# FINANCIAL SYSTEM

**Introduction**

In its simple meaning the term 'finance' refers to monetary resources & the term 'financing' refers to the activity of providing required monetary resources to the needy persons and institutions. The term 'financial system' refers to a system that is concerned with the mobilization of the savings of the public and providing of necessary funds to the needy persons and institutions for enabling the production of goods and/or for provision of services. Thus, a financial system can be understood as a system that allows the exchange of funds between lenders, investors, and borrowers. In other words, the system that facilitates the movement of finance from the persons who have surplus funds to the persons who need it is called as financial system. It consists of complex, closely related services, markets, and institutions used to provide an efficient and regular linkage between investors and depositors. Financial systems operate at national, global, and firm-specific levels. It includes the public, private and government spaces and financial instruments which can relate to countless assets and liabilities.

**Components/Constituents/Elements/Parts of Financial System**

1. Financial Assets
2. Financial Intermediaries/Financial Institutions
3. Financial Markets
4. Financial Rates of Return
5. Financial Instruments and
6. Financial Services

**Functions/Importance/Objectives/Advantages of Financial System**

1. Provision of liquidity
2. Mobilization of savings
3. Size transformation/Capital formation
4. Maturity transformation
5. Risk transformation
6. Lowering of cost of transaction
7. Payment mechanism
8. Assisting new projects
9. Enable better decision making
10. Meet short and long term financial needs
11. Provide necessary finance to the Government
12. Accelerate the process of economic growth of the country

**Features/Characteristics of Financial System**

1. Financial system acts as a bridge between savers and borrowers
2. It consists of a set of inter-related activities and services
3. It consists of both formal and informal financial sectors. The existence of both formal and informal system is also called as financial dualism.
4. It formulates capital, investment and profit generation
5. It is universally applicable at firm level, regional level, national level and international level
6. It consists of financial institutions, financial markets, financial services, financial instruments, financial practices and financial transactions.

## FINANCIAL ASSETS

**Meaning of financial assets**

Financial assets refer to the cash or cash equivalents that are used for production or consumption or for further creation of assets. Cash, Bank Deposits, Shares, Debentures, Investment in Gold, Land & Buildings, Contractual right to receive cash or another financial asset, etc., are called as financial assets.

**Classification of Financial Assets**

Financial assets are classified in two ways

1. On the basis of marketability
2. On the basis of nature

**Classification of Financial Assets on the basis of marketability**

1. Marketable – The financial assets that can be bought and sold are called as marketable financial assets. They include Shares, Government Securities, Bonds, Mutual Funds, Units of UTI, Bearer Debentures
2. Non-marketable – The financial assets that cannot be bought and sold are called as non-marketable finance assets. They include Bank Deposits, Provident Funds, LIC Policies, Company Deposits, Post Office Certificates

**Classification of Financial Assets on the basis of nature**

1. Money or Cash Asset – Coins, Currency Notes, Bank Deposits
2. Debt Asset – Debenture & Bonds
3. Stock Asset – Equity Shares & Preference Shares

## FINANCIAL INTERMEDIARIES/FINANCIAL INSTITUTIONS

Different kinds of organizations/institutions which intermediate and facilitate financial transactions of both individual and corporate customers are called as financial intermediaries or financial institutions. Basically they are classified into two types:

1. Unorganized Sector
2. Organized Sector

**Unorganized Sector**

The sector that is not governed by any statutory or legal authority is known as unorganized sector. This sector consists of the individuals and institutions for whom there are no standardized rules and regulations governing their financial dealings. They are not under the supervision and control of RBI or any other regulatory body. This sector consists of the individuals and institutions like Local money lenders, Pawn brokers, Traders, Landlords, Indigenous bankers, etc., who lend money to needy persons and institutions.

**Organized Sector**

The sector that is governed by some statutory or legal authority is known as organized sector. This sector consists of the institutions like Commercial Banks, Non Banking Financial Institutions, etc. They are further classified into two:

1. Capital Market Intermediaries
2. Money Market Intermediaries

**Capital Market Intermediaries**

Capital Market refers to the market for long term finance. The intermediaries provide long term finance to individuals and corporate customers. IDBI, SFCs, LIC, GIC, UTI, MFs, EXIM BANK, NABARD, NHB, NBFCs (Hire Purchasing, Leasing, Investment and Finance Companies) Government (PF, NSC) etc., are in the organized sector providing long term finance.

**Money Market Intermediaries**

Money Market refers to the market for short term finance. The intermediaries provide short term finance to individuals and corporate customers. RBI, Commercial Banks, Co-operative Banks, Post Office Savings Banks, Government (Treasury Bills) are in the organized sector providing short term finance.

## FINANCIAL MARKETS

The group of individuals and corporate institutions dealing in financial transactions are termed as financial markets. The centres or arrangements that facilitate buying and selling of financial assets, claims and services are the constituents of financial market. Basically they are classified into two categories:

1. Unorganized Market
2. Organized Market

**Unorganized Market**

The sector that is not governed by any statutory or legal authority is known as unorganized sector. This sector consists of the individuals and institutions for whom there are no standardized rules and regulations governing their financial dealings. They are not under the supervision and control of RBI or any other regulatory body. Local money lenders, Pawn brokers, Traders, Landlords, Indigenous bankers, etc., who lend money are in the unorganized sector.

**Organized Market**

The sector that is governed by some statutory or legal authority is known as organized sector. This sector consists of the institutions for whom there are standardized rules and regulations governing their financial dealings. They are under the supervision and control of RBI and other statutory bodies. They are further classified into two:

A. Capital Market
B. Money Market
C. Foreign Exchange Market

**A. Capital Market**

Capital Market refers to the market for long term finance. Financial assets which have a long or indefinite maturity period are dealt in this market. Capital Market is further classified into the following three:

a) Industrial Securities Market
b) Government Securities Market
c) Long-term Loans Market

**a) Industrial Securities Market -** The financial market where industrial securities like equity shares, preference shares, debentures, bonds, etc., are dealt with is called as Industrial Securities Market. In this market, the industrial concerns raise their capital and debts by issuing appropriate securities. This market is again classified into the following two viz., Primary Market and Secondary Market

**Primary Market -** The financial market concerned with the fresh issue of industrial securities is called as primary market. It is also called as new issue market. In this market, industrial securities which are issued for the first time to the public are dealt.

**Secondary Market -** The financial market concerned with the purchase and sale of already existing industrial securities is called as secondary market. In this market, industrial securities which are already held by the individuals and institutions are bought and sold. Generally, these securities are quoted in the stock exchanges. This market consists of all the stock exchanges recognized by the

Government of India. Securities Contracts (Regulation) Act, 1956 regulates the stock exchanges and Bombay Stock Exchange is the main stock exchange in India which leads the other stock exchanges.

**b) Government Securities Market or Gilt-edged Securities Market -** The financial market where Government securities like stock certificates, promissory notes, bearer bonds, treasury bills, etc., are dealt with is called as Government Securities Market. The long term securities issued by the Central Government, State Governments, Semi-government authorities like City Corporations, Port Trusts, etc., Improvement Trusts, State Electricity Boards, All India and State level financial institutes and public sector enterprises are bought and sold in this market.

**c) Long-term Loans Market -** The financial market where long-term loans are provided to the corporate customers is called as Long-term Loans Market. Development Banks and Commercial Banks play a major role in this market. This market is classified into three categories viz., Term loans market, Mortgages market and Financial guarantees market:

**Term loans market -** This market consists of the industrial financing institutions which supply long term loan to corporate customers. They are created by the Government both at the national level and regional level. They provide term loans to corporate customers and also help them in identifying investment opportunities. They also encourage new entrepreneurs and support modernization efforts. IDBI, IFCI, ICICI, SFCs, etc., come under this market.

**Mortgages market -** This market consists of the institutions which supply mortgage loan mainly to individuals. The term 'mortgage' refers to the transfer of interest in a specific immovable property to secure a loan.

**Financial guarantees market -** This market consists of the institutions which provide financial guarantee to individuals and corporate customers. The term 'guarantee' refers to a contract whereby one person promises another person to discharge the liability of a third person in case of his default. There are different types of guarantees prominent among them are Performance guarantee and Financial guarantee.

**B. Money Market**

Money Market refers to the market for short term finance. Financial assets which have a short period of maturity are dealt in this market. Near money like Trade Bills, Promissory Notes, Short term Government Papers, etc., are traded in this market.

**Composition of money market (Financial instruments dealt in money market) -** The money market comprises of the following:

1. Call money market
2. Commercial bills market
3. Treasury bills market
4. Short-term loan market

**Call money market -** The market where finance is provided just against a call made by the borrower is called call money market. In this market finance is provided for an extremely short period of time.

**Commercial bills market -** The market where finance is provided by discounting of commercial bills is called as commercial bills market. The term 'commercial bills' refer to the bills of exchange arising out of genuine trade transactions.

**Treasury bills market -** The market where finance is provided against the treasury bills is called as treasury bills market. The term 'treasury bill' refers to the promissory notes or finance bills issued by the government for its short-term finance requirements.

**Short-term loans market -** The market where finance is provided in the form of short term loans is called as short term loans market. The term 'short-term' refers to a period less than one year.

Commercial banks provide short term loans in the form of overdrafts and cash credits. These loans are given to meet the working capital requirements of traders and industrialists.

**C. Foreign Exchange Market**

The market where foreign currencies are bought and sold against domestic currency is called foreign exchange market. In other words, the system where the domestic currency is converted into foreign currency and vice-versa is called as foreign exchange market.

## FINANCIAL RATE OF RETURN

The term 'financial rate of return' refers to the percentage of income generated from the financial assets throughout its effective life. For calculation of financial rate of return, two types of incomes are considered. The first type of income is the annual income generated i.e., dividend on shares or interest on securities. The second type of income is the capital appreciation. Capital appreciation means increase in the value of securities over and above the purchase price of the securities. Financial rate of return acts as a tool for investment decisions of the public and other financial institutions. The financial system should offer attractive rate of return on investments so that the investors would be ready to invest their surplus funds in the financial markets. The return on Government securities and bonds are generally less than the Commercial securities as the risk involved in Government securities is comparatively less.

The central bank of the country fixes the key interest rates like CRR, SLR, REPO rates, Reverse REPO rates, etc. The rate of return on any security depends on the risk involved in the investment, the duration of the investment, the purpose for which the investment is utilized, the risk free rate of return, etc. The interest rate policy of the country is designed by the central bank to achieve the following objectives:

1. To enable the government to borrow funds at a lower rate of interest
2. To ensure stability by striking a balance between the economic growth and inflation
3. To mobilize savings in the economy
4. To support specific sector through concessional lending rates.

**Illustration**

Mr. A subscribes to the equity shares of RKS Ltd., on 1/4/2014 for Rs. 1,00,000. After receiving 15% dividend from the company, he sells the said equity shares for Rs. 1,20,000. What is the financial rate of return?

**Solution**

Investment value Rs. 1,00,000  
Income generated  
= Dividend + Capital appreciation  
= Rs. 15,000 + Rs. 20,000  
= Rs. 35,000  
Financial rate of return = (Income generated / Investment) X 100  
= (35,000 / 1,00,000) X 100  
= 35%

## FINANCIAL INSTRUMENTS

Financial instruments refer to the documents that represent financial claim. A financial claim is claim to the repayment of a certain amount of money at the end of a specified period along with interest or dividend. Shares, Government Securities, Bonds, Mutual Funds, Units of UTI, Debentures, Bank Deposits, Provident Funds, LIC Policies, Company Deposits, Post Office Certificates, etc., are some of the examples of financial instruments. These instruments are classified into two types, viz., Primary securities and Secondary securities.

**Primary Securities –** These are the financial instruments that are issued directly to the savers by the users of the funds. For example, shares or debentures issued by a joint stock company directly to the public and institutions are called as primary securities.

**Secondary Securities –** These are the financial instruments that are issued to the savers by some intermediaries. For example, units issued by Unit Trust of India and other Mutual Fund Organizations are called as secondary securities

## FINANCIAL SERVICES

Financial services refer to the activities of channelizing the flow of funds from the savers to the users. It involves the mobilization of savings of the persons and institutions who have surplus funds and allocating or lending them to the persons and institutions who are in need of such funds. The financial services are categorized into two groups, viz., Traditional services and Modern services

1. Traditional services refer to the services that the financial institutions are rendering from a very long time. They are further classified into two viz.,
   a) Fund based services and
   b) Non-fund or Fee based services.
2. Modern services refer to the services that the financial institutions are rendering in the recent years.

## GROWTH OF FINANCIAL SYSTEM IN INDIA

Until independence in the year 1947, there was no strong financial system in India. Private sector and unorganized financial intermediaries were playing the key role of financing the industry. They were not following any justifiable way in financing the trade and commerce. On the whole, the financial system was facing a chaotic condition. The growth of financial system in India since independence is discussed below:

- *Nationalization of Financial Institutions* - After independence, with the adoption of mixed economy, the government started creating new financial institutions for the supply of finance for both industrial and agricultural purposes. For this purpose, some important financial institutions of those days were nationalized. The financial institutions that were nationalized over the years are as under:
  - In the year 1948, Reserve Bank of India (which was established in the year 1935 as a private sector central bank) was nationalized
  - In the year 1955, the then Imperial Bank of India was nationalized and renamed as State Bank of India
  - In the year 1956, 245 life insurance business entities (consisting of 154 life insurance companies, 16 foreign companies and 75 provident companies) were nationalized and merged to form Life Insurance Corporation of India.
  - In the year 1969, 14 Commercial Banks were nationalized
  - In the year 1972, 107 general insurance business entities (consisting of 55 Indian insurance companies and 52 other general insurance operations of other companies) were nationalized and merged to form General Insurance Corporation of India
  - In the year 1980 another 6 Commercial Banks were nationalized
- *Establishment of Unit Trust of India* – The Unit Trust of India (UTI) was established in the year 1964 to strengthen the Indian financial system and supply institutional credit to industries. It was entrusted with the work of mobilization of the savings of the public and provision of credit facility to institutions for productive purposes. In recent years, it has established the following subsidiaries:
  - The UTI Bank Ltd.,
  - The UTI Investor Service Ltd.,

  - The UTI Security Exchange Ltd.,
- *Establishment of Development Banks* – Development banks are the institutions that provide medium and long term finance for agriculture and industrial development purposes. These are established to provide not only credit facility but also assist in discovering investment projects, preparing project reports, arranging technical advice, managing industrial units, etc. Basically they are intended to develop backward regions as well as small and new entrepreneurs. The development banks that were established over the years are as under:
  - The Industrial Finance Corporation of India (IFCI) at the central level established in the year 1948 to provide medium and long term finance to industrial concerns
  - The State Financial Corporation (SFCs) at the state level established under the State Financial Corporation Act, 1951 to provide medium and long term finance to medium and small industries in the respective states.
  - The Industrial Credit and Investment Corporation of India (ICICI) established in the year 1955 to develop large and medium industries in private sector. (Now this is merged with ICICI Bank)
  - The Refinance Corporation of India (RCI) established in the year 1958 with a view to provide refinance facilities to banks against term loans granted by them to medium and small units. (Now this is merged with Industrial Development Bank of India.
  - The Industrial Development Bank of India (IDBI) established in the year 1964 as a wholly owned subsidiary of the Reserve Bank of India to act as the apex institution in the area of development banking and coordinate the activities of all the other financial institutions. (Now the ownership of IDBI is with the central government)
  - The State Industrial Development Corporation (SIDBI) / State Industrial Investment Corporation (SIIC) established in the year 1990 under Small Industries Development Bank of India Act, as the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities.
- *Establishment of Agriculture Financing Institutions* – Agricultural Refinance and Development Corporation (ARDC) was established in the year 1963 to finance major development projects like minor irrigation, farm mechanization, land development, horticulture, dairy development, etc. However, National Bank for Agriculture and Rural Development (NABARD) was established in the year 1982 and the ARDC was merged with it. Now the whole sphere of agricultural finance has been entrusted with NABARD
- *Establishment of Export and Import Bank of India (EXIM Bank)* – The Export and Import Bank of India (EXIM Bank) was established in the year 1982 to take over the operations of the International Finance Wing of IDBI. Its primary objective is to provide finance to exporters and importers. It also functions as the principal financial institution for coordinating the working of other institutions engaged in the financing of foreign trade.
- *Establishment of National Housing Bank (NHB)* – The National Housing Bank was established in the year 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions both at regional and local levels. It provides refinancing, underwriting and guaranteeing facilities to housing finance institutions and coordinates the working of all agencies connected with housing finance.
- *Establishment of Stock Holding Corporation of India Ltd., (SHCIL)* – The Stock Holding Corporation of India Ltd., (SHCIL) was established in the year 1987 to tone up the stock and capital markets in India. It provides quick share transfer facilities, clearing services, depository services, management information services and development services to both individual and corporate investors.
- *Encouraging Mutual Funds Industry* – Both private and public sector financial institutions are being encouraged to float mutual funds.

