paragraph 5.17).
22. The regulatory/supervisory authorities in India should give early consideration to introducing, in a phased manner, a practice of disclosure of adverse supervisory action. The Advisory Group recommends that when penalties are imposed, however small, they should be publicised; minimal but timely adverse action would alert all stakeholders viz. owners, depositors and employees and there would be early convergence to least cost remedial action. A cardinal principle of sound regulation/ supervision should be that it should never be varied over the business cycle. It is entirely a monetary policy function to deal appropriately with the business cycle. *Per contra*, monetary policy should not be diluted to make it less costly for financial intermediaries to comply with prudential norms (Paragraphs 5.18, 5.19 and 5.20).

23. In terms of transparency, the setting out of the principal objective of monetary policy would also provide the broad contours for exchange rate policy. The Advisory Group is of the view that the Indian disclosure standards compare favourably when considered against the *disclosure template* set out in the BIS Report on *Enhancing Transparency Regarding the Authorities Foreign Currency Liquidity Position* (September 1998). The Advisory Group recommends that the RBI should continue to be in the *avant garde* on disclosure of forward liabilities. This is an instance where Indian practices are ahead of international 'best practices'. Revealing the maturity pattern of forward liabilities would help stabilise market reaction to variations in the reserves resulting from maturing forward purchases/sales (Paragraph 5.21).
24. The Advisory Group recommends that the efficiency of the forex market would be greatly enhanced if, without in any way compromising the freedom of action on exchange rate policy, the RBI were to reveal, on a regular basis, separately, its direct and indirect intervention operations (Paragraph 5.22).
25. The Advisory Group is of the view that for an effective transmission of monetary policy the changes in the various segments of the financial markets should be allowed to traverse freely through different segments of the financial markets (Paragraph 5.23).

CHAPTER-14

CONSORTIUM LOANING

- A syndicated loan (or consortium advance or multiple banking arrangements) is a large loan in which a group of banks provide funds for a borrower, usually several but without joint liability. There is usually a lead bank or group of banks (the "Arranger/s" or "Agent/s") that takes a percentage of the loan and syndicates or sells the rest to other banks. In contrast, a bilateral loan, only involves one borrower and one lender (often a bank or financial institution.) A syndicated loan is a much larger and more complicated version of a participation loan. There are typically more than two banks involved in syndication.
- Syndicated loans can be underwritten or arranged on a best endeavors basis. Where a loan is underwritten the Arrangers or Agents guarantee the terms and conditions and costs of the loan before it is sold to other banks, essentially removing the market risk for the Borrower.

RBI regulations

- Various regulatory prescriptions regarding were withdrawn by Reserve Bank of India in October 1996 with a view to introducing flexibility in the credit delivery system and to facilitate smooth flow of credit.
- The banks are encouraged to strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks as under:
 - (i) At the time of granting fresh facilities, banks may obtain declaration from the borrowers about the credit facilities already enjoyed by them from other banks in **Annex 1**. In the case of existing lenders, all the banks may seek a declaration from their existing borrowers availing sanctioned limits of Rs.5.00 crore and above or wherever, it is in their knowledge that their borrowers are availing credit facilities from other banks, and introduce a system of exchange of information with other banks as indicated above.
 - (ii) Subsequently, banks should exchange information about the conduct of the borrowers' accounts with other banks in the format given in **Annex II** at least at quarterly intervals.
 - (iii) Obtain regular certification by a professional, preferably a Company Secretary, regarding compliance of various statutory prescriptions that are in vogue, as per specimen given in **Annex III**.
 - (iv) Make greater use of credit reports available from CIBIL.
 - (v) The banks should incorporate suitable clauses in the loan agreements in future (at the time of next renewal in the case of existing facilities) regarding exchange of credit information so as to address confidentiality issues.

Annexure to refer

- Annexure I
- Annexure II
- Annexure III (from the link <http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=4487&Mode=0>)

CHAPTER-15

CREDIT RATINGS & CREDIT GAPS

CRISIL definition

- Credit rating is an unbiased and independent opinion as to issuer's capability to honor the repayment schedule.
- This precisely determines the issuer's "Ability to Pay" and "Willingness to Pay".
- Rating does not mean low profitability but it suggests higher profitability.

Concept

- Credit rating is a technique of credit risk valuation for the corporate debt instruments reflecting borrower's expected capability and inclination to pay interest and principal in a timely manner.
- Rating is a symbolic indicator of the current opinion on the relative capability of timely servicing of the debts and obligations.
- Lower rating does not mean lesser funds available rather it suggests higher risk level.
- Credit rating essentially establishes a link between risk and return.
- A rating is valid for the lifetime of the debt instrument subject to continuous surveillance and depending upon the performance of the issuer, it may be retained, placed under watch, upgraded or downgraded.

Benefits of CR

1. Benefits to Investors

- Safeguard against bankruptcy
- Recognition of risk
- Credibility of issuer
- Easy understandability of investment proposal
- Saving of resource
- Independent of investment decision
- Choice of investments
- Benefits of rating surveillance

Contd....

- **Benefits of Rating to Company**
 1. Lower cost of borrowing
 2. Wider audience for borrowing
 3. Rating as marketing tool
 4. Reduction of cost in public issues
 5. Motivation for growth
 6. Unknown issuer recognition
 7. Benefits to brokers and financial intermediaries

Disadvantages of CR

1. Biased rating and misrepresentations
2. Static study
3. Concealment of material information
4. Rating is no guarantee for soundness of company
5. Human bias
6. Reflection of temporary adverse condition
7. Down grade
8. Difference in rating of two agencies

Background

- Credit Rating (CR) as financial service, has come a long way, since John Moody first introduced the concept 1909. In India it started in 1988.
- Risks are not guarantee against loss, it's on the risk of default.
- Credit rating is has been used to rate debt instrument viz. Fixed Deposit, Commercial Paper.

Methodology

- In evaluation both qualitative and quantitative criteria are applied.
- It involves past performance as an assessment of its future prospects and entails judgement of the company's competitive position, operating efficiency, management evaluation, accounting quality, legal position, earnings, cash flow adequacy, financial flexibility, the quality of the product etc.

Benefits

- Rating system works in the interest of the issuing company as well as the investors.
- Rating directly influence the cost and availability of funds to the issuers (upward rating = funds at lower cost).
- Ratings help channel funds according to the inherent worth of the projects rather than according to mere names.

Credit Rating In India

- India is first among the third world countries to set up a CR agency in 1988 – Credit Rating Information Services of India Ltd. (CRISIL), promoted by ICICI, UTI & Others.
- Second CR agency, Investment Information & Credit Rating Agency (ICRA), was set up in 1991, promoted by IFCI.
- The third CR agency, CARE started working in 1993, promoted by IDBI.

Types Of Rating

1. Bond / Debenture Rating
2. Equity Rating
3. Preference share rating
4. Commercial Paper rating
5. Fixed deposit rating
6. Borrower rating – Rating of borrower
7. Individuals Rating – Individuals credit rating
8. Structured Obligation – Asset backed security
9. Sovereign Rating – Rating of a country

Credit gap

- The credit gap is defined as the difference between the current ratio of credit to GDP and a slowly changing measure of the trend value of this ratio.
- When using this measure, a key issue is determining when the gap has become “too large.” For instance, if we were to use a credit gap of 5% as a threshold and announce that a financial crisis would occur over the next three years whenever this threshold was exceeded, we would be able to predict 74% of the crises that occurred subsequently. Lowering the threshold to 4% would increase the number of crises accurately forecast but would also increase the number of false predictions. Thus, determining what value to use as a threshold remains a matter of judgment.

Illustration

- The credit gap since 1980, using annual U.S. data starting in 1955. The credit gap's value for 1985, for instance, represents the difference between the ratio of total non financial-sector credit in the economy to GDP multiplied by 100 and the trend value of that ratio calculated using data from 1955 to 1985. This credit gap measure has exceeded 5% every year since 2001, though its highest recent value occurred last year. The all-time peak occurred in the mid-1980s, when it stayed above 5% for three years.

UNIT III

CHAPTER-1

MUTUAL FUNDS

Introduction

- These units are investment vehicles that provide a means of participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully.
- An institutional device through which investors pool funds of savers to invest in a diversified portfolio of securities, thus spreading and reducing risk. These funds are invested in a wide variety of securities in such a way so as to minimize risk while ensuring steady returns.
- It is a form of collective investment brought in by a large group of investors for the mutual benefit of savers as well as investors.