- *Encouraging Venture Capital Industry* – Both private and public sector financial institutions are being encouraged to finance through venture capital.
- *Establishment of Credit Rating Agencies* – Credit rating agencies like Credit Rating and Information Services of India Ltd., (CRISIL), Investment Information and Credit Rating Agency of India Ltd., (ICRA) and Credit Analysis and Research Ltd., (CARE) are being established to help investors make decision of their investment and also to protect them from risky ventures.
- *Introduction of new financial instruments* – New and different types of financial instruments like public sector bonds, national savings certificates, post office savings scheme, different variety of shares and debentures, different schemes of insurance, different types of bank deposits, are being introduced to cater to the needs of different investors.
- *Legislative support* – Over a period of time many legislative measures were taken up to protect the interests of investors and streamline the financial functioning of various institutions. Capital Issues Control Act, 1947; The Companies Act, 1956; Securities Contracts (Regulation) Act, 1956; Monopolies and Restrictive Trade Practices Act, 1970; Foreign Exchange Regulation Act, 1973 etc., are a few examples of legislations that support the smooth functioning and growth of effective financial system in India.

**ROLE OF FINANCIAL SYSTEM IN THE ECONOMIC DEVELOPMENT OF THE COUNTRY**

An effective financial system in the country offers a variety of financial products and services to suit the different requirements of the investing public and corporate. The financial system plays the following role in the economic development of the country & provides the following benefits:

1. Help to form huge financial resources through mobilization of savings of the public and corporate
2. Promote investment in agriculture, manufacturing and service industries by providing the necessary finance for the cultivation of land, production of goods and provision of services
3. Transfer surplus funds from one part of the economy to another keeping in mind the national priorities
4. Encourage people to divert their physical assets into financial assets and make it available for balanced growth of trade, commerce, agriculture, manufacturing and service industries
5. Provide mechanism to control the risk and uncertainties
6. Multiply the monetary resources by the process of credit creation
7. Provide a variety of financial assets to suit the different needs of investing public and corporate
8. Encourage entrepreneurial skills among the public
9. Increase the growth rate of the economy

## LIMITATIONS OR WEAKNESSES OF INDIAN FINANCIAL SYSTEM

The measures taken by the government over the years to develop a strong financial system has definitely resulted in a considerable amount of consistency and growth in the economy. However, some of the weaknesses or limitations of Indian Financial System are that are still to be addressed are:

1. Lack of coordination between different financial institutions
2. Monopolistic market structures
3. Dominance of development banks in industrial financing
4. Inactive and erratic capital market
5. Imprudent & immoral financial practice.

**2 Marks Questions**

1. Give the meaning of finance
2. Give the meaning of financing
3. Give the meaning of financial system
4. State the components of financial system

5. What is financial asset?
6. What is financial market?
7. What is meant by financial intermediary?
8. What is meant by financial rate of return?
9. Give the meaning of financial service
10. State any four characteristics of financial system
11. State any four roles of financial system
12. State any four benefits of financial system
13. State any four weaknesses of financial system
14. What are marketable securities? Give any two examples
15. What are non-marketable securities? Give any two examples
16. What is cash asset? Give an example
17. What is debt asset? Give an example
18. What is stock asset? Give an example
19. Mention any four financial intermediaries of unorganized sector
20. Mention any four financial intermediaries of organized sector
21. Mention any four capital market intermediaries
22. Mention any four money market intermediaries
23. What is industrial securities market?
24. Mention any two industrial securities
25. What is capital market?
26. What is money market?
27. What is foreign exchange market?
28. What is primary market?
29. What is secondary market?
30. Mention any two securities that are issued in primary market
31. Mention any two securities that are traded in secondary market
32. What is government securities market?
33. What is guilt-edged security?
34. What is direct or primary security?
35. What is indirect or secondary security?
36. What is financial dualism?
37. What is long-term loans market?
38. State the categories of long-term loans market
39. What is term loans market?
40. What is mortgages market?
41. What is financial guarantee market?
42. What is call money market?
43. What is commercial bills market?
44. What is treasury bills market?
45. What is short-term loans market?
46. What is meant by call money?
47. What is meant by commercial bills?
48. What is meant by treasury bills?
49. Who issues treasury bills?
50. What is meant by periodical return? Give example
51. What is meant by capital appreciation? Give example
52. What is meant by financial instrument?
53. Name any four financial instruments?
54. What is meant by fund based service?

55. What is meant by non-fund based service?
56. What is meant by fee-based service?
57. When was RBI nationalized?
58. When was Imperial Bank of India nationalized?
59. What is the pre-nationalization name of State Bank of India?
60. Expand LIC. When was LIC established?
61. How many life insurance business entities were nationalized to form LIC?
62. Expand GIC. When was GIC established?
63. How many general insurance business entities were nationalized to form GIC?
64. How many banks were nationalized in the year 1969?
65. How many banks were nationalized in the year 1980?
66. When was UTI established?
67. What is the primary objective of UTI?
68. What is meant by development bank?
69. What is the primary objective of development bank?
70. Expand IFCI. When was IFCI established?
71. Expand ICICI. When was ICICI established?
72. Expand IDBI? When was IDBI established?
73. Expand SIDBI
74. Expand MSME
75. Expand NABARD. When was NABARD established?
76. What is the primary objective of NABARD?
77. Expand EXIM Bank. When was EXIM Bank established?
78. What is the primary objective of EXIM Bank?
79. Expand NHB. When was NHB established?
80. What is the primary objective of NHB?
81. Expand SHCIL. When was SHCIL established?
82. What is the primary objective of SHCIL?
83. Expand CRISIL
84. Expand ICRA

**6 Marks Questions**

1. What is financial system? What are its components?
2. Give the meaning and significance of financial system
3. Briefly explain the limitations or weaknesses of Indian financial system
4. Briefly explain the functions of financial system
5. Briefly explain the characteristics of financial system
6. Briefly explain the growth of financial system in India

## FINANCIAL MARKETS

**Introduction**

The group of individuals and corporate institutions dealing in financial transactions are termed as financial markets. The centers or arrangements that facilitate buying and selling of financial assets, claims and services are the constituents of financial market. In economics, typically, the term *market* means the aggregate of possible buyers and sellers of a certain good or service and the transactions between them. Thus a financial market may be defined as a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Financial securities include stocks and bonds, commodities include precious metals or agricultural products and fungible items include something that can be exchanged for something else of the same kind (for example, one gram of gold that is exchanged for one gram of gold sometime later.) Basically they are classified into two categories:

3. Unorganized Market
4. Organized Market

**Unorganized Market**
The sector that is not governed by any statutory or legal authority is known as unorganized sector. This sector consists of the individuals and institutions for whom there are no standardized rules and regulations governing their financial dealings. They are not under the supervision and control of RBI or any other regulatory body. Local money lenders, Pawn brokers, Traders, Landlords, Indigenous bankers, etc., who lend money are in the unorganized sector.

**Organized Market**
The sector that is governed by some statutory or legal authority is known as organized sector. This sector consists of the institutions for whom there are standardized rules and regulations governing their financial dealings. They are under the supervision and control of RBI and other statutory bodies. They are further classified into three:

D. Capital Market
E. Money Market
F. Foreign Exchange Market

**A. Capital Market**
Capital Market refers to the market for long term finance. Financial assets which have a long or indefinite maturity period like Shares, Debentures, Bonds, etc., are dealt in this market. It includes all the facilities and the institutional arrangements for borrowing long-term funds by private sector industries and the government for the purpose of manufacturing and development activities.

**Functions of Capital Market**
The main functions of capital market include the following

1. Mobilization of long term funds for the companies for manufacturing and service activities.
2. Raising of long term funds for the government for undertaking various development activities.

**Significance / Importance of Capital Market /Advantages of Capital Market**

1. Very important avenue for investors
2. Productive use of the economy's savings
3. Facilitate capital formation
4. Offer reasonable rate of return on savings
5. Facilitate production and productivity
6. Induce economic growth
7. Promotion of stability in values of securities
8. Facilitate technological up-gradation

**Classification of Capital Market**
The capital market is further classified into the following three:

d) Industrial Securities Market
e) Government Securities Market
f) Long-term Loans Market

**Industrial Securities Market -** The financial market where industrial securities like equity shares, preference shares, debentures, bonds, etc., are dealt with is called as Industrial Securities Market. In this market, the industrial concerns raise their capital and debts by issuing appropriate securities. This market is again classified into two viz., Primary Market and Secondary Market.

**Primary Market (new issue market) -** The financial market concerned with the fresh issue of industrial securities is called as primary market. It is also called as new issue market. In this market, industrial securities which are issued for the first time to the public are dealt. The industries issue new securities against long-term funds from the public. This market consists of all financial institutions, which contribute, underwrite, and directly subscribe to the securities. The main securities that are dealt in primary market are shares and debentures.

**Functions of primary market**

The primary market plays a very important role of mobilizing the savings and channelizing the same for productive purposes. For the purpose of mobilizing the savings, shares and debentures are issued by the companies. Depending upon the time and purpose of issue, it is classified into two categories, viz., Initial Public Offering (IPO) and Follow-on Public Offering (FPO). When the companies issue shares to the public, for the first time, for the purpose of raising initial capital, it is called as Initial Public Offering (IPO). When the companies issue shares to the public, subsequently, for the purpose of raising additional capital, it is called as Follow-on Public Offering (FPO). Through IPO & FPO, capital formation takes place in the primary market. The capital formation is done in four ways viz., Public Issue, Offer for Sale, Rights Issue and Private Placement.

- Under *Public Issue* the industries raise capital by sale of securities to the general public.
- Under *Offer for Sale* the industries raise capital by outright sale of securities to the intermediaries like Issue Houses and Share Brokers
- Under *Rights Issue* the industries raise additional capital by sale of securities to the existing shareholders on a preferential basis and
- Under *Private Placement* the industries raise fresh or additional capital by sale of securities to a small group of investors in the known circle.

**Significance/importance/features of primary market**

1. It is a market for the fresh issue of shares, debentures, etc.
2. It helps companies to raise capital and long-term loans
3. It includes various financial institutions that support the fresh issue of securities
4. It enables formation of capital by channelizing the savings of the public
5. It provides companies sufficient funds for starting a new enterprise, for expansion of the existing enterprise, for diversification of existing operations, etc.,

**Major participants in the primary market**

1. Merchant bankers who look after the issue management completely
2. Registrars to issue who undertake all activities connected with servicing of the investors
3. Collecting Bankers and Coordinating Bankers who collect the subscription from the public in cash, cheque, stock invest, etc.,
4. Underwriters and Brokers who take up the responsibility of ensuring complete subscription of the issue
5. Printers, Advertising agencies, Mailing agencies, etc., who take up the task of reaching the subscribers.

**Advantages of Primary Market**

1. Very important avenue for investors
2. Productive use of the economy's savings
3. Facilitate capital formation

4. Offer reasonable rate of return on savings
5. Facilitate production and productivity
6. Induce economic growth
7. Promotion of stability in values of securities
8. Facilitate technological up-gradation

**Disadvantages of Primary Market**

1. Possibility of deceiving the investors
2. No fixed norm for project appraisal
3. Lack of post-issue seriousness
4. Ineffective role of merchant bankers
5. Delay in allotment process
6. Poor mobilization of savings
7. Hesitancy among the investing public

**Secondary Market -** The financial market concerned with the purchase and sale of already existing industrial securities is called as secondary market. In this market, industrial securities which are already held by the individuals and institutions are bought and sold. Stock exchanges are the important ingredients of the secondary market and generally all the securities are quoted in the stock exchanges. Stock exchanges recognized by the Government of India facilitate the buying and selling activities. Securities Contracts (Regulation) Act, 1956 regulates all the stock exchanges and Bombay Stock Exchange & National Stock Exchange are the main stock exchanges in India.

**Functions of secondary market**

The secondary market provides liquidity to the securities. Continuous and regular market in the form of stock exchange is present in this market for trading the securities. Government, Semi-Government and Company securities are traded in the stock exchange. The component of secondary market that deals with Government securities is called as Guilt-edged market as the government securities never lose their basic value. The stock exchanges in India are established under the provisions of the Securities Contracts (Regulation) Act, 1956 and are regulated and controlled by the Securities and Exchange Board of India (SEBI)

**Stock Exchange**

Stock exchange is a place where securities like shares, debentures bonds, etc., are bought and sold on a continuous and regular basis. It is organized as an association, a society or a company with a limited number of members. The persons who act as brokers for purchase and sale of securities are called as stock brokers and only such stock brokers can become the members of a stock exchange. Under the Securities Contracts (Regulation) Act, 1956 a stock exchange is defined as "an association , organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities".

**Characteristics of a stock exchange**

The main characteristics of stock exchange are:

1. It is an organized market where securities are bought and sold
2. It allows trading of only listed securities
3. The various transactions of the stock exchange are regulated by the rules and laws of the respective stock exchange.
4. It provides complete information about the prices, volume of trade, etc., on a daily basis.
5. It acts as an indicator of the economic activity of the country.

**Functions of the stock exchange**
The main functions of a stock exchange are:

1. Providing liquidity and marketability for securities through a ready and continuous market
2. Providing of information about prices, purchases, sales, etc.
3. Providing safety to the funds and dealings in securities
4. Providing means for mobilization of savings and supply of long term funds through capital formation
5. Enabling movement of funds from unprofitable ventures to profitable ventures
6. Motivating the companies to improve their performance
7. Acting as a barometer that reflects the economic and business conditions of the country
8. Allocating the available funds in a better and useful way
9. Providing platform for marketing of new issues through listing in the stock exchange.

**Advantages of stock exchange**
The main benefits of stock exchange are:

A. To the company
   1. Better goodwill and credit rating.
   2. Global market for their securities
   3. Better bargaining power in the areas of collective ventures, mergers, etc., as a result of better goodwill, credit rating and market across the world.
   4. Convenience to decide upon the size, price and timing of the issue.

B. To the investors
   1. Ready market for their securities
   2. Freedom from anxiety about the delivery and payment problems.
   3. Rational decisions as accurate and timely information is available
   4. Convenience of raising loans from banks on the basis of listed securities

C. To the society
   1. Increase in the savings and investment
   2. Increase in the capital formation
   3. Promotion and expansion of industrial activities
   4. Indicate the changing economic health of the country
   5. Help government to raise required funds for development activities

**Government Securities Market or Gilt-edged Securities Market -** The financial market where Government securities like stock certificates, promissory notes, bearer bonds, treasury bills, etc., are dealt with is called as Government Securities Market. The long term securities issued by the Central Government, State Governments, Semi-government authorities like City Corporations, Port Trusts, etc., Improvement Trusts, State Electricity Boards, All India and State level financial institutes and public sector enterprises are bought and sold in this market.

**Features of Government Securities**

1. Government securities are issued in denominations of Rs. 100
2. Interest on these is payable half yearly
3. They carry tax exemptions
4. Generally the commercial banks buy these securities to comply with SLR requirements
5. Long term securities are sold through the Public Debt Office of the RBI and the Treasury bills are sold through auctions
6. They offer a good source of less expensive finance for the Government.
7. Their value never diminishes and hence they are also called as Gilt-edged Securities.

**Long-term Loans Market -** The financial market where long-term loans are provided to the corporate customers is called as Long-term Loans Market. Development Banks and Commercial Banks play a major role in this market. This market is classified into three viz., Term loans market, Mortgages market and Financial guarantees market.

**Term loans market -** This market consists of the industrial financing institutions which supply long term loan to corporate customers. They are created by the Government both at the national level and regional level. They provide term loans to corporate customers and also help them in identifying investment opportunities. They also encourage new entrepreneurs and support modernization efforts. IDBI, IFCI, ICICI, SFCs, etc., come under this market.

**Mortgages market -** This market consists of the institutions which supply mortgage loan mainly to individuals. The term 'mortgage' refers to the transfer of interest in a specific immovable property to secure a loan. There are different types of mortgages. They are:

1. Equitable mortgage where only the title deeds are deposited with the lender.
2. Legal mortgage where title in the property is legally transferred to the lender.
3. First charge mortgage where the mortgage is created for the first time
4. Second charge mortgage where the already mortgaged property is given as security to secure second or subsequent loan.

The major institutions supplying mortgage loan are HUDCO, LDBs, Commercial Banks and LIC.

**Financial guarantee market -** This market consists of the institutions which provide financial guarantee to individuals and corporate customers. The term 'guarantee' refers to a contract whereby one person promises another person to discharge the liability of a third person in case of his default. There are different types of guarantees prominent among them are Performance guarantee and Financial guarantee. The financial guarantee is related to deferred payments for imports and exports, loans raised overseas, loans advanced by bank and other financial institutions, etc. These guarantees are provided mainly by commercial banks, development banks, specialized guarantee institutions like Export Credit Guarantee Corporation, Deposit Insurance and Credit Guarantee Corporation, etc.