Evolution of Mutual Funds

- Early pioneering investments of Scottish and English investors in the American West in the 1800s, and later of the early global portfolio investors in Japan in the 1960s.
- In 1822, royalty (in the form of King William I of the Netherlands) came up with an option for the rest of us: The Close-end fund.
- It came to India only in the 1960s.
- Association of Mutual Funds in India (AMFI) was formed.

Types of Mutual Funds

- Open and closed end funds.
- Income and growth-oriented fund.
- Area, industry, customer group funds.
- Taxation funds.

Advantages of Mutual Funds

- Professional management.
- Diversification.
- Convenient administration.
- Return potential.
- Low costs.
- Liquidity.
- Transparency.
- Flexibility.
- Choice of schemes.
- Well regulated.

How to pick the right Mutual Fund?

- The Fund's offering
- The Fund's performance.
- The Fund manager/ management style.
- Portfolio management.
- Risk- adjusted return and volatility.
- Expense ratio and loads.
- The Fund house.
- Seek advice.
- The Portfolio Management System (PMS) option.

CHAPTER-2

INVESTMENT TRUST COMPANIES

Introduction

- An investment company is a company whose main business is holding securities of other companies purely for investment purposes. The investment company invests money on behalf of its shareholders who in turn share in the profits and losses.
- Investors' money is pooled together from the sale of a fixed number of shares a trust issues when it launches. The board will typically delegate responsibility to a professional fund manager to invest in the stocks and shares of a wide range of companies (more than most people could practically invest in themselves). The investment trust often has no employees, only a board of directors comprising only non-executive directors.

History of investment trust companies

- The first investment trust was started in 1868 by F&C (Foreign & Colonial Investment Trust).
- Investment trusts are common in the UK and well established within legal and regulatory frameworks.

Why investment trusts companies live in the shadow of the unit trusts

- The first and most important reason is promotion: Investment trusts are prevented by law, like all other public companies, from advertising or promoting the sale of their shares.
- The second is commission: Generally speaking the rates of commission or brokerage paid to an intermediary on the sale of investment trust company shares are non-existent or much lower than those payable on the sale of units in a unit trust. Hence, financial planners and other investment advisors have hitherto been more inclined to recommend those products which provide them with higher remuneration and
- Thirdly: Unlike unit trusts, investment trusts do not pay advisors trail commissions (commission deducted annually from the investor's assets for as long as they are invested in the fund).

Split Capital Investment Trusts

- **Splits** issue different classes of share to give the investor a choice of shares to match their needs. Most Splits have a limited life determined at launch known as the wind-up date. Typically the life of a Split Capital Trust is five to ten years.
- Every Split Capital Trust will have at least two classes of share:
- In order of (typical) priority and increasing risk
- *Zero Dividend Preference shares* - no dividends, only capital growth at a pre-established redemption price (assuming sufficient assets)
- *Income shares* - entitled to most (or all) of the income generated from the assets of a trust until the wind-up date, with some capital protection
- *Annuity Income shares* - very high and rising yield, but virtually no capital protection
- *Ordinary Income shares* (aka Income & Residual Capital shares) - a high income and a share of the remaining assets of the trust after prior ranking shares
- *Capital shares* - entitled most (or all) of the remaining assets after prior ranking share classes have been paid; very high risk
- Splits may also issue *Packaged Units* combining certain classes of share, usually reflecting the share classes in the trust usually in the same ratio. This makes them essentially the same investment as an ordinary share in a conventional Investment Trust.

CHAPTER-3

UNIT TRUST OF INDIA (UTI)

INTRODUCTION

- The basic objective is to encourage investment and participation in the income, profits and gains accruing to the corporation from the acquisition, holding, management of securities.
- In 1963, the government undertook aggressive programmes to mobilize the long – term savings of the people and direct them into productive channels with a view to fostering industrial growth in the country.
- The trust commenced its operations from July 1, 1964, with an initial capital of Rs. 5 crores which was raised from the Reserve Bank of India, LIC, SBI and its subsidiaries, scheduled banks and other financial institutions.
- It is managed and controlled by Board of Trustees, which is headed by a chairman appointed by the Government of India. 4 trustees and the Executive Trustee are appointed by IDBI. Remaining trustees are nominated by the other contributors to the initial capital.

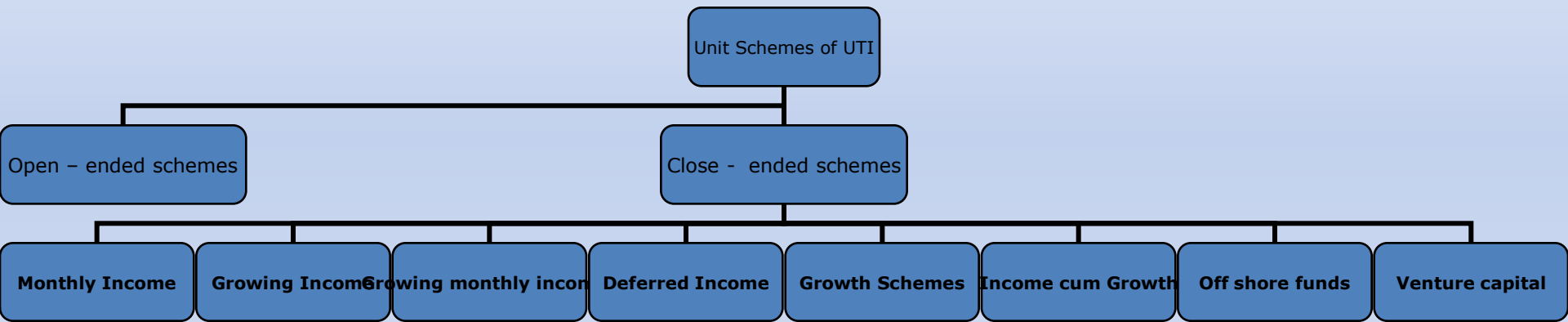
Objectives of UTI

- To mobilize savings of the community by offering savers the triple benefits of safety, liquidity and profitability on investments.
- To channelize the pooled savings into productive outlets.
- To give every one a chance to indirectly own shares and securities in a large number of select companies and to enable the investors to share in the widening prosperity consequent on industrial growth.

Structure of UTI

- The fund manager runs the trust for profit.
- The trustees ensure the fund manager keeps to the fund's *investment objective* and safeguards the trust assets.
- The unit holders have the rights to the trust assets.
- The distributors allow the unit holders to transact in the fund manager's unit trusts
- The registrars are usually engaged by the fund manager and generally acts as a middleman between the fund manager and various other stakeholders

Mobilisation of savings by UTI



Types of Scheme	No.of Schemes
Open – end schemes	37
Closed – end schemes	
◆ Monthly Income Unit Schemes	21
◆ Deferred Income Unit Plans	2
◆ Special Schemes	2
◆ Growth Schemes	16
◆ Income cum Growth Schemes	8
Off – shore Funds (Close ended)	7
Venture Capital (Close ended)	3
Sub Total	59
Total	96

Subsidiaries to UTI

- The UTI Bank Ltd.
- UTI Investor Services Ltd.
- UTI Securities Exchange LTD. (UTI - SEL).
- UTI Investment Advisory Services.
- UTI Institute of Capital Markets (UTI - ICM).

Pricing policy of US 64 scheme

- It is the first and largest unit scheme introduced by UTI.
- It lays down the formula for determining the sale and repurchase prices. There are three elements of it:
 - Net Asset Value per unit.
 - Income received or accrued from investments from beginning of the year.
 - Incidental charges.

All these values are added up to get the value.

Causes of negative reserve of US 64

- Heavy investment in equities and higher depreciation in their market prices was directly responsible for the reduction in the scheme's earnings and widening gap between NAV and the sale and repurchase prices.
- The policy of following a stable price irrespective of market fluctuations has contributed to the investor perception that safety of capital was assured to the investors.
- The policy of distributing dividends irrespective of the income contributed to the negative reserves leading to the crisis of 1998.