**Major Participants of Capital Market / Types of Capital Market Institutions / Financial Intermediaries in the Capital Market**

Following are the important participants of capital market.

1. Development Financial Institutions like IFCI, ICICI, IDBI, UTI, etc.,
2. Insurance Companies like LIC, GIC, etc.,
3. Commercial Banks like SBI, SBM, Canara Bank, Syndicate Bank, etc.,
4. Provident Funds like SPF, RPF, PPF, etc.,
5. Others like Merchant Bankers, Leasing Companies, Venture Capital Companies, etc.,

**B. Money Market**

Money Market refers to the market for short term finance. Financial assets which have a short period of maturity are dealt in this market. Near money like Trade Bills, Promissory Notes, Short term Government Papers, etc., are traded in this market.

**Functions of Money Market**

1. It meets the short-term financial needs of various borrowers like individuals, institutions and governments
2. It provides liquidity to investors and savers of money

3. It provides a platform for dealing in short-term securities which have a maturity period of less than one year

**Significance / Objectives / Importance of money market**

1. Provide a parking place for short term surplus funds mainly of commercial banks
2. Provide room for overcoming short term deficits
3. Facilitate development of trade and industry
4. Facilitate development of capital market
5. Facilitate smooth functioning of commercial banks
6. Enable central bank to influence and regulate liquidity in the economy
7. Provide non-inflationary finance to the government
8. Enable formulation and revision of monetary policy
9. Provide a reasonable access to borrowers of short term funds to meet their requirements quickly, adequately and at reasonable costs.

**Features of money market**

1. Money market is a market for lending and borrowing of short term funds
2. It deals with financial assets having a maturity period of a maximum of one year
3. It deals with only those assets which can be converted into cash immediately without any loss and with minimum transaction cost
4. It provides liquidity to lenders
5. It includes all individuals, institutions and intermediaries dealing with short term funds
6. The transaction takes place through telephone, mail, etc
7. Transactions are conducted without the help of brokers
8. It consists of a verity of specialized markets like Call money market, Acceptance market, Bill market, etc.

**Distinctions between money market and capital market**

| Money Market | Capital Market |
|---|---|
| This is a market for short term funds | This is a market for long term funds |
| Finance is provided for current business operations & working capital requirements of industrial organisations and short period requirements of Government | Finance is provided for long term business operations & fixed capital requirements of industrial organisations and long period requirements of Government |
| Bill of exchange, Treasury bills, Commercial papers, Deposit certificates, etc., are the instruments that are dealt in this market | Shares, Debentures Government Bonds, etc., are the instruments that are dealt in this market |
| Each single money market instrument is of large amount. Each treasury bill is of minimum Rs. 1,00,000 and each Deposit certificate is of minimum Rs. 25,00,000 | Each single capital market instrument is of small amount. Each share value may be Rs. 10 and each debenture or bond value may be Rs. 100 |
| The RBI and Commercial Banks are the major institutions in this market | Development Banks and Insurance Companies are the major institutions in this market<br>Generally this market has secondary market. |
| Generally this market does not have secondary market. | Transactions are generally done through stock |

| | |
|---|---|
| Transactions are generally done through telephone or mails<br><br>Transactions take place without the help of brokers | exchanges<br><br>Transactions take place only with the help of authorized dealers / brokers. |

**Characteristics / Features / Essentials of a well developed money market**

1. Highly organized banking system
2. Presence of central bank
3. Availability of proper credit instruments
4. Existence of sub-markets
5. Availability of ample resources
6. Existence of secondary market
7. Existence of large demand and supply for short term funds
8. Rapid industrial development leading to the emergence of stock exchanges
9. Large volume of international trade leading to the system of bill of exchange
10. Political stability in the country
11. Favourable conditions for foreign direct investment
12. Price stability in the economy, etc.

**Composition of money market (Financial instruments dealt in money market)**

The money market comprises of the following:

1. Call money market
2. Commercial bills market
3. Treasury bills market
4. Short-term loan market

**Call money market**

The market where finance is provided just against a call made by the borrower is called call money market. In this market finance is provided for an extremely short period of time. The main borrowers of this loan are commercial banks and dealers in stock exchanges. The period of loan may be as short as one day and may extend to a maximum of fourteen days. Since the loan can be raised just by making a call & may need to be repaid immediately on receiving a call from the lender, this market is termed as call money market. The loan may be repaid either at the option of the borrower or at the option of the lender. The distinguishing feature of call money market is that the interest rates vary from day to day and even from hour to hour.

**Major Participants of Call money market**

1. Commercial banks which deal in this market to meet requirement of large payments, Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)
2. Stock brokers and speculators who deal in stock exchanges and bullion markets
3. Commercial bills market who are required to meet the matured bills
4. The Discount and Finance House of India (DFHI) and the Securities Trading Corporation of India (STCI) which activates the call market
5. The individuals of very high financial status who deal in this market for trade purposes and to save interest on overdraft or cash credit facility

The above participants are classified into two categories viz., (1) those who can act as lenders as well as borrowers and (2) those who can act only as lenders. All commercial banks, co-operative banks, DFHI, STCL, can act as lenders as well as borrowers. LIC, GIC, UTI, IDBI, NABARD, MF, etc., can act only as lenders.

**Advantages of call money market**

1. High liquidity
2. High profitability
3. Maintenance of SLR and CRR
4. High safety
5. Most cheap as brokerage is not required to be paid
6. Help RBI (central bank) to formulate or modify monetary policy as and when required

**Drawbacks of call money market in India**

1. Confinement of market only to big industrial and commercial centers
2. Lack of integration among markets spread across the country
3. High volatility in the interest rates

**Commercial Bills Market or Discount Market**

The market where finance is provided by discounting of commercial bills is called as commercial bills market. 'Commercial bills' refer to the bills of exchange arising out of genuine trade transactions. Section 5 of the Negotiable Instruments Act defines a bill of exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument". Finance against bills of exchange is provided by many commercial banks by discounting the bills before their maturity. The process of taking over of a bill of exchange for a lesser value than the face value is called as discounting of bills. In India this market is not very well developed and hence, it does not have a secondary market.

**Types of Bills of Exchange**

1. Demand Bills – These are the bills payable immediately as soon as they are presented. The time of payment is not specified in these bills. These are also called as 'Sight bills' as they are payable at sight and not at the expiry of a specified period.
2. Usance Bills – These are the bills payable at the expiry of a specified period. The time of payment is specified in these bills. These are also called as 'Time bills' as they are payable after the expiry of a specified period like three months, four months, etc.,
3. Documentary Bills – These are the bills that accompany the documents of title to goods like Railway receipt, Lorry receipt, Bill of lading, etc.,
4. Clean Bills – These are the bills that do not accompany the documents of title to goods.
5. Inland Bills – These are the bills that are drawn upon a person residing in India and are payable in India.
6. Foreign Bills – These are the bills that are originated or drawn outside India upon a person either outside India or a person residing in India and are payable either in India or outside India.
7. Export Bills – These are the bills that are drawn by Indian exporters on importers of other country.
8. Import Bills – These are the bills that are drawn by Exporters of other country on the Indian importers.
9. Indigenous Bills – These are the bills that are drawn by indigenous bankers according to native custom or usage of trade. The popular name of these bills is 'Hundi". The hundis are known by different names like Shah Jog, Nam Jog, Jokhani, Termain Jog, Darshani Jog, Dhani Jog, etc.
10. Accommodation Bills – These are the bills that are drawn for the purpose of mutual financial needs of the parties and are not supported by a genuine trade transaction. They are also called as Kite bills & Wind bills.

**Advantages of Commercial Bills**

1. Provision of liquidity
2. Certainty of payment
3. Ideal investment
4. Simple legal remedy
5. High and quick yield
6. Easy central bank control

**Drawbacks of Commercial Bills**

1. Absence of bill culture
2. Absence of rediscounting facility
3. Stamp duty and inadequate availability of stamp papers
4. Absence of secondary market
5. Difficulty in ascertaining genuine trade bills
6. Limited foreign trade
7. Absence of acceptance services
8. No encouragement by banks for rediscounting.

**Treasury bills market**

The market where finance is provided against the treasury bills is called as treasury bills market. The term 'treasury bill' refers to the promissory notes or finance bills issued by the government for its short-term finance requirements. RBI is the only agency which issues these bills on behalf of the Government. These bills are issued through auction and do not require any endorsement or acceptance since it is a claim against the government. Since, its repayment is guaranteed by the government, it is considered as one of the most safe and liquid financial asset. Generally, the treasury bills have a maturity period of 91 days or 182 days or 364 days. These bills are considered as one of the important means of parking temporary surpluses of various financial intermediaries. There are two types of treasury bills, viz., (a) Ordinary or Regular bills and (b) 'Ad hoc' bills.

a) Ordinary treasury bills are issued to the general public, banks and other financial institutions with a view of raising resources for the central government to meet its short-term financial needs.
b) Ad hoc treasury bills are issued only in favour of RBI. They are not sold in the money market.

**Major Participants of Treasury Bills Market**

1. RBI which issues treasury bills on behalf the government
2. Commercial banks which deal in this market to meet requirement of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) and account for nearly 90% of the transactions in this market.
3. The Discount and Finance House of India (DFHI) and the Securities Trading Corporation of India (STCI) which activates the treasury bills market
4. Other financial institutions like LIC, GIC, UTI, IDBI, ICICI, IFCI, NABARD, etc.,
5. Corporate customers and the individuals of very high financial status

**Advantages of Treasury Bills**

1. Highest Safety
2. Most Liquid
3. Ideal for short-term investment
4. Ideal for fund management as they are traded in the secondary market
5. Ideal for meeting Statutory Liquidity Requirement of commercial banks
6. Ideal for meeting Cash Reserve Requirement of commercial banks

7. Ideal source of fund for the government for its short term requirement
8. Ideal non-inflationary monetary tool for control of economic conditions by the government
9. Ideal for using the bills for hedging purpose. (taking advantage of high interest rate in one investment by substituting it in another investment is called as hedging)

**Defects of Treasury Bills**

1. Interest rate is very less compared to other securities
2. Competitive bidding is less among the participants
3. Less trading activity since the holders generally keep the treasury bills till maturity

**Short-term loans market**

The market where finance is provided in the form of short term loans is called as short term loans market. The term 'short-term' refers to a period less than one year. Commercial banks provide short term loans in the form of overdrafts and cash credits. These loans are given to meet the working capital requirements of traders and industrialists.

**C. Foreign Exchange Market**

The market where foreign currencies are bought and sold against domestic currency is called foreign exchange market. In other words, the system where the domestic currency is converted into foreign currency and vice-versa is called as foreign exchange market. Central bank, Commercial banks, Foreign exchange dealers and brokers, etc., deal in foreign currencies. For the regulation of foreign exchange business, a separate legislation is enacted by the central government. The name of that legislation is "Foreign Exchange Management Act, 1999".

**Functions of Foreign Exchange Market**

1. To make necessary arrangements for transfer of purchasing power from one country to another.
2. To promote export and import (i.e., foreign trade) by providing adequate credit facilities.
3. To cover foreign exchange risks by providing hedging facilities

**Foreign Exchange Market in India**

In India, foreign exchange market has a three tiered structure consisting of the following:

1. Trading between banks and their commercial customers
2. Trading between banks through authorized brokers
3. Trading with banks abroad

**2 Marks Questions**

1. What are financial markets?
2. What are the constituents of financial market?
3. What are financial securities? Give example
4. What is organized market?
5. What is unorganized market?
6. How is the organized market classified?
7. What is capital market?
8. What is money market?
9. What is foreign exchange market?
10. State the functions of capital market?
11. What is industrial securities market?
12. What is government securities market?
13. What is guilt-edged securities market?

14. State any four features of government securities
15. What is mortgages market?
16. What is financial guarantee market?
17. What is long-term loans market?
18. What is new issue market?
19. Expand IPO & FPO
20. What is public issue?
21. What is rights issue?
22. What is private placement?
23. What is secondary market?
24. What is stock exchange?
25. State any four characteristics of stock exchange
26. What is money market?
27. State any four features of money market
28. State any four objectives of money market
29. Distinguish between money market and capital market
30. State any four essentials of a well developed money market
31. Name the financial instruments that are dealt in money market
32. What is meant by call money? Who are the main borrowers of it?
33. What is meant by commercial bills? Who issues them?
34. What is meant by treasury bills? Who issues them?
35. What is call money market?
36. What is commercial bills market?
37. What is treasury bills market?
38. What is foreign exchange market?
39. Name any four participants of primary market
40. State any four advantages of primary market
41. State any four limitations of primary market
42. State any two functions of money market
43. State any four objectives of money market
44. State any four advantages of call money market
45. Name any four types of bills of exchange
46. What are demand bills?
47. What are usance bills?
48. What are documentary bills?
49. What are clean bills?
50. What are inland bills?
51. What are foreign bills?
52. What are export bills?
53. What are import bills?
54. What are indigenous bills?
55. What are accommodation bills?
56. State any four advantages of commercial bills
57. State any four limitations of commercial bills
58. Name the major participants of treasury bills market
59. State any four advantages of treasury bills market
60. State any two defects or limitations of treasury bills market
61. State the functions of foreign exchange market

**6 Marks Questions**

1. Briefly explain the functions and significance of capital market
2. Briefly explain the functions and significance of primary market
3. Briefly explain the functions and significance of secondary market
4. Briefly explain the functions and significance of stock exchange
5. Briefly explain the features of money market
6. Briefly explain the objectives of money market
7. Briefly explain the distinctions between money market and capital market
8. Briefly explain the essentials of a well developed money market
9. Briefly explain the composition of money market or Briefly explain the financial instruments that are dealt in money market?
10. Briefly explain the advantages of primary market
11. Briefly explain the limitations or disadvantages of primary market
12. Briefly explain the meaning and significance of money market

## FINANCIAL INSTITUTIONS

**Introduction**

In its simple meaning a financial institution is an institution that provides financial services. Financial services refer to the activity of transfer of financial resources from the savers or investors to the users or borrowers. Thus, essentially financial institutions are the intermediaries between the savers and borrowers of the money. More specifically, the term "financial institutions" refers to all kinds of organizations which intermediate and facilitate financial transactions of both individual and corporate customers.

**Functions of financial institutions**

1. Financial institutions mobilize the savings of the public
2. They provide credit facility to the needy persons
3. They render various other financial services like transfer of funds from one place to another, payment mechanism, etc.,

**Benefits of Financial Institutions**

1. Financial institutions enable transferring of funds from investors to corporate customers and other business entrepreneurs
2. They facilitate the flow of money from one corner of the country to another corner
3. They enable achievement of economy of large scale operations by providing funds for large scale business activities
4. They reduce the cost of transaction by increasing the number of transactions
5. They reduce the risk of loss of capital through diversification of funds to different industries

**Classification of Financial Institutions / Types of Financial Institutions**

Basically there are three types of financial institutions, viz., (a) Banking Institutions (b) Non Banking Financial Institutions and (c) Mutual Funds

**Banking Institutions**

According to the Banking Regulations Act, a banking institution is an institution that does the business of banking. The term banking business is defined as the accepting of deposits of money from the public for the purpose of lending or investment and repayable on demand. A banking institution mobilizes the savings of the public through accepting of deposits of money and lends the same to the individual and corporate customers to meet their short term, medium term and long term financial requirements and invests the surplus amount in various securities or financial instruments in the financial market.

**Types of Banking Institutions**
On the basis of the functions performed by the banking institutions, they are classified into the following types:

a) Commercial Banks
b) Investment Banks / Industrial Banks
c) Exchange Banks
d) Co-operative Banks
e) Land Development Banks
f) Regional Rural Banks
g) Savings Banks
h) Central Bank

**Commercial banks**
The banks which engage in the activity of providing finance to various commercial establishments for meeting their working capital requirements are called as commercial banks. The term "working capital requirement" refers to the funds required for meeting the day to day activities like buying of raw materials, payment of salaries, etc. These banks raise the required funds in the form various kinds of deposits from the public and lend short term and medium term loans to traders and business persons mainly for meeting working capital requirements. The commercial banks are classified into two types viz., scheduled banks and non-scheduled banks.

**Scheduled Banks** - The banks which are registered in the second schedule of the RBI are called as scheduled banks. In order to be registered under the second schedule of the RBI, the following conditions should be fulfilled:

1. The bank must be carrying the business of banking in India
2. The bank must have a paid up capital and reserve of an aggregate value of not less than Rs. 5 lakhs and
3. The bank must satisfy the RBI that its affairs are not being conducted in a manner detrimental to the interests of the depositor.

**Non-scheduled Banks –** The banks which are not registered in the second schedule of the RBI are called as non-scheduled banks.

**Benefits enjoyed by scheduled banks**
The scheduled banks come under the direct purview of the credit control measures of the RBI and are entitled to borrowings and rediscounting facilities. Non-scheduled banks are not entitled to such benefits.

**Industrial Banks / Investment Banks**
The banks which engage in the activity of providing finance to industrialists for meeting their fixed capital requirements are called as industrial banks. The term "fixed capital requirement" refers to the funds required for purchasing fixed assets like Land, Building, Plant, Machinery, Furniture, etc. These banks raise the required funds in the form of issue of shares, debentures and bonds to the public and various financial institutions and lend medium term and long term loans to industrialists & big businessmen mainly for meeting their fixed capital requirements.

**Exchange Banks**
The banks which engage in foreign exchange business are called as exchange banks. The term "foreign exchange business" refers to the business of converting domestic currency into foreign currency and vice-versa. These banks convert foreign currency into Indian currency and Indian currency into foreign currency and play a significant role in import and export activities.

**Co-operative Banks**
The banks which are formed on the principle of mutual co-operation to meet the needs of its members are called as co-operative banks. They are formed by small group of individuals belonging to same or similar kind of activities like farming, retailing, small scale industry, etc. These banks raise the required funds in the form of various kinds of deposits from the members and the public. They lend short term and medium term loans to members and other traders, business persons and agriculturists mainly for meeting working capital requirements at generally low rate of interest and play a significant role in financing agricultural and allied activities in India.

**Land Development Banks**
The banks which are formed by the agriculturists on the principle of mutual co-operation to meet the long term needs of agriculturists are called as land development banks. These banks raise the required funds by the issue of shares and debentures, bonds, etc., mainly to the specific group of persons and other financial institutions. They provide short term and medium term loans to members and other agriculturists mainly for procuring tools and equipments needed and also to make permanent improvement of the land and for allied activities like cattle farming, etc., at generally low rate of interest and play a significant role in financing agricultural and allied activities in India. These banks are now-a-days called as Agriculture and Rural Development Banks.

**Regional Rural Banks**
The banks which are formed to mobilize the savings of the rural people and fulfill the credit needs of the relatively less served or not served sections of the societies in rural areas are called as Regional Rural Banks (RRBs). They are the banks that were set up as government sponsored regional based rural banking institutions under the Regional Rural Banks Act, 1976. The shareholding pattern of these banks is 50 : 35 : 15 among central government, sponsoring bank and state government respectively. They were configured as hybrid micro banking institutions, combining the local orientation and small scale lending culture of the cooperatives and the business culture of commercial banks. Small farmers, agricultural labourers and socio-economically weaker sections of the society are the main customers of these banks.

**Savings Banks**
The banks which are formed to mobilize savings of the poor and middle income people of the society are called as savings banks. The primary objective of these banks is to promote the habit of thrift and savings among the people with small incomes. The money saved in these banks is permitted to be withdrawn by the depositors in time of need. However, there are certain restrictions on the number and the amount of withdrawal to be made in a particular period. In India, the central government runs savings bank through the postal department. Almost all of the commercial banks also do the function of savings bank and encourage people to open savings account with them. Generally, these banks do not engage in the activity of lending money to the public.

**Central Bank**
The bank formed for supervising, controlling and regulating the activities of both banking and other non banking financial institutions is called as central bank. Generally, every country will have only one central bank. In India, Reserve Bank of India is the central bank. The central bank acts as a leader of the money market, enforces monetary discipline in the economy of the country, manages the issue and circulation of the currency, controls the creation of bank deposits and safe guards the financial stability of the country. It also keeps a close touch with the government and assists in the implementation of its economic policies. It serves as banker, agent and advisor to the government. Thus, it functions as the apex bank of the country and contributes to the better maintenance of the monetary and economic stability of the country. It accepts deposits from the government, banks and other financial institutions

and lends the same to the government, banks and other financial institutions to enable them balance their funds position. Following list shows the main functions of central bank.

**Main functions of central bank**

The functions of central bank are classified into three viz., Traditional functions, Promotional functions and Supervisory functions.

*Traditional functions*

a) Monopoly of note issue
b) Banker to government
c) Agent and advisor to government
d) Banker to banks
e) Act as national clearing house
f) Lender of last resort
g) Controller of credit
h) Foreign exchange management
i) Exchange control
j) Publication of information

*Promotional functions*

a) Promotion of banking habits
b) Provide refinance for export promotion
c) Provide facilities for agricultural activities
d) Provide facilities for small scale industries
e) Provide help to co-operative sector

*Supervisory functions*

a) Granting of license to banks
b) Supervising and inspecting the activities of financial institutions
c) Implementing of deposit insurance scheme
d) Controlling of financial institutions

**Non Banking Financial Institution / Non Banking Financial Corporation (NBFCs)**

A Non Banking Financial Institution popularly called as Non Banking Financial Company (NBFC) refers to a specialized financial institution other than a banking institution that mobilizes the savings of a certain segment of the public and lends the same to the individual and corporate customers to meet their specialized needs. It is registered under the Companies Act, and is engaged in the business of lending to specialized purposes and investing in shares, debentures, bonds, etc. As per section 45(1)(f) of the Reserve Bank of India Act, a non banking financial company is a non banking institution which is a company and which has its principal business the receiving of deposits under any scheme or lending in any manner. It is compulsory for a NBFC to get itself registered with RBI as a deposit accepting company. A company intending to do the business as a NBFC must have a minimum of Rs. 25 lakhs as owned fund. It should have more than 50% of assets in the form of financial assets and more than 50% of income as income from financial assets.

**Differences between NBFCs and Banking Companies**

| NBFC | Banking Company |
|---|---|
| 5. Cannot accept demand deposits<br>6. Cannot issue cheque books/leafs to customers | 12. Can accept demand deposits<br>13. Can issue cheque books/leafs to customers |

| | |
|---|---|
| 7. Deposit insurance facility is not available to the customers | 14. Deposit insurance facility is available to the customers |
| 8. Accept / renew deposits for a minimum period of 12 months and a maximum period of 60 months | 15. Accept / renew deposits for any period |
| 9. Cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time | 16. Can offer interest rates higher than the ceiling rate prescribed by RBI from time to time |
| 10. Cannot offer gifts / incentives or any other additional benefit to the depositors | 17. Can offer gifts/incentives or any other additional benefit to the depositors |
| 11. Credit rating by an agency is compulsory | 18. Credit rating is not compulsory |

**Types of Non Banking Financial Companies (NBFCs)**

NBFCs are classified in two ways (1) Classification as per RBI and (2) Classification on the basis of activities performed or General Classification

**Classification as per RBI**

According to RBI, the NBFCs are classified into three categories viz., (1) Asset Financing Companies, (2) Investment Companies and (3) Loan Companies.

**Asset Financing Companies**

These are the companies whose business is to provide finance for purchase of physical assets like automobiles, tractors, earth moving and material handling equipments, etc. (Example - Bajaj Auto Finance Corporation, Fullerton India).

**Investment Companies**

These are the companies whose business is to acquire and trade in industrial as well as government securities like shares, stocks, bonds, debentures etc., mainly in the capital market. (Example – Stock Broking Companies, Gilt Firms)

**Loan Companies**

These are the companies whose business is to give loans to activities other than their own. They give different kinds of loans like housing loans, gold loans, etc. (Example – Mannappuram Gold Finance, Muthoot Finance, Atica Gold Finance, HDFC, etc.)

**Classification on the basis of activity performed or General classification**

On the basis of activities performed or according to general classification, the NBFCs are classified into four categories viz., (1) Development Institutions, (2) Specialized Institutions (3) Investment Institutions and (4) Other Institutions

**Development Institutions**

They are the institutions that provide long term finance for agriculture and industrial development purposes. These are multipurpose institutions that provide not only credit facility but also assist in discovering investment projects, preparing project reports, arranging technical advice, managing industrial units, underwriting, promotional activities, etc. Basically they are intended to develop backward regions as well as small and new entrepreneurs. They provide medium and long term finance to business units mainly for acquisition / development of basic facilities like land and buildings, plant and machinery, etc. These institutions generally do not accept deposits from the public. IDBI, ICICI, IFCI, SIDBI, SFCs & SIDC fall under this category. The main features of development institutions are:

- They are specialized financial institutions

- They provide medium and long term finance
- Generally they do not accept deposits from the public
- They provide multipurpose financial assistance
- Their primary objective is to promote the economic development of the country
- They encourage small and new entrepreneurs and work in the general interest of the country

**Specialized Institutions**
They are the institutions that provide assistance to special sectors like housing, infrastructure, agriculture, etc. These institutions generally do not accept deposits from the public. NABARD, NHB, NHAI & EXIM Bank fall under this category

**Investment Institutions**
They are the institutions that acquire and trade in securities mainly in the capital market. They mobilize savings of public in various forms other than in the form of demand deposits and utilize the same for investment activities mainly in the capital market. LIC, GIC & UTI fall under this category

**Other Institutions**
They are the institutions that carry a particular activity like Core Investment, Micro Financing, Equipment Leasing, Hire Purchasing Finance, Housing Finance, Mutual Benefit (Nidhi) Company, Chit Fund Company, etc.

**Factors contributing to the growth of NBFCs**

1. The banking companies were controlled through a comprehensive and detailed regulation over their activities. However, there were no such comprehensive and detailed regulations over the non-banking financial institutions in the past. This has become the main reason for the growth of non-banking financial institutions.
2. Non-banking financial institutions were more easily accessible by the customers than the banking institutions in the past. This is another reason for the growth of NBFCs.
3. Non-banking institutions followed much less formalities during the pre and post sanction requirements. Their services were less complicated, fast and tailor made. This also has led to the growth of NBFCs
4. The monetary policy and credit policy announced by the RBI sometimes keeps away some borrowers from approaching the banking institutions. NBFCs cater to the needs of such borrowers who remain outside the purview of commercial banks. This also has led to the growth of NBFCs.
5. Generally, the rate of interest offered on the deposits by the NBFCs is higher when compared to the banking institutions. This also has led to the growth of NBFCs.

**Functions of NBFCs**
The NBFCs mainly perform the functions of receiving of deposits, lending of money and investment of money.

**Receiving deposits –** NBFCs receive mainly two types of deposits. They are:

a) Regulated Deposits – The deposits on which there is a ceiling limit or certain other restrictions prescribed by the RBI are called regulated deposits. For example, hire purchase companies and equipment leasing companies can receive deposits only upto ten times of their net-owned funds.
b) Exempted Deposits – The deposits on which there are no ceiling limits or other restrictions by any controlling authority are called exempted deposits. These deposits include borrowing

from other banks and financial institutions, money received from Government, inter-company borrowings, security deposits, money received from local authorities, directors, etc.

**Lending of money** – NBFCs lend money in various forms like hire purchase finance, leasing finance, consumption finance, finance for social activities, housing finance, development finance, etc.

**Investment of money** – NBFCs invest their surplus funds in various forms of securities like shares, stock, debentures, bonds, etc.

**Services rendered by NBFCs**

The important services rendered by NBFCs are:

1. Mobilization of savings by offering attractive schemes and attractive rates of interest
2. Timely provision of adequate credit facility in a easy and simple way
3. Act as financial supermarket where credit facility is available for diversified activities.
4. Channelize funds for productive purposes by financing the capital intensive industries
5. Encourage thrift and develop savings habit among general public by receiving deposits in various attractive forms.
6. Enable asset creation by providing housing finance
7. Increase standard of living of people by providing installment facilities to buy consumer durables
8. Render expert advice on investment of funds
9. Promote economic development by providing wider choice to both borrowers and investors

**Regulations of NBFCs**

As already discussed, in the earlier days, there were no comprehensive and detailed regulations over the functioning of NBFCs. However, in 1960 the RBI made an attempt to regulate NBFCs through issuing directions in respect of the following:

1. Maximum amount of deposits that can be accepted by a NBFC
2. The period of deposits
3. The rate of interest
4. Maintenance of certain percentage of funds in the forms of liquid assets
5. Creation of reserve funds
6. Transfer of certain percentage of profits to reserve fund every year, etc.

The amendment made to the RBI Act in the year 1997 gave comprehensive powers to the RBI to regulate the functioning of NBFCs. Accordingly the NBFCs are controlled by RBI and the important regulations in respect of NBFCs are:

1. It is mandatory for every NBFC to obtain a certificate of registration and have minimum net owned funds.
2. Ceilings are prescribed for acceptance of deposits, capital adequacy, credit rating and net-owned funds.
3. RBI is entrusted with the development of a comprehensive system to supervise NBFCs.
4. Statutory auditors are required to report all kinds of non-compliance of specific rules and regulations.

**Overall contributions of NBFCs to the Indian Economy**

1. Development of infrastructure facility
2. Generation of employment opportunity
3. Creation of wealth
4. Meet the requirements of economically weaker sections of the society
5. Balanced growth of different regions and industries

## CONSTITUTION, OBJECTIVES & FUNCTIONS OF IDBI

**Constitution of IDBI**

The IDBI was constituted as a wholly owned subsidiary of the RBI in July 1964 under the IDBI Act, 1964 as a Development Financial Institution. Later on, in the year 1975 it was taken over by the Central Government under the Public Financial Institutions Law (Amendment) Act, 1975. The Central Government de-invested around 28% of its holding in the year 1995 by selling the shares to the public. Presently about 72% of the share capital of the IDBI is held by the Government.

IDBI served as a Development Financial Institution (DFI) for 40 years and in the year 2004, the IDBI was transformed into a Bank through forming a new company called Industrial Development Bank of India Limited (IDBI Ltd.,) as a wholly owned subsidiary of IDBI under the Companies Act, 1956. The company was incorporated on September 27, 2004 and the undertaking of IDBI was transferred and vested in IDBI Ltd., with effect from October 1, 2004. IDBI took over the business of United Western Bank Ltd., in the year 2006 and the merger came into effect from October 3, 2006. Effective from May 7, 2008 the name of IDBI Ltd., was changed to IDBI Bank Ltd., and presently the bank is functioning in the same name.

**Role of IDBI**

1. The primary role of IDBI is to act as the principal financial institution for coordinating the activities of various financial institutions that are engaged in the financing, promoting and developing of various industries.
2. It plans, promotes and develops industries keeping in mind the national priorities.
3. It also provides technical and administrative assistance for promotion, management, expansion activities of the industry.
4. It undertakes market and investment research and surveys and techno-economic studies to contribute to the development of the industry and attempts to bring a balanced growth of the industries in all corners of the country.

**Objectives of IDBI**

1. Coordination, regulation and supervision of the working of other financial institutions such as IFCI, ICICI, UTI, LIC, Commercial Banks and SFCs.
2. Supplementing the resources of other financial institutions and thereby widening the scope of their assistance.
3. Planning, promotion and development of key industries and diversification of industrial growth.
4. Developing and enforcing a system of industrial growth that conforms to national priorities.

**Functions of IDBI**

1. IDBI provides direct as well as indirect financial assistance to industrial enterprises like IFCI, SFCs or any other financial institution by way of refinancing. The IDBI grants loans and advances to industrial concerns. There is no restriction on the upper or lower limits for assistance to any concern itself. The bank guarantees loans raised by industrial concerns in the open market from the State Co-operative Banks, the Scheduled Banks, the Industrial Finance Corporation of India (IFCI) and other 'notified' financial institutions. It also refinances the term loans to industrial concerns repayable within 3 to 25 years given by the IFCI, the State Financial Corporation and some other financial institutions and to SIDCs (State Industrial Development Corporations), Commercial banks and Cooperative banks which extend term loans not exceeding 10 years to industrial concerns. IDBI subscribes to the shares and bonds of the financial institutions and thereby provide supplementary resources

2. It promotes institutions engaged in industrial development. In fulfillment of its developmental role, the bank performs a wide range of promotional activities relating to developmental programs for new entrepreneurs, consultancy services for small and medium enterprises and programs designed for accredited voluntary agencies for the economic upliftment of the underprivileged. These include entrepreneurship development, self-employment and wage employment in the industrial sector for the weaker sections of society through voluntary agencies, support to Science and Technology Entrepreneurs' Parks, Energy Conservation, Common Quality Testing Centers for small industries.
3. It provides technical and administrative assistance for promotion, management or expansion of industry. With a view to making available at a reasonable cost, consultancy and advisory services to entrepreneurs, particularly to new and small entrepreneurs, IDBI, in collaboration with other All-India Financial Institutions, has set up a network of Technical Consultancy Organizations (TCOs) covering the entire country. TCOs offer diversified services to small and medium enterprises in the selection, formulation and appraisal of projects, their implementation and review. Realizing that entrepreneurship development is the key to industrial development, IDBI played a prime role in setting up of the Entrepreneurship Development Institute of India for fostering entrepreneurship in the country. It has also established similar institutes in Bihar, Orissa, Madhya Pradesh and Uttar Pradesh.
4. It undertakes market and investment research and surveys in connection with development of industry. IDBI also extends financial support to various organizations in conducting studies or surveys of relevance to industrial development.
5. It also performs other functions like, discounting or rediscount bills of industrial concerns, underwriting or subscribing to shares or debentures of industrial concerns, subscribing to or purchasing stock, shares, bonds and debentures of other financial institutions, granting a line of credit or loans and advances to other financial institutions such as IFCI, SFCs, etc., guaranteeing deferred payment due from any industrial concern, guaranteeing loans raised by industrial concerns in the market or from institutions, providing consultancy and merchant banking services in or outside India, debenture trusteeship, forex services, depository participant service, establishment of subsidiaries, etc.