Financial assistance to Corporate enterprises

- Purpose wise distribution
- Sectoral distribution
- Industry pattern
- State – wise distribution

UNIT-IV

CHAPTER-1

NON BANKING FINANCE INSTITUTION (NBFCs)

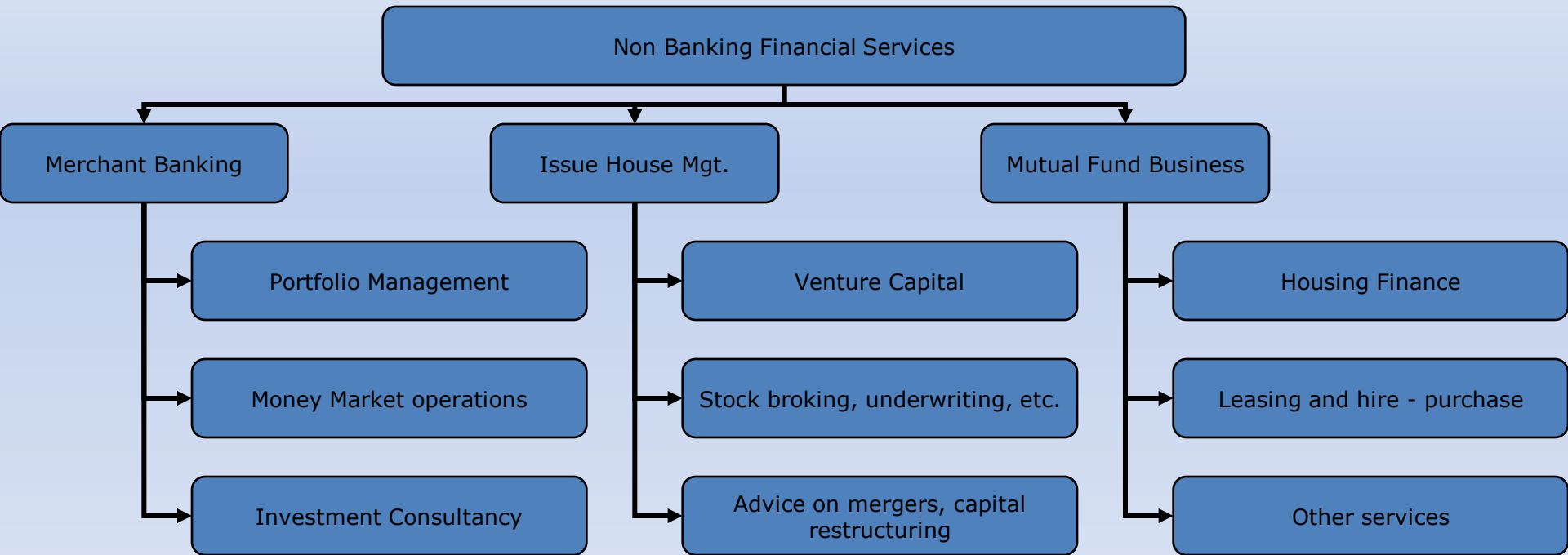
Introduction-NBFC

- **A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property.**
- A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (residuary non-banking company).
- Provides credit to unorganised sector and small borrowers.

Difference between Bank and NBFC

- a NBFC cannot accept demand deposits (demand deposits are funds deposited at a depository institution that are payable on demand -- immediately or within a very short period -- like your current or savings accounts.)
- (ii) it is not a part of the payment and settlement system and as such cannot issue cheques to its customers; and
- (iii) deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available for NBFC depositors unlike in case of banks.

Services by Non Banking Financial Institutions



Role of NBFC

- Intermediary between savers and investors.
- Mobilization of deposits.
- Loan companies
- Investment companies
- Hire purchase finance companies
- Equipment leasing companies
- Mutual benefit finance companies
- Housing finance companies

Classification of NBFC

With effect from December 6, 2006 the above NBFCs registered with RBI have been reclassified as

- (i) Asset Finance Company (AFC)
- (ii) Investment Company (IC)
- (iii) Loan Company (LC)

AFC would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive / economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.

Regulatory framework of NBFC

- Entry norms : Registration with RBI, minimum Net Owned Funds (NOF) of Rs. 20 million after April 20, 1999.
- Capital Adequacy Requirement: Capital to Risk Asset Ratio is 12% since March 31, 1999.
- Maintenance of liquid assets : To maintain liquid assets at 12.5% and 15% of public deposits with effect from April 1,1998 and April 1, 1999 respectively.
- Prudential norms : On income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, as in the case of banks.
- Exposure norms : Vasudev Committee (1998) has recommended ceilings for the exposure to real estate, investment in capital markets, especially unquoted shares and exposure to connected companies in which directors are interested.
- Acceptance of deposits : higher ceiling for equipment leasing and hire – purchase companies whose assets are secured, while prescribing a lower ceiling for loan and investment companies.

THANK YOU!!!!