## CONSTITUTION, OBJECTIVES & FUNCTIONS OF SFCS

### Constitution of SFCs

In order to meet the financial requirements of small scale and medium-sized industries, there was a need of special financial institutions. With this view, the Central Government passed the State Financial Corporation Act of 28th September, 1951 which empowered the state government to establish financial corporation to operate within the state. State Financial Corporations are constituted under the State Financial Corporation Act, 1951 through a notification in the Official Gazette. A minimum of 75% of the share capital of these corporations shall be held by the State Government, RBI, Scheduled Banks, Insurance Companies, Investment Trusts, Co-operative banks and other financial institutions. Remaining 25% of the share capital may be issued to the general public.

### Objectives of SFCs

1. To establish uniformity in regional industries
2. To provide incentive to new industries
3. To bring efficiency in regional industrial units
4. To provide finance to small-scale, medium sized and cottage industries in the state
5. To develop regional financial resources.

**Functions of SFCs**

1. The SFCs grant loans for a period not exceeding 20 years to industrial units mainly for acquisition of fixed assets like land, building, plant and machinery, etc.,
2. The SFCs provide financial assistance to industrial units whose paid-up capital and reserves do not exceed Rs. 3 crore (or such higher limit up to Rs. 30 crore as may be specified by the central government)
3. The SFCs underwrite new stocks, shares, debentures etc., of industrial concerns for a period not exceeding 20 years
4. The SFCs provide guarantee loans raised in the capital market by scheduled banks, industrial concerns, and state co-operative banks to be repayable within 20 years.
5. SFCs also perform various other functions like appraisal of investment projects, credit syndication, project documentation, placement of debt, industry research, legal advisory services, etc., to small and medium sized industries.

## CONSTITUTION, OBJECTIVES & FUNCTIONS OF SIDCS

**Constitution of SIDCs**

State Industrial Development Corporations are constituted by the respective States as a wholly owned Government Company under the Companies Act, 1956.

**Objectives of SIDCs**

1. To act as catalyst for promoting industrial growth in the State, especially in the medium and large sector by identifying industrial opportunities, providing guidance and advice to prospective entrepreneurs, providing necessary financial assistance and other related services to realize these opportunities.
2. To act as the designated agency of the Government to plan and formulate proposals for industrial infrastructure development projects after assessing the need in different sectors/areas; and monitor the specified mega projects during implementation as the nodal agency.

**Functions of SIDCs**

1. SIDCs provide term loans like normal term loan, equipment finance, lease finance, corporate loan, bill discounting, subscription to non-convertible debentures, bridge loans, rehabilitation loans, deferred payment guarantees, etc., to small, medium and large scale sectors, including sectors like health care , hospitals, hotels, tourism, etc.,
2. They render various financial services like pubic issue management, rights issue management, bought out deals, project consultancy, project appraisal, credit syndication, underwriting of shares, management advisory services, etc.,
3. They perform industrial promotional activities like project identification, identification and selection of suitable entrepreneurs, assistance in securing statutory and government approvals and clearances, direct participation in equity, promotion of joint sector projects, providing of escort services, acting as a nodal agency of the respective state government for specified major/mega projects, attracting industrial investment including direct foreign investment and NRI investment, arranging meetings of the industrialists and other related bodies, conducting industrial promotion campaigns within and outside the respective state, organizing visits of delegation of industrialists to overseas countries, inviting delegations and trade bodies from overseas countries, etc.,
4. They perform various developmental activities like development of industrial parks, industrial townships, industrial growth centres, international standard airports, minor sea ports, etc.,

## CONSTITUTION, OBJECTIVES & FUNCTIONS OF LIC

**Constitution of LIC**

The Life Insurance Corporation of India popularly known as "LIC of India" was incorporated on September 1, 1956 by nationalizing 245 Indian as well as foreign companies. It was established with a view to provide an insurance cover against various risk in life.

**Objectives of LIC**

1. To spread the insurance products all over India particularly in rural areas and economically background classes and to provide financial insurance covers against death at low premium.
2. To mobilize the peoples savings through insurance linked savings schemes
3. To invest the funds, bearing in mind the national priorities and obligations of attractive return to the insured.
4. To conduct the business with utmost economy
5. To act as trustees of the insured public
6. To meet the various life insurance needs of the community that would arise in the changing social and economic environment
7. To involve the employees of the organization to the best of their capacity in furthering the interests of the insured public
8. To promote amongst all the employees and agents of the corporation a sense of participation, pride and job satisfaction.

**Functions of LIC**

1. LIC offers a variety of insurance products to its customers such as insurance plans, pension plans, unit-linked plans, special plans and group schemes
2. It carries on the business of capital redemption, annuity and reinsurance
3. It advances or lends money to the public for construction of house property
4. It advances or lends money to the government for developmental activities
5. It invests money in various other financial and non-financial corporations

## CONSTITUTION, OBJECTIVES & FUNCTIONS OF EXIM BANK

**Constitution of EXIM Bank**

Export Import Bank of India (EXIM Bank) is the premier export finance institution in India, established in 1982 under the Export Import Bank of India Act, 1981. The EXIM Bank has a 17 member Board of Directors, with Chairman and Managing Director as the chief executive and full-time director. The Board of Directors consists of the representative of the Government of India, RBI, IDBI, ECGC, commercial banks and the exporting community. The authorized capital of EXIM Bank is Rs. 200 crores, of which Rs. 75 crores is paid up. The bank has secured a long-term loan of Rs. 20 crores from the Government of India. It can also borrow from the RBI. It is also empowered to raise resources in the domestic and international markets.

**Role of EXIM Bank**

EXIM Bank is primarily established to act as a catalyst and a key player in the promotion of cross border trade and investment. Its primary role is to enable Indian industries, particularly the Small and Medium Enterprises (SMEs) to enter global market by offering a wide range of products and services at all stages of the business cycle starting from import of technology to export of products. It helps SMEs in areas like import of technology, product development for export purpose, export marketing, pre shipment, post shipment and overseas investment.

**Objectives of EXIM Bank**

1. To provide financial assistance to exporters and importers
2. To function as the principal financial institution for coordinating the working of institutions engaged in the financing of export and import of goods and services
3. To provide refinance facilities to commercial banks and financial institutions against their export-import financing activities
4. To promote the country's international trade
5. To ensure an integrated and coordinated approach in solving the allied problems encountered by exporters in India.
6. To pay specific attention to the exports of capital goods
7. To help in the field of export projection
8. To facilitate and encourage joint ventures and export of technical services and international and merchant banking
9. To extend buyers' credit and lines of credit
10. To tap domestic and foreign markets for resources for undertaking development and financial activities in the export sector.

**Functions of EXIM Bank**

1. Planning, promoting and developing exports and imports
2. Providing technical, administrative and managerial assistance for promotion, management and expansion of exports sector
3. Undertaking market and investment surveys and techno-economic studies related to development of exports of goods and services.

## MUTUAL FUNDS

**Meaning of mutual funds**

Mutual Fund can be thought of as an investment company that brings together a group of people and invests their savings in stocks, bonds and other securities generally in the capital market. It may even invest its resources in money-market instruments, gold, gold related instruments and real estate assets. The combined holding of stocks, bonds or other assets is known as portfolio of mutual funds. Each person who contributes his savings into mutual fund becomes a part owner of the fund. Mutual funds are also called regulated investment company where a company or a trust uses its capital and invests in other companies. Mutual funds earn income through dividend on shares, interest on securities and also capital gains. Mutual funds is formed by the coming together of number of investors who transfer their surplus funds to a professionally qualified organization to manage the portfolio of investments. The profit or loss is shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. To pool the savings of small investors, the mutual funds adopt a very simple technique of dividing each fund into a small fraction called 'units' of equal value. Each investor is allocated units in proportion to the size of respective investment.

**Definition of mutual funds**

According to Securities and Exchange Board of India (Mutual Funds) Regulation Act, 1996, "mutual fund is a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets"

**Features of mutual funds**

1. Mutual funds are the companies that mobilize the savings of individuals in the form of units.
2. Each person who contributes his savings into mutual funds is allocated units of mutual fund
3. These savings are invested in the securities, bonds, money market instruments and other assets.
4. The portfolio of investments is planned and managed by financial experts
5. The income earned in the form of dividend on shares, interest on securities and capital gain that arise on account of trading of securities by the mutual fund companies is distributed to the unit holders

**Advantages of mutual funds**

1. *Channelizing the savings for investment* – Mutual funds channelize the savings of small investors by offering various schemes suitable to the various classes of investors. These savings are directed towards capital formation and thus enables the development of the economy as a whole.
2. *Benefit of wide portfolio of investment* – Mutual funds offer the benefit of wide portfolio of investment through diversification of investment. This is in accordance with the maxim *'not to keep all eggs in one basket'*. Diversification of investment refers to investing in a number of different stocks of many different industries so as to minimize the impact of loss in one asset. Investing in hundreds of different stocks in many different industries would not be possible for a small investor. Mutual funds can invest in a large number of stocks of different industries so that the risk spreads over a large number of assets. This minimizes the impact of loss in one asset through gains in other assets.
3. *Economies of scale* – As a mutual fund buys and sells large number of securities at a time, the per unit transaction costs become lower than what a small investor would incur for such transactions. Thus, mutual funds reap the benefit of economies of large scale business.
4. *Professional management at low cost* – The primary advantage of mutual funds is that the money of small investors is professionally managed. Generally the small investors do not possess the necessary expertise and also time to analyze the suitable security to invest in. A mutual fund provides an inexpensive way for them to get a full time expert manager to plan and monitor their investments.
5. *Better yields* – Mutual funds command large funds at their disposal and are able to strike any deal at lower rates of brokerage. They also enjoy the economies of large scale transactions and professional management at low cost. This results in better yield to the unit holders.
6. *Benefit of research work* – Mutual funds command large funds at their disposal and are capable of making an in-depth study and research work on the corporate securities and other investment opportunities. The investment can be made purely on the basis of such research work. Research involves a lot of time, efforts and expenditure and it is not feasible for a small investor to undertake research work before investing. By investing in a mutual fund, a small investor can reap the benefits of research work done by them.
7. *Liquidity* – The units of mutual fund can be converted into cash at any time. This ensures liquidity to the small investor.
8. *Simplicity* – Many banks and non-banking institutions have their own line of mutual funds and buying a unit of mutual fund is very easy. Most institutions have systematic investment plans (SIPs) that enable one to invest as little as Rs. 1,000 on a monthly basis and purchase the desired units of mutual funds.
9. *Tax Benefits* – Many mutual funds offer units that provide tax benefits under different sections of Income Tax Act, 1961. The income earned by mutual funds is also free from taxes and hence, a lot of tax benefits accrue to the small investors.
10. *Flexible investment schedules* – Mutual funds offer units under different schemes that enable the small investors to shift from one scheme to another easily.

11. Supporting capital market – Mutual funds provide a sustainable domestic source of demand for capital market instruments and support capital market to be active all the time.
12. *Promoting industrial development* – Mutual funds supply a large amount of funds for the industries to meet their capital requirements and promote their development.
13. *Assured benefit of IPOs* – Many a times it may not be possible for a small investor to subscribe to the IPOs of companies. Mutual funds get a guaranteed allotment of such IPOs and thus a small investor who invests in mutual funds get the benefit of IPOs in an indirect way.
14. *Reduction of marketing costs of new issues* – Since the mutual funds subscribe to a large size of new issues, the marketing cost of new issues is substantially reduced.
15. *Supporting money market* – Generally money market instruments are not accessible to the small investors as the minimum amount of investment in such instruments is more. Mutual funds support the money market by investing the funds in money market instruments and thus keep the money market active.

**Disadvantages of mutual funds**

1. *Professional management* – Many small investors are of the opinion that the so called professionals are no better than individual investors in picking up stocks. Moreover, the professionals have no direct impact of loss or gain on the investments. Even if the fund loses money, the managers are still paid their salary.
2. *Costs* – Running a mutual fund is a costly affair. Creating, maintaining and distributing units of mutual fund involves a lot of expenses. These expenses are actually passed on to the small investors.
3. *Dilution* – As the mutual funds have small holdings in a number of stocks of different companies, high returns from a few investments are diluted due to the small returns from other investments.
4. *Compulsion* – Successful mutual fund attracts large savings from the small investors and makes the mutual funds compelled to find new avenues for investment. This may affect the overall profitability of the funds.
5. *Taxes* – When a security is sold, it may attract capital gains tax. Investors who are concerned about the impact of taxes need to keep these things in mind while investing in mutual funds.

**Types of Mutual Funds**

**Money Market Funds**

The funds that invest in short term fixed income securities like government bonds, treasury bills, bankers' acceptances, commercial papers, certificate of deposits, etc., are called as Money Market Funds. They are generally safer investments but the yield potential is lower when compared to other types of mutual funds.

**Fixed Income Funds**

The funds that invest in fixed & regular interest yielding investments like government bonds, debentures, etc., are called as Fixed Income Funds. The government bonds are safer but the rate of interest is lower. The corporate bonds, i.e., debentures are riskier but the rate of interest is generally higher.

**Equity Funds**

The funds that invest in equity shares and stocks of joint stock companies are called as Equity Funds. These funds aim to grow faster than money market or fixed income funds. They provide the benefit of capital appreciation besides regular dividend. Generally they are riskier when compared to other funds.

**Balanced Funds**

The funds that invest in a mix of equities and fixed income securities are called as Balanced Funds. They try to balance the aim of achieving higher return and safety of funds.

**Index Funds**

The funds that invest in investments in accordance with the specific index such as S&P are called as Index Funds. The value of such investments will go up or down as the index goes up or down. In case of investment in index funds, the portfolio manager is relieved of doing much research on his investment decisions.

**Specialty Funds**

The funds that invest in specialized areas like real estate, commodities, environment protection companies, etc., are called as Specialty Funds.

**Fund of Funds**

The funds that invest in other mutual funds are called as Fund of Funds. They aim to reap the benefit of research and analysis done by other funds.

**2 Marks Questions**

1. Give the meaning of financial institution
2. State the functions of financial institutions
3. State any two benefits of financial institutions
4. What is a banking institution?
5. What is NBFC?
6. State the types of banking institutions
7. What is a Commercial Bank?
8. What is a Scheduled Bank?
9. What is a Non-scheduled Bank?
10. What benefits are available to Scheduled Banks?
11. What is an Investment Bank?
12. What is an Industrial Bank?
13. What is an Exchange Bank?
14. What is a Co-operative Bank?
15. What is a Land Development Bank?
16. What is a Regional Rural Bank?
17. What is a Savings Bank?
18. What is a Central Bank?
19. State any four traditional functions of central bank
20. State any four promotional functions of central bank
21. State any four supervisory functions of central bank
22. What is an Asset Financing Company?
23. What is an Investment Company?
24. What is a Loan Company?
25. What is a Development Institution?
26. State any four features of Development Institutions?
27. What is meant by Regulated Deposit?
28. What is meant by Exempted Deposit?
29. Give the meaning of mutual fund
30. Define mutual fund
31. State any two features of mutual fund

32. State any two advantages of mutual fund
33. State any two limitations of mutual fund

**6 Marks Questions**

1. Briefly explain the functions traditional functions of central bank
2. Distinguish between Banking Companies and Non Banking Financial Companies
3. Explain the classification of NBFCs as per RBI
4. Explain the reasons for the growth of NBFCs
5. Explain the main functions of NBFCs
6. Explain the services of NBFCs
7. Explain the measures taken for regulation of NBFCs
8. Explain the constitution, objectives and functions of IDBI
9. Explain the constitution, objectives and functions of SFCs
10. Explain the constitution, objectives and functions of LIC
11. Explain the constitution, objectives and functions of EXIM Bank
12. What is mutual fund? What are its advantages?
13. Briefly explain the meaning and significance of mutual fund

## COMMERCIAL BANKS

**Meaning of Bank**

According to some experts on banking, the term 'bank' is said to have been derived from the French word 'Banco' or 'Bancus' or 'Banque' which means a 'bench or table'. In fact, in the earlier days, the Jews of Lombardy were transacting their banking business by using benches covered by green tablecloths atop them as makeshift desks or exchange counters. Thus, it is argued that the word Banco, over a period of time, got anglicized into 'Bank'. But according to some other experts, the term 'bank' is derived from the German word 'banc' or 'banck' which means a joint stock fund or a common fund or heap of money.

Today the term 'bank' refers to the institution that engages itself in the business of banking. The business of banking involves "accepting for the purpose of lending and investment, of deposits of money from the public, repayable on demand, order or otherwise and withdrawable by cheque, draft, order or otherwise.

**Meaning of Banker**

The term 'banker' refers to a person or institution engaged in the banking business.

**Indian Banking System**

The Indian banking system is made up of two components viz., Unorganized sector and Organized sector.

**Unorganized Sector**

In the unorganized sector there are money lenders, pawn brokers, landlords, indigenous bankers, etc. The characteristics of the banking business done by unorganized sector may be summed up as under:

- In the unorganized sector, the individuals carry on the business of banking.
- Persons in the unorganized sector lend money, act as money changers and also provide finance for internal trade through bills of exchange (Hundies).
- The banking business done by these persons is generally in the form of a family business and the entire capital required for this business is contributed through owned funds.
- While granting loans, they take gold, jewellery, land, promissory notes, etc., as collateral security.
- Generally, they do not have contact with other sections of the banking world.
- They combine banking business with their other activities

- They generally deal with agriculturists and small traders
- They charge a higher rate of interest on loans than the rate of interest charged by organized banking sector
- They are much sought after because of their flexibility, absence of formalities and promptness
- They occupy a prominent position in the Indian Banking System. It is said that about half the internal banking business of India is done by these unorganized bankers.

**Organized Sector**

In the organized sector there are commercial banks, cooperative banks, regional rural banks, etc. The characteristics of the banking business done by organized sector may be summed up as under:

- In the organized sector, it is not the individuals but the institutions which carry on the business of banking.
- Institutions in the organized sector lend money, act as money changers, provide finance for short term, medium term and long term needs.
- The capital required for banking business is contributed through share capital and deposits from the public.
- They grant loans on both personal and collateral security.
- While doing the business, they establish a network of relationship with other sections of the banking world.
- They do not combine banking business with other activities
- They deal with all sections of the society and cover both individuals and institutions.
- They charge a lower rate of interest on loans than the rate of interest charged by unorganized banking sector
- They are much sought after because of their adherence to professional norms, quantum of loans granted, encouragement and support of the government, etc.
- They occupy a prominent position in the Indian Banking System. It is said that the organized banking sector is the life blood of the economy of the country.

**Meaning of Commercial Banks**

The banks that cater to the financial needs of business and other commercial entities are known as commercial banks. They accept demand deposits from the public and provide loans and advances to business and other commercial entities.

**Types of commercial banks**

Based on registration or shareholding the commercial banks may be classified as under:

| On the basis of registration | On the basis of shareholding |
| --- | --- |
| a. Scheduled Banks<br>b. Non-scheduled Banks | a. Public sector banks<br>b. Private sector banks<br>c. Foreign banks |

**Scheduled banks –** The banks that are registered under II Schedule of RBI are called as scheduled banks. These banks come under the direct purview of the credit control measures of RBI and enjoy the privilege of borrowing and rediscounting facility from RBI. The following conditions must be fulfilled by a bank for inclusion in the II Schedule of RBI.

- The bank concerned must be doing banking business in India
- The bank must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5,00,000 (presently not less than Rs. 100 crore)
- The bank must satisfy the RBI that its affairs are not being conducted in a manner detrimental to the interests of the depositors.

**Non-scheduled banks** – The banks that are not registered under II Schedule of RBI are called as non-scheduled banks. These banks do not enjoy the privilege of depositing their excess money in RBI and obtaining refinance facility from the same.

**Public Sector banks** – The banks in which majority of the shareholding is in the hands of Government or RBI are called as public sector banks. State Bank of India and its subsidiary banks, Canara Bank, Syndicate Bank, Vijaya Bank, Indian Overseas Bank, Dena Bank, Bank of Baroda and Corporation Bank are the examples of public sector banks.

**Private Sector banks** – The banks in which majority of the shareholding is in the hands of general public (including financial institutions other than government financial institutions) are called as private sector banks. Karnataka Bank Ltd., The Karur Vysya Bank Ltd., Dhanalakshmi Bank Ltd., and ING Vysya Bank Ltd., are the examples of private sector banks.

**Foreign banks** – The banks whose registered office is in a foreign country and the banking business is done in India through their branches are called as foreign banks. Hong Kong and Shanghai Banking Corporation (HSBC Bank) Citibank, City Bank, American Express Bank, Standard & Chartered Bank and Grindlay's Bank are the examples of foreign banks.

**Role of Commercial Banks**

Commercial banks play a pivotal role in the economic development of the country. They help the economic development of the country in the following ways:

1. Capital formation through mobilization of savings of the public
2. Granting loans and advances to the trade, industry & commerce
3. Granting loans and advances to the agricultural activities
4. Granting personal loans and advances to the consumer for consumption activities
5. Granting loans and advances for various employment generating activities
6. Helping formation of monetary policy of the government
7. Encouraging the growth of right type of industries
8. Promote various commercial virtues like punctuality, honesty and forethought
9. Fulfillment of various socio-economic objectives

**Functions of commercial banks**

The functions of commercial banks may be classified into two viz., primary functions and secondary functions:

**Primary functions of commercial banks**

a. *Receiving of deposits* – The commercial banks receive various deposits like savings deposits, fixed deposits, recurring deposits, current deposits, etc.
b. *Making loans and advances* – The commercial banks make loans and advances in the form of overdraft, cash credit, bill discounting, money at call, money at short notice, term loans, housing loans, personal loans, consumer credit, etc.,
c. *Credit creation* – The banks create credit by automatically creating a deposit account as and when a loan or advance is sanctioned to the customer. Generally, when the loan is sanctioned, the customer is not given cash but an account is opened in his name and the loan amount is credited to that account. Thus, even though there is no cash movement, the deposit amount in the books of the bank will increase. This is called as credit creation.
d. *Promote the use of cheques* – The banks promote the use of cheques for transfer of money from one person to another. The cheque book is provided to the customers at a very nominal

charge. Cheque is used by banks as paper based clearing system wherein the cheque issued by one party is credited to the other party through a system called clearing house.

e. *Foreign exchange services* – The banks undertake the activity of buying and selling foreign currencies.
f. *Banker to the government* – The banks act as banker to the government and render services like collection of taxes, payment of salaries, pension, subsidies, etc. They also undertake the responsibility of distribution of government bonds and handling of public provident fund accounts.
g. *Promote the use of Automated Teller Machines (ATMs)* – The term 'teller' means 'cash dispenser'. The banks dispense the cash to their customers through the automatic machines installed at places convenient to their customers. Thus they promote the use of ATMs.
h. *Promote the use of new technology* – The banks promote new technology like Electronic Clearing System (ECS), Real Time Gross Settlement (RTGS), and National Electronic Fund Transfer (NEFT).
    a. *Electronic Clearing System* is an electronic mode of funds transfer from one bank account to another. It can be used by institutions for making payments such as distribution of dividend, interest, salary, pension, etc. It can also be used to pay bills and other charges such as telephone bills, electricity bills, water bills, loan installments, Systematic Investment Plans (SIPs) etc. ECS can be used for both credit and debit purposes.
    b. *Real Time Gross Settlement* is defined as the continuous (real time) settlement of funds individually on an order by order basis (without converting to net figure). 'Real Time' means the processing of instructions at the time they are received rather than at some later time. 'Gross Settlement' means the settlement of funds transfer instructions occurs individually. Under this system the funds settlement takes place in the books of the RBI and the payments are final and irrevocable.
    c. *National Electronic Funds Transfer* is a nation-wide payment system facilitating one-to-one funds transfer. Under this scheme, individuals can electronically transfer funds from any bank branch to any other bank branch in the country participating in the scheme.

**Secondary Functions of commercial banks**

The secondary functions consist of agency functions and miscellaneous or general utility functions.

**Agency Functions**

Agency functions refer to the functions performed by the commercial banks on behalf their customers and include the following:

1. Payment and collection of public subscriptions of shares, interest on securities, dividend on shares, salaries, pension, etc.
2. Purchase and sale of securities
3. Acting as income tax consultant
4. Execution of standing orders
5. Acting as executor, administrator and trustee
6. Acting as correspondent

**Miscellaneous or general utility functions**

Miscellaneous or general utility functions refer to the functions performed by the commercial banks for the general utility of their customers and include the following:

1. Safe deposit locker facility
2. Issue of letters of credit

3. Issue of travelers cheques
4. Merchant banking
5. Acting as referee
6. Providing information on overseas trade
7. Dealing in foreign exchange business
8. Lease financing
9. Factoring
10. Housing finance
11. Underwriting of shares and debentures
12. Tax consultancy
13. Issue of credit and debit cards
14. Issue of gift cheques,
15. Teller system, etc.

**Investment Policy of Commercial Banks**

One of the primary functions of a bank is investment of funds. The banks are required to invest their funds in such a way that they earn a decent profit from their investment and the profit so earned is not at the cost of liquidity and safety of the funds. Therefore, the banks follow a set of guidelines in their investment so as to ensure liquidity, safety and profitability before investing their funds. Such set of guidelines that the banks follow before investing is known as investment policy of commercial banks. Thus, the investment policy of commercial banks consists of ensuring of liquidity, safety and profitability. Each of these concepts is explained in the following paragraphs:

A. **Liquidity -** The term liquidity refers to the convertibility of the investments into cash quickly without any loss. The banks are required to repay the deposits on demand. Therefore, they should invest the funds in such securities which can be sold quickly without any loss or shifted to other banks or RBI so that necessary amount of cash is procured to meet the immediate cash obligations. Deposits with RBI, treasury bills, call and short notice loans, etc., are the examples of investments that posses the element of liquidity. As for as a commercial bank is considered, the term liquidity consists of two types of liquidity – Deposit Liquidity and Loan Liquidity. Deposit liquidity requires that the bank must be able to meet the demands of their depositors for cash as and when they arise. Loan liquidity requires that the bank must be able to meet all the legitimate credit requirements of its customers. These two types of liquidity are contrasting to each other in the sense that when the deposit liquidity is higher the loan liquidity will be lower and vice-versa. The important factors that indicate the liquidity position of a bank are cash reserve ratio (CRR), statutory liquidity ratio (SLR) and loan to deposit ratio. The important factors that influence the liquidity of banks are:

    1. *Cash reserve ratio:* - This is the minimum cash reserve to be maintained by every bank under statute and as per the instructions from the central bank. If the CRR is increased, the liquidity increases and vice-versa.
    2. *Statutory liquidity ratio:* - This is the minimum amount to be invested in money market instruments under statute and as per the instructions from the central bank. If the SLR is increased, the liquidity increases and vice-versa
    3. *Banking system:* - The banking system may be unit banking system or branch banking system. Under unit banking system, each bank has to maintain more liquid assets. Under branch banking system, each branch may maintain less or moderate amount of liquid assets as there is a facility of transfer of funds from one branch to another in case of need.

4. *Use of cheque:* - If the use of cheque system is popular among the customers in particular and the public in general, the cash asset to be maintained by the bank can be kept at a minimum level.
5. *Nature of business conditions:* - Business conditions refer to the inflation and depression conditions. During the depression conditions, the businessmen borrow less and hence, the banks will have more cash and vice-versa
6. *Nature of money market:* - In a well developed money market, keeping less cash reserve is justified as there is a possibility of raising cash for immediate requirements through sale of money market instruments.
7. *Nature of depositors:* - The banks may have individual persons or business entities (corporate customers) as their customers. If the corporate customers are dominant, then the banks need to maintain high cash reserves whereas if the individual customers are dominant, then the banks can maintain less cash reserves.
8. *Seasonal conditions:* - The liquidity of a bank is also affected by the seasonal conditions. During the festival seasons, harvest seasons, etc., the demand for cash will be more. Therefore, the banks have to maintain more liquidity during such seasons.
9. *Policy of fellow bankers:* - The policy of fellow bankers follow a policy of maintaining high cash reserve, the other banks also need to follow the same policy to be on par with them.
10. *Clearing house facility:* - If there is an effective clearing house facility, inter-bank mutual claims can be easily settled through book entries and hence, less cash reserves can be maintained. On the other hand, if the clearing house facility is absent or less effective, it becomes necessary to maintain more cash reserves.

B. **Safety -** The term safety refers to the absence of risk of loss of the principal amount invested. The banks act as the trustees of money belonging to the public. Hence, they must exercise greatest care and vigilance in the matter of investing funds. The investments which yield higher returns have an element of high risk and vice versa. If the bank chooses to invest in high risk investments, the returns may be high but the safety of the principal is ignored. On the other hand, if the bank chooses to invest in highly safe investments, the returns may be very poor. Hence, the banks should consider the amount of return and risk carefully and follow a balancing act of investing in such securities which yield decent returns and are also reasonably safe.

C. **Profitability -** The term profitability refers to the ability of the investments to yield reasonably good rate of return. The banks are required to earn a decent income in order to meet all expenses and also to pay a fair amount of dividend to their shareholders. Long term securities yield higher amount of return but lack liquidity and short term securities yield lower amount of return and have high amount of liquidity. Thus, the concepts liquidity and profitability are conflicting with each other. Therefore, the banker should consider both profitability and liquidity carefully and strike a balance between the two while investing the funds. The factors that affect the profitability of banks are:

1. *Branch expansion:* - While expanding the business by establishing branches, cost benefit analysis should be made. Undue expansion of the branch ignoring the cost & the benefits leads to decline in the overall profits of the bank.
2. *Non Performing Assets:* - The banks should grant loans after doing a careful scrutiny of the borrowers need and their ability to repay. Undue granting of loans leads to mounting NPAs and leads to decline in the overall profits of the bank.
3. *Bad debts:* - The loan recovery system should be effective so as to reduce the amount of bad debts. Any increase in bad debts leads to decline in the overall profits of the bank.

4. *Mass banking to fulfill social obligations:* - The provision of mass banking facility to fulfill social obligations without due consideration of cost of operations leads to decline in the overall profits of the banks.
5. *Granting loans at concessional rate of interest under different government schemes:* - Banks grant loans to some priority sectors at concessional rate of interest. This also reduces the profitability of a bank.
6. *Indiscriminate lending to sick industries:* - While granting loans to industries, the banker must use high amount of caution. If the loan is granted to a sick industry, it may lead to increase in the NPAs and decrease the profits of the bank.
7. *Merger of smaller banks with big banks:* - In order to safeguard the interests of the depositors, sometimes, the loss making small banks may be merged with the profit making big banks. This again leads to decrease in the profits of the bank.
8. *Competition from international banks:* - Now-a-days, foreign banks are playing a vital role and offering loans at highly competitive rates. This compels the domestic banks also to reduce the interest rates and hence, their profitability reduces.
9. *Higher cost of operation due to widespread small loans:* - When the banks grant small loans to a large number of customers, per unit cost of servicing each loan will be high as compared to granting of big loan to small number of customers. Thus, when the number of small loans is more, the profits of the bank declines due to higher cost of operation.
10. Bank frauds: - Increased bank frauds leads to heavy loss to the banks. This is another reason for the declining profits of the bank.

To conclude, it can be said that the investment policy of a bank should strike a balance between liquidity, safety and profitability. For this purpose, the following principles may be adhered to by the banks.
1. Invest a portion of the amount in securities that possess a high element of liquidity.
2. Invest another portion of the amount in securities of different sectors. That is, diversify the investments so that the risk is minimized and safety is ensured.
3. Invest some other portion of the amount in securities that yield fixed rate of dividend or interest so that reasonable and stable profit is ensured.
4. Invest a small portion of the amount in securities that offer high rate of return so that the overall profit is maximized.

**Narasimaham committee report on banking sector reforms**

**2 Marks Questions**
1. What is a Commercial Bank?
2. What is a Scheduled Bank?
3. What is a Non-scheduled Bank?
4. What is a Public Sector Bank?
5. What is a Private Sector Bank?
6. What are Foreign Banks?
7. State any four primary functions of commercial banks
8. State any four secondary functions of commercial banks
9. Expand ATM and give its meaning
10. Expand ECS and give its meaning
11. Expand RTGS and give its meaning
12. Expand NEFT and give its meaning
13. Give the meaning of investment policy
14. Give the meaning of liquidity
15. Give the meaning of safety

16. Give the meaning of profitability

**6 Marks Questions**

1. What is scheduled bank? What are the conditions to be fulfilled to become a scheduled bank?
2. Explain the various types of Commercial Banks
3. Explain the functions of Commercial Banks
4. Explain the investment policy of Commercial Banks
5. Suggest some suitable principles for investment by banks.

## REGULATORY INSTITUTIONS

**Reserve Bank of India**

For the purpose of carrying on the functions of central bank of the country, Reserve Bank of India was established on April 1, 1935 through Reserve Bank of India Act, 1935. The main office of RBI was initially established in Kolkata but in the year 1937, it was permanently moved to Mumbai. The chief of RBI is called as Governor of RBI and he functions from the main office. Originally the RBI was established as a privately owned central bank with a share capital of Rs. 5 crores divided into 5 lakh shares of Rs. 100 each. After independence, the RBI was nationalized and it started functioning as government owned central bank from January 1, 1949.

Reserve Bank of India has 26 Regional Offices and Branches, a number of training centres, research institutes and subsidiaries. National Housing Bank (NHB), Deposit Insurance and Credit Guarantee Corporation (DICGC) and Bharatiya Reserve Bank Note Mudran Private Ltd., (BRBNMPL) are the fully owned subsidiaries of RBI. RBI also has a major stake in the National Bank of Agriculture and Rural Development (NABARD).

The management of RBI is governed by a central board of directors which is appointed by the Government of India in accordance with the provisions of RBI Act, 1935. The board consists of a governor, four deputy governors, four directors to represent regional board and ten other directors from various other fields. Till September 30, 2016 RBI was governed by 22 governors. Dr. Raghuram Rajan was the 22$^{nd}$ governor of RBI and retired on September 30, 2016. Presently, Mr. Urjit Patel is the governor of RBI.

**Objectives of RBI**

1. To manage monetary and credit system of the country
2. To stabilize internal and external value of the domestic currency
3. To ensure balanced and systematic development of the banking industry in the country
4. To help organized development of money market in the country
5. To establish friendly monetary relations with other countries of the world
6. To help in the centralization of cash reserves of commercial banks
7. To maintain a balance between demand and supply of currency notes
8. To conduct research and publish data on financial matters

**Functions of RBI**

The functions of RBI may be classified under three heads viz., traditional functions, promotional functions and supervisory functions.

**Traditional functions**

1. *Monopoly of note issue:* – In terms of section 22 of the RBI Act, the RBI is given the statutory power to issue notes on a monopoly basis. No other bank or institution is allowed to issue notes for

public circulation. In the earlier days, the notes used to be issued on the basis of "Proportional Reserve System" wherein the notes were issued in proportion to the reserves of gold coins, gold bullion and foreign securities. However, due to difficulty of maintaining the reserves proportionately, now the "Minimum Reserve System" is adopted to issue notes. Under this system, the RBI should maintain a minimum reserve of Rs. 200 crore worth of gold coins, gold bullion and foreign securities in which gold coin and gold bullion should not be less than 115 crore. Presently RBI issues notes of Rs. 10 denomination and above. Coins and notes of less than Rs. 10 denomination are issued by the government of India. The management of circulation of money is done through currency chests maintained by RBI, SBI, Subsidiaries of SBI, Public Sector Banks, Government Treasuries and Sub-treasuries. Currency chests refer to the receptacles in which stocks of issuable and new notes and coins are stored.

2. *Banker to the Government:* - In terms of section 21 of the RBI Act, the government should entrust its money remittance, exchange and banking transactions in India to RBI. In terms of section 21A the state governments should also entrust their remittance, exchange and banking transactions in the respective states to RBI. Therefore, RBI acts as a banker to both the central and state governments. RBI does not earn any income by conducting these functions. However, it earns income by way of commission for managing the governments' public debt. By virtue of section 45 of the RBI Act, wherever RBI has no branch, SBI or its subsidiaries are required to function as the agents and sub-agents of RBI. These agent or sub-agent banks would get commission on all transactions conducted on turnover basis.

Being a banker to the governments the RBI extends "Ways and Means Advances (WMA)" to both central and state governments. "Ways and Means Advances (WMA)" refers to the credit facility to meet the temporary shortfall in government revenue as compared to the monthly expenditure.

As a banker to the government RBI renders the following services to the government.

a) Collection of taxes
b) Payment to various parties
c) Accepting of deposits from governments
d) Collection of cheques and drafts
e) Providing of short term loans to the government
f) Maintaining various accounts of the government departments
g) Maintaining of currency chests
h) Advising the government on their borrowing programs
i) Maintaining and operating the central government accounts in International Monetary Fund (IMF)

3. *Agent and Advisor to the Government:* - The RBI acts as the financial agent and adviser to the government and renders the following services
    a) Managing the public debts and accepting the loans on behalf of the government
    b) Issue of government bonds, treasury bills, etc.
    c) Advising the government in all important economic and financial matters of the country

4. *Banker to the Banks:* - The RBI acts as banker to all the scheduled banks. All banks in India are required to keep certain percentage of their demand and time liabilities as reserves with the RBI. This is known as Cash Reserve Ratio (CRR)

5. *Acting as National Clearing House:* - The RBI acts as the clearing house for settlement of banking transactions in India. The function of clearing house is to settle the interbank claims easily and at

low cost. Wherever the RBI does not have a clearing house, the function of clearing house is carried out in the premises of State Bank of India.

6. *Acting as Controller of Credit:* - One of the primary functions of the commercial banks is credit creation by automatically creating a deposit account as and when a loan or advance is sanctioned to the customer. Credit creation has a direct impact on the economic conditions of the country. Hence the RBI acts as the controller of credit creation through quantitative and qualitative measures.

By acting as the controller of credit, RBI would strive to achieve the following objectives:

a) Maintaining the desired level of circulation of money
b) Maintaining the stability in the prevailing price level in the economy
c) Controlling the effects of trade cycles
d) Controlling the fluctuations in the foreign exchange rates
e) Channelizing the credit to productive sectors of the economy

The important measures used by RBI for control of credit creation are:

a) Bank Rate Policy
b) Open Market Operations
c) Variation of SLR
d) Variation of CRR
e) Fixation of Margin Requirements
f) Moral Suasion
g) Issue of Directives
h) Direct Action

7. *Acting as Custodian of Foreign Exchange Reserves:* - The RBI acts as custodian of foreign exchange reserves. Foreign-exchange reserves (also called forex reserves or FX reserves or official international reserves or international reserves), refers to the foreign currency deposits and bonds held by central banks and monetary authorities. It commonly includes foreign exchange and gold, special drawing rights (SDRs) and International Monetary Fund (IMF) reserve positions. Foreign exchange reserves are important indicators of ability to repay foreign debt and for currency defense, and are used to determine credit ratings of nations.

8. *Foreign Exchange Control:* - Foreign exchange control, popularly referred to as 'exchange control' refers to the activity of regulating the demand for foreign exchange for various purposes against the supply constraints. When the Government finds a shortage of foreign exchange due to the low level of external reserves on account of deficit in the balance of payments, exchange control becomes necessary. Exchange control implies a kind of rationing of foreign exchange for the various categories of demand for it. The Reserve Bank of India implements exchange control on a statutory basis. The Foreign Exchange Regulation Act, 1973 empowers the bank to regulate investments as well as trading, commercial and industrial activities in India of foreign concerns (other than banking), foreign nationals and non-resident individuals. Moreover, the holding of immovable property abroad and the trading, commercial and industrial activities abroad by Indian nationals are also regulated by the Bank under exchange control. The Reserve Bank manages exchange control in accordance with the general policy of the Central Government. In India, exchange control is grossly related to and supplemented by trade control. While trade control is confined to the physical exchange of goods, exchange control implies supervision over the settlement of payments – financial transactions pertaining to the country's exports and imports. Comparatively, exchange control is more comprehensive than trade control, since it

covers all exports and imports as well as invisible and capital transactions of the country's balance of payments. Under the present exchange control system, the Reserve Bank does not directly deal with the public. The bank has authorized foreign exchange departments of commercial banks to handle the day-to-day transactions of buying and selling foreign exchange. Further, the bank has given money changer's licences to certain established firms, hotels, shops, etc. to deal in foreign currencies and travellers' cheques to a limited extent.

9. *Publication of Economic Statistics and Other Information:* - The RBI collects statistical and other information on economic and financial matters of the country. The statistics and other information so collected are published periodically in an analytical manner. It also presents the genuine financial position of the government and the economic condition of the whole country.

10. *Fights against the Economic Crisis:* - The RBI aims at the economic stability in the country. Whenever it feels that there is a danger to the economic stability, it immediately interferes and takes suitable measures to put the economy on the right track. For this purpose, it forms and implements various policies and adopts various quantitative and qualitative measures.

**Promotional Functions**

1. *Promotion of Banking Habits:* - The RBI promotes banking habits among the public through expanding the banking business to various corners of the country and also by establishing various corporations like Deposit Insurance Corporation, Unit Trust of India, IDBI, NABARD, Agricultural Refinance Corporation, Industrial Reconstruction Corporation of India, etc.

2. *Providing of Refinance for Export Promotion:* - The RBI takes initiative for widening the facilities for financing of foreign trade. Export Credit and Guarantee Corporation (ECGC) and EXIM Bank are established for the purpose of expanding the foreign trade. It also encourages export trade through refinance facilities for export credit granted by commercial banks. Further, it prescribes rates of interest on export credits.

3. *Promotion of Agriculture:* - The RBI promotes agriculture through financial facilities on a regular basis. For this purpose, it provides refinance facility to NABARD. Through NABARD it provides short-term and long-term financial facilities at lower rate of interest to agriculture and allied activities.

4. *Promotion of Small Scale Industries:* - The RBI takes active steps for the promotion of SSI through issuing directives to the commercial banks to extend credit facilities to SSIs. It also encourages commercial banks to provide guarantee services to SSIs. RBI has classified bank advances to SSI as priority sector advance.

5. *Promotion of Co-operative Banks:* - The RBI extends indirect financing facilities to co-operative banks and connects them with the main banking system of the country.

**Supervisory Functions**

1. *Granting of license to Banks:* - The RBI grants license to open new banks. It also grants license to open new branches or close existing branches. With this function, the RBI ensures avoidance of unnecessary competition among banks, even growth of banks in different regions, adequate banking facility in all regions, etc.

2. *Inspection and Enquiry:* - The RBI inspects and makes enquiry in respect of various matters covered under Banking Regulation Act, 1949.

3. *Deposit Insurance Scheme:* - The RBI implements the deposit insurance scheme for the benefit of small depositors. Under this scheme, deposit of an individual depositor upto Rs. 1,00,000 is guaranteed for payment. Through this scheme, the confidence of common people on the banking system is improved.

4. *Review of Working:* - The RBI periodically reviews the work done by the commercial banks. It takes suitable measures to enhance the efficiency of the banks and make various policy changes and implement programs for the well being of the nation and for improving the banking system as a whole.

5. *Control of NBFCs:* - The RBI issues necessary directions to the NBFCs and conducts inspections through which it exercises control over such institutions. Deposit mobilization by NBFCs requires permission from RBI.

## MONETARY POLICY

Monetary policy is defined as the macroeconomic policy laid down by the central bank of a country. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity. The main goals of monetary policy include relatively stable prices and low rate of unemployment. The monetary policy is denoted as either expansionary or contractionary policy.

*Expansionary Monetary Policy:* - The expansionary monetary policy increases the total money supply in the economy more rapidly than normal and tries to combat unemployment during recession. Under this policy, the rate of interest on loan is reduced so that people borrow more for their commercial and other activities resulting in more money in the hands of the public. Increase in the commercial and other activities improves the condition of business establishments and reduces the unemployment problem.

*Contractionary Monetary Policy:* - The contractionary monetary policy decreases the total money supply in the economy more rapidly than normal and tries to combat inflationary conditions. Under this policy, the rate of interest on loan is increased so that people borrow less for their commercial and other activities resulting in less money in the hands of the public. Decrease in the commercial and other activities brings down the condition of business establishments and increases the unemployment problem.

**Objectives of Monetary Policy**

Through an effective monetary policy the RBI attempts to strike a balance between recessionary and inflationary conditions in the country. RBI controls the supply of money in the economy by exercising its control mainly over interest rates in order to maintain price stability and achieve high economic growth. The main objectives of the monetary policy of RBI are as under:

1. Price Stability
2. Controlled expansion of bank credit
3. Promotion of fixed investment
4. Restriction of inventories
5. Promotion of exports
6. Promotion of food procurement operations
7. Desired distribution of credit

8. Equitable distribution of credit
9. Promotion of efficiency in the money market
10. Promotion of considerable autonomy to the banks

**Credit control measures**
Monetary policy of RBI does not just focus on credit restriction but also aims at providing legitimate credit facilities. It also attempts to ensure that the credit facility is not misused for unproductive and speculative purposes. The RBI uses the following quantitative as well as qualitative measures to control the credit.

**General or Quantitative Credit Control Measures**
By virtue of provisions under the RBI Act, 1935 and BR Act, 1949 the RBI exercises credit control through the following quantitative measures:

1. *Bank Rate Policy:* - Bank Rate, also called as Discount Rate refers to the long term rate at which RBI lends money to the commercial banks for their liquidity requirements. Bank rate acts as leader of interest rates in the economy of the country. RBI keeps modifying the bank rate to control inflation and recession. At present the bank rate is 7% (September 2015). In the recent years, the RBI is not using bank rate for monetary management. Instead, it is using MSF rate. The present MSF rate is the same as bank rate.

2. *Marginal Standing Facility (MSF)* - It is a special window for banks to borrow from RBI against approved government securities in an emergency situation like an acute cash shortage. MSF rate is always higher than Repo rate. Current MSF Rate is 7% (June 2016)

3. *Open Market Operations:* - Open market operations refers to the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. While purchase of government securities by RBI injects more money into the banking system, the sale of government securities takes away money from the banking system.

4. *Cash Reserve Ratio (CRR):* - By virtue of provisions under the RBI Act, 1935 every commercial bank has to keep a certain percentage (3% to 15%) of its time and demand deposits in the form of cash reserve with the RBI. The percentage of cash reserve to be maintained by commercial banks with RBI is called as Cash Reserve Ratio (CRR). By increasing or decreasing the CRR, RBI regulates the available cash with banking system for lending activities. When a bank's deposits increase by Rs100, and if the cash reserve ratio is 9%, the banks will have to hold Rs. 9 with RBI and the bank will be able to use only Rs 91 for investments and lending purpose. Therefore, higher the ratio, the lower is the amount that banks will be able to use for lending and investment. This power of Reserve bank of India to reduce the lendable amount by increasing the CRR, makes it an instrument in the hands of a central bank through which it can control the amount that banks lend. Thus, it is a tool used by RBI to control liquidity in the banking system. At present the CRR is 4% (June 2016)

5. *Statutory Liquidity Ratio:* - Every bank is required to maintain at the close of business every day, a minimum proportion of their Net Demand and Time Liabilities as liquid assets in the form of cash, gold and un-encumbered approved securities. *Net Demand Liabilities* refer to the bank accounts from which one can withdraw his money at any time (like savings accounts and current account). *Time Liabilities* refer to the bank accounts from which one cannot immediately withdraw his money but have to wait for certain period (like fixed deposit accounts). The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio (SLR). RBI is

empowered to increase this ratio up to 40%. An increase in SLR restricts the bank's leverage position to pump more money into the economy and vice versa. Thus, it is a tool used by RBI to control the capacity of a bank to extend credit facility. At present the SLR is 21.25% (June 2016)

6. *Repo and Reverse Repo Rates:* - Repo (Repurchase) rate also known as the benchmark interest rate is the rate at which the RBI lends money to the banks for a short term. When the repo rate increases, borrowing from RBI becomes more expensive. If RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate. Similarly, if it wants to make it cheaper for banks to borrow money it reduces the repo rate. Reverse Repo rate is the short term borrowing rate at which RBI borrows money from banks. The Reserve bank uses this tool when it feels there is too much money floating in the banking system. An increase in the reverse repo rate means that the banks will get a higher rate of interest from RBI. As a result, banks prefer to lend their money to RBI which is always safe instead of lending it others (people, companies etc) which is always risky. Repo Rate signifies the rate at which liquidity is injected in the banking system by RBI, whereas Reverse Repo rate signifies the rate at which the central bank absorbs liquidity from the banks. Reverse Repo Rate is linked to Repo Rate with a difference of 0.5% between them. At present the Repo and Reverse Repo Rate is 6.5% and 6% (June 2016)

**Selective or Qualitative Credit Control Measures**

Under selective credit measures, the credit is provided to only selected borrowers for only selected purposes depending upon the specific needs of the economy. The important measures under this are as follows:

1. *Ceiling on Credit:* - Under this measure, the RBI fixes the maximum ceiling on the amount of loan that can be granted by the commercial banks against certain controlled securities.

2. *Margin Requirements:* - Under this measure, the RBI fixes the margin requirement for sanctioning loan. Margin refers to the amount to be contributed by the borrower towards the collateral security against which the loan is raised. For example, if the borrower wants to do a business that requires an investment of Rs. 100, the bank may require him to contribute Rs. 20 as capital and the remaining Rs. 80 may be sanctioned by the bank as loan. In this case, Rs. 20 contributed by the entrepreneur is called as margin money. The credit creation by banks may be controlled by either increasing or decreasing the margin requirement so that the lending capacity of the bank is controlled.

3. *Discriminatory Interest Rate (DIR):* - Under this measure, the RBI fixes different rates of interest on different types of loans and ensures flow of credit to various sectors. For example, RBI fixes concessional rate of interest on the loan sanctioned to priority or weaker sectors and ensures flow of more credit to that sector.

4. *Directives:* - Under this measure, the RBI issues directives to the banks regarding the purpose for which loans may or may not be given by them.

5. *Direct Action:* - Under this measure, the RBI may take direct action by refusing to rediscount the bill or cancelling the license of the bank. This measure is rarely adopted by the RBI

6. *Moral Suasion:* - Under this measure, the RBI issues periodical letters requesting the banks to exercise control over the credit in general or advances against particular commodities. The RBI may also organize periodical meetings with the officials of the banks and persuade them to control the credit towards certain directions.

Lags in Monetary Policy

Lag in monetary policy refers to the time gap between the need of action and actual occurrence of it. The effectiveness of monetary policy is affected by this time gap. The situation that necessitated some action could have been changed by the time the monetary policy is implemented. Thus, the effect of monetary policy may become ineffective. There are three types of lags in the monetary policy. They are, Inside lag, Intermediate lag and Outside lag.

1. *Inside lag:* - This is the time gap between the arising of need for action and actual action taken. There are two types of inside lag, viz., recognition lag and administration lag. Recognition lag is the lag between the time of recognition of need and the time when the action is taken. Administration lag is the time taken by the RBI to implement the required monetary policy from the time it recognized the problem.

2. *Intermediate lag:* - This is the time gap taken by the economy to respond to the action implemented through the monetary policy from the time of implementation of the monetary policy.

3. *Outside lag:* - This is the time gap between the response and employment and the changes implemented in the monetary policy. There are two types of outside lag, viz., decision lag and production lag. Decision lag refers to the time gap between the interest rate change and change in the spending decisions. Production lag refers to the time gap between the implementation of monetary policy of the public and implementation of monetary policy of the business sector.

**Limitations of Monetary Policy**

Monetary policy is not an ultimate remedy to the problems of the economy. It suffers from the following limitations.

1. *Huge budgetary deficits:* - The government may present a budget with huge deficits leading to inflationary conditions. This makes the monetary policy less effective.

2. *Coverage of only commercial banks:* - The monetary policy covers only commercial banks. The inflationary conditions due to the influence of other reasons like less production, scarcity of goods, deficit financing, etc., are not under the control of RBI

3. *Inefficient management of banks and other financial institutions:* - Effectiveness of monetary policy depends upon the efficiency with which the banks and other financial institutions are functioning. If the very banks and other financial institutions are inefficiently managed or engaged in financial scams, then the monetary policy will not be effective.

4. *Unorganized money market:* - In India, the presence of unorganized market is very significant. Since, the RBI has very less power over this sector, the monetary policy becomes less effective.

5. *Less accountability:* - Lack of specific terms in setting the goals, lack of clarity in the responsibility of the government and RBI, etc., lead to less accountability. This again makes the monetary policy less effective.

6. *Black money:* - The black money generated in the country escapes from the purview of banking control of RBI. The growth of black money makes the monetary policy less effective.

7. *Increase volatility:* - The integration of domestic and foreign exchange markets could lead to increased volatility in the domestic market. The domestic market may be affected by the

exogenous factors transmitted by the foreign exchange markets and thus, the monetary policy may become less effective.

8. *Lack of transparency:* - It is necessary to have a greater transparency in the formulation and transmission process and the role of RBI should be clearly demarcated. Lack of such transparency leads monetary policy to be less effective.

## FINANCIAL SERVICES

**Meaning of financial services**

Financial services refer to the activities of channelizing the flow of funds from the savers to the users. It involves the mobilization of savings of the persons and institutions who have surplus funds and allocating or lending them to the persons and institutions who are in need of such funds.

**Features or Characteristics of financial services**

1. Intangible
2. Heterogeneity
3. Dominance of human element
4. Perishability
5. Information based
6. Fluctuating demand
7. Customer orientation
8. Simultaneous performance
9. Protection of customers interest
10. Dynamism

**Objectives of financial services**

1. Mobilization of funds
2. Allocations of funds
3. Rendering of specialized services like credit rating, venture capital financing, leasing, housing finance, etc.,
4. Contributing to the economic development of the country

**Advantages / Significance of financial services**

1. Promotion of savings
2. Economic growth
3. Capital formation
4. Provision of liquidity
5. Financial intermediation
6. Contribution to GDP & GNP
7. Creation of employment opportunities

**Types of financial services**

1. Traditional services
2. Modern services

**Traditional services**

1. Fund based services
    a. Lending
    b. Factoring

c. Leasing
d. Venture Capital
e. Consumer Finance
f. Housing and Vehicle Finance
g. Underwriting of Shares and Debentures
h. Participating in Money Market Instruments
i. Dealing in Foreign Exchange services

2. Non-fund based services or fee based services
   a. Managing the capital issues
   b. Investment consultancy
   c. Portfolio management
   d. Making arrangement for placement of capital and debt
   e. Arrangement of funds from other financial institutions
   f. Assisting and guiding in the process of clearances from the government and other agencies

**Modern services**

1. Capital restructuring
2. Planning for mergers and acquisitions
3. Rehabilitation of sick units
4. Credit rating
5. Credit cards
6. Risk management services
7. Loan syndication
8. Mutual funds
9. Custodial services
10. Depository services
11. Secretion of debts
12. Merchant banking
13. Rendering project advisory services
14. Guiding corporate customers in capital restructuring
15. Acting as trustees of debenture issues

## Important Types of Financial Services

**Factoring**

Factoring refers to the service of purchasing the accounts receivables of a business undertaking at a discount. In other words, factoring is the activity of undertaking the responsibility of debt collection on behalf of a third party. Under this, the sales ledger of a business undertaking is managed by a financial institution and the risk of debt collection is assumed by them. Factoring involves three parties, viz., the creditor (also called as client of the factoring institution), the debtor and the factor (factoring institution).

Creditor is the person who has sold goods and has Bills Receivable against the same. Debtor is the person who has purchased the goods on credit and is liable to pay the bills. Factor is the person who purchases from the creditor the Bills Receivables at a discount and later on collects the money from the debtor. Bills Receivable is essentially a financial asset associated with the debtor's liability to pay money to the seller (Creditor). Generally, the debtor will be informed of the discounting (sale) of Bills Receivable to the factor.

Under factoring, at least two of the following services are provided by the factor.

a) Financing
b) Maintenance of debts (Maintenance of Sales Ledger)
c) Collection of debts
d) Protection against credit risk

In India, factoring is undertaken by different institutions like SBI Factors & Commercial Services Private Ltd., Canara Bank Factors Ltd., etc.

**Mechanism of factoring**
The activity of factoring involves the following steps:

a) The client (seller/creditor) gets order from the debtors (customers) for goods and services to be provided on credit and makes an invoice.
b) The invoice made by the client is then assigned to the factor (factoring institution) and also sends the invoice to the customer in the usual way with a notification that the invoice is assigned to the factor and the payment must be made to the factor
c) The client then submits copies of invoices to the factors with a schedule of offer accompanied by the receipt, delivery challan, or any other document which is a proof of dispatch
d) The factor makes prepayment of cash to the client upto 80% of the value of invoice and sends periodical statements
e) The debtors (customers) make payments to the factor as and when due
f) The factor makes payment of cash to the extent of the balance 20% on realization of full payment from the debtors

It is important to note that the factoring institution provides prepayment upto 80% of the invoice value to the client and also follows up with the customers for realization of payments due. The factoring institution also sends a monthly statement of accounts to the client showing the details about factored invoices and payments made. The balance 20% payment is made to the client only after the full payment is received from the customers.

**Features (Characteristics) of factoring**

a) Factoring is a short term borrowing source to the sellers
b) The cost of factoring services is high when compared to borrowing other short term loans. It varies from 1.5% to 3% per month depending upon the financial strength of the debtors (customers)
c) The period of each factoring ranges from 90 days to 150 days and the factoring services is provided even on invoices as low as Rs. 1,000

**Advantages of factoring**

a) Factoring service helps the seller to save time and effort on collecting the debts. The time and effort saved thus can be redirected towards other activities of the business like marketing, selling, customer development, etc.
b) Factoring service is done on the basis of invoice raised and hence does not require any other collateral security.
c) Factoring institutions generally make a prepayment of 80% of the invoice value which is generally more than what one would get when any other short term loan is borrowed.

**Leasing (Lease Financing)**
Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee. The periodical payment made by the lessee to the lessor is known as lease rental. Under lease financing, lessee is given the right to use the asset but the

ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

**Types of Lease**

Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories. Finance lease and operating lease.

**Finance Lease**

It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals. In other words, it puts the lessee in the same condition as he/she would have been if he/she had purchased the asset. Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.

**Features of Finance Lease**

From the above discussion, following features can be derived for finance lease:

a) A finance lease is a device that gives the lessee a right to use an asset.
b) The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.
c) The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.
d) Lessee is responsible for the maintenance of asset.
e) No asset-based risk and rewards is taken by lessor.
f) Such type of lease is non-cancellable; the lessor's investment is assured.

**Operating Lease / Service Lease**

Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee. The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why this type of lease is also known as service lease.

**Features of Operating/Service Lease**

a) The lease term is much lower than the economic life of the asset.
b) The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.
c) The lessor provides the technical knowhow of the leased asset to the lessee.
d) Risks and rewards incidental to the ownership of asset are borne by the lessor.
e) Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.

**Advantages of lease financing**

Leasing is becoming a preferred solution to resolve fixed asset requirements vs. purchasing the asset. While evaluating this investment, it is essential for the owner of the capital to understand whether leasing would yield better returns on capital or not. Let us have a look at leasing advantages and disadvantages:

1. Balanced Cash Outflow: The biggest advantage of leasing is that cash outflow or payments related to leasing are spread out over several years, hence saving the burden of one-time significant cash payment. This helps a business to maintain a steady cash-flow profile.

2. Quality Assets: While leasing an asset, the ownership of the asset still lies with the lessor whereas the lessee just pays the rental expense. Given this agreement, it becomes plausible for a business to invest in good quality assets which might look unaffordable or expensive otherwise.
3. Better Usage of Capital: Given that a company chooses to lease over investing in an asset by purchasing, it releases capital for the business to fund its other capital needs or to save money for a better capital investment decision.
4. Tax Benefit: Leasing expense or lease payments are considered as operating expenses, and hence, of interest, are tax deductible.
5. Off-Balance Sheet Debt: Although lease expenses get the same treatment as that of interest expense, the lease itself is treated differently from debt. Leasing is classified as an off-balance sheet debt and doesn't appear on company's balance sheet.
6. Better Planning: Lease expenses usually remain constant for over the asset's life or lease tenor, or grow in line with inflation. This helps in planning expense or cash outflow when undertaking a budgeting exercise.
7. Low Capital Expenditure: Leasing is an ideal option for a newly set-up business given that it means lower initial cost and lower CapEx requirements.
8. No Risk of Obsolescence: For businesses operating in the sector, where there is a high risk of technology becoming obsolete, leasing yields great returns and saves the business from the risk of investing in a technology that might soon become out-dated. For example, it is ideal for the technology business.
9. Termination Rights: At the end of the leasing period, the lessee holds the right to buy the property and terminate the leasing contract, this providing flexibility to business.

The advantages of lease financing can be summed up as follows:

| To Lessor | To Lessee |
|---|---|
| - As lease rental is received regularly over the period of lease, the lessor is assured of regular income<br>- As the lessor transfers only the risk and rewards incidental to ownership to the lessee without the transfer of ownership of asset, he can preserve the ownership with himself<br>- As the lesser keeps the ownership of the asset he can claim depreciation on the asset and obtain tax benefit<br>- As the return based on lease rental is much higher than the interest payable on financing the asset it is highly profitable.<br>- As lease financing is one of the cost-efficient forms of financing, economic growth can be maintained even during the period of depression.<br>- As the lessor receives regular payment over a period of time, the investment can be recovered in full. | - Lessee need not have to spend a lot of money for acquiring an asset but he can use the asset by paying small monthly or yearly rentals.<br>- As lease payment can be deducted as a business expense, the lessee can get the tax benefits<br>- Leasing is a source of financing which is cheaper than almost all other sources of financing for the lessee<br>- Lessee gets some sort of technical support from the lessor in respect of leased asset.<br>- Leasing is inflation friendly, the lessee has to pay fixed amount of rentals each year even if the cost of the asset goes up.<br>- After the expiry of primary period, lessor offers the lessee to purchase the assets at a very small sum of money. |

**Disadvantages of lease financing**

1. Lease Expenses: Lease payments are treated as expenses rather than as equity payments towards an asset.
2. Limited Financial Benefits: If paying lease payments towards a land, the business cannot benefit from any appreciation in the value of the land. The long-term lease agreement also remains a burden on the business as the agreement is locked and the expenses for several years are fixed. In a case when the use of asset does not serve the requirement after some years, lease payments become a burden.
3. Reduced Return for Equity Holders: Given that lease expenses reduce the net income without any appreciation in value, it means limited returns or reduced returns for an equity shareholder. In such case, the objective of wealth maximization for shareholders is not achieved.
4. Debt: Although lease doesn't appear on the balance sheet of a company, investors still consider long-term lease as debt and adjust their valuation of a business to include leases.
5. Limited Access of Other Loans: Given that investors treat long-term leases as debt, it might become difficult for a business to tap capital markets and raise further loans or other forms of debt from the market.
6. Processing and Documentation: Overall, to enter into a lease agreement is a complex process and requires thorough documentation and proper examination of an asset being leased.
7. No Ownership: At the end of leasing period the lessee doesn't end up becoming the owner of the asset though quite a good sum of payment is being done over the years towards the asset.
8. Maintenance of the Asset: The lessee remains responsible for the maintenance and proper operation of the asset being leased.
9. Limited Tax Benefit: For a new start-up, the tax expense is likely to be minimal. In these circumstances, there is no added tax advantage that can be derived from leasing expenses.

The disadvantages of lease financing can be summed up as follows:

| To Lessor | To Lessee |
|---|---|
| - Lessor gets fixed amount of lease rental every year and they cannot increase this even if the cost of asset goes up.<br>- Sales tax may be charged twice, first at the time of purchase of asset and second at the time of leasing the asset.<br>- As ownership is not transferred, the lessee may uses the asset carelessly and there is a great chance that asset cannot be useable after the expiry of primary period of lease. | - Finance lease is non-cancellable and even if a company does not want to use the asset, lessee is required to pay the lease rentals.<br>- The lessee will not become the owner of the asset at the end of lease agreement unless he decides to purchase it.<br>- Lease financing is more costly than other sources of financing because lessee has to pay lease rental as well as expenses incidental to the ownership of the asset.<br>- As lessee is not the owner of the asset, such an asset cannot be shown in the balance sheet which leads to understatement of lessee's asset. |

**Venture Capital**

Among the various financing options entrepreneurs can turn to when starting a new company is venture capital. Venture capital is money that is given to help build new startup firms that often are considered to have both high-growth and high-risk potential. These companies generally center on health care or new technology, including things such as software, the Internet and networking. In addition a new breed of venture capital firms has recently formed to focus solely on investing in socially responsible companies. It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business. Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify. Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms. It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan. Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives. Software and other intellectual property are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.

**Features of Venture Capital investments**

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

**Methods of Venture capital financing**

- Equity
- participating debentures
- conditional loan

**The Funding Process**

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

**Step 1: Idea generation and submission of the Business Plan**

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

**Step 2: Introductory Meeting**

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

**Step 3: Due Diligence**

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

**Step 4: Term Sheets and Funding**

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

**Types of Venture Capital funding**

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- *Seed money: Low level financing for proving and fructifying a new idea*
- *Start-up: New firms needing funds for expenses related with marketingand product development*
- *First-Round: Manufacturing and early sales funding*
- *Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit*
- *Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company*
- *Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process*

**A) Early Stage Financing:**

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

**B) Expansion Financing:**

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

**C) Acquisition or Buyout Financing:**

Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

**Advantages of Venture Capital**

- They bring wealth and expertise to the company
- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

**Disadvantages of Venture Capital**

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

**Exit route**

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor