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MASTER OF COMMERCE

Paper: COM 1056
FINANCIAL MARKETS AND INSTITUTIONS

CONTENTS:

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BLOCK I : Unit-1
Concept and Functions of a Financial System

Unit Structure:

1.1 INTRODUCTION:

The Growth and development of an economy is a reflection of growth and development of its financial system. The Indian Financial System is quite old with rich and varied evolutionary experiences. The way that the financial intermediaries discharge their roles effectively will be a signal to indicate that the act of mobilization of resource and their effective employment are being done in a more efficient manner. This also serves as a symptom to show to what extent the funds are mobilized effectively and to what extent the mobilized funds are used productively. The efficacy of these functions will help reduce transaction costs and increased productivity of capital. Further this process helps to attain the ideal growth and development of the economy. That is why it is called that the more efficient and financial system, the stronger the economy. Considering these facts the present chapter aims and discussing some important aspects of a financial system.

1.2 OBJECTIVES:

This unit is an attempt to analysis the concept and functions of a financial system. After going through this unit you will be able to:

- Define the concept of financial system
- Explain the nature of financial system
- Describe functions of financial system
- Identify weakness of Indian financial system
- Depict the structure of Indian financial system

1.3 CONCEPT OF FINANCIAL SYSTEM:

A financial system is a complex, well integrated set of sub-systems of financial institution, instruments and service which facilities the transfer and allocation of funds, efficiently and effectively. Financial system is such a system which aims at establishing and providing smooth, regular, cost effective and efficient linkage between depositors and investors.

From the above discussion, it is seen that the transformation of 'savings' into investments and 'consumption' is thus facilitated by the active role played by the financial system. The process of transformation is aided by various types of various types of financial suiting the individual of financial assets is supported by the role of 'financial intermediaries' who invariably intermediate between these two segments of investors and spenders.

STOP TO CONSIDER
The offering of multifarious financial assets is supported by the rule of financial intermediaries who invariably intermediate between investors and spenders. A financial system is a set of basically four sub-systems. These are financial institutions, financial markets, financial instruments and financial services.

1.4 NATURE OF FINANCIAL SYSTEM:

Different natures of financial system are discussed under the following points:

i) **Financial system is a Sub-system:** A Financial system forms a part of the overall economic environment. The economic environment forms a part of the overall economic environment. The economic environment influences the financial system. The latter, in turn impacts the firm's the investing and financial decisions.

ii) **Elements:** The financial system consists of basically four elements viz. financial assets or instrument, financial markets, financial institutions and financial services.

iii) **Mechanism:** The financial system helps transform savings into investment and consumption. Financial system provides means and mechanism of transferring resources from those who have an excess income over expenditure to those who can make productive use of the same.

iv) **Formal and informal financial sector:** The co-existence of both formal and informal financial sector is another important nature of a financial system. This co-existence of two sectors is known as 'financial dualism'. Formal financial sector is well organized and regulated, where as the informal financial sector is unorganized, non-institutional and non-regulated.

v) **Accelerating savings:** Besides mobilizing savings the financial system helps accelerate the volume and rate of savings by providing diversified range of financial instruments and services through intermediaries.

STOP TO CONSIDER

The different elements or components of the financial system are closely interrelated and do change continuously. Over the years, it has now become globalized, liberalized and closely integrated. The financial system helps transform savings into investment and consumption. These elements of financial system (Financial Institution, Financial markets, financial instrument and financial services) do not function in isolation. Their interaction leads to the development of a smoothly functioning financial system. Financial institutions mobilize savings by issuing different financial instrument which are traded in the financial markets. Financial intermediaries have close links with the financial markets. Financial markets have also an impact on the functioning of financial intermediaries such as banks and financial institutions.

Check Your Progress 1.1

Q: 1 Name four elements of a financial system?
Q: 2 Write five nature of financial system?

1.5 FUNCTIONS OF FINANCIAL SYSTEM:

The financial system tries to improve the allocation efficiency in the economy and in the process helps cost of resources as interest rates are the very strong indicators of the strength of an economy as well as the financial system. The functions of financial system are discussed under the following points-

i) **Acts as intermediary:** One of the basic functions of financial system is to act as an intermediary in between savers and investors through mobilizing saving by supplying diversifying portfolio of financial instruments and by providing incentives. By this function financial system is to link the savers and investors.

ii) **Channelize funds:** Another important function performed by financial system is the channelizing flow of accumulated funds in to profitable investment. This way financial system forms the necessary capital.

iii) **Payment system:** Financial system provides a payment system for the exchange of goods and service. By performing payment system financial system helps in efficient functioning of settlement of transaction. Payment and settlement system play important role ensure that funds move safely, quickly and in timely manner.

iv) **Transfer of financial resources:** Financial system provides a mechanism for special and temporal transfer of resources. It facilitates transfer of financial resources across time and geographical boundaries.

v) **Controlling risk and uncertainty:** Financial system provides a way of managing and controlling uncertainty and risk. These are basically three means of controlling risk and uncertainly. These are-
   - Diversification of risk
   - Insurance
   - Hedging

vi) **Generate information:** Generates price relate information is another important function performed by financial system. This information is used by different financial decision makers. Financial markets disseminate information for enabling participants to develop and informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

vii) **Financial structure:** Financial system helps in creation of a financial structure which facilitates lower transaction costs and higher returns. This has a beneficial influence on the rate of return to savers.

viii) **Monitor Corporate Performance:** financial system helps in selecting projects to be funded. Thereby it inspires the operators to monitor the performance of the investment.

ix) **Portfolio adjustment:** Another important function performed by financial system is that it offers portfolio adjustment facilities. Both the financial markets and financial institution provide these facilities, such as banks and mutual funds.

x) **Financial deepening and broadening:** financial system promotes the process of financial deepening and broadening. Financial deepening implies an increase of financial assets as a percentage of the Gross Domestic Product (GDP).

STOP TO CONSIDER

The growth and development of any economy depends squarely on the savings, investment as well as the capital formation of the particular system. Hence, comes the role of the financial system. The financial system apart from acting as an effective national payment system helps the flow of funds from the surplys sectors if the economy viz. THE SAVERS to the deficit and needy sectors of the economy viz. THE INVESTORS. Thus, the financial system plays a significant role in efficient and speedy allocation resources. In the proves accelerating economic growth the role of the financial system can be enhanced to the extent to which the system can widen its reach to a large population, the extent to which it can minimize the transaction costs and finally the extent to which it can speedily respond effectively.

Check Your Progress 1.2

Q: 1 Fill up the blanks

i) A Financial system acts as an intermediary in between _______ and investors.

ii) By the way of channelizing funds, financial system forms the necessary _______.

Q: 2 Name three means of controlling risk provided by the financial system?

Q: 3 Mention any five functions of financial system.

1.6 WEAKNESS OF INDIAN FINANCIAL SYSTEM:

Many weaknesses of Indian Financial System induce a high level of no-performing assets in solve banks and financial institutions, disciplinary issues with regard to non-banking financial companies, government's high domestic debit and borrowings, volatility in financial markets, absence of a yield curve and co-operative bank scams. Below some more weaknesses of Indian financial system are addressed-

i) The Indian financial system has failed to meet the financial needs to small scale industries. It has rather pardoned the big industries houses who are already well-off.

ii) The mushrooming of financial institutions has deteriorated the quality and effectiveness of the sector to some extent.

iii) The Indian financial system fails to create a well-defined and organized capital market.

iv) It fails to motivate economically marginal or small entrepreneurs by providing micro credit to them.

v) The Indian financial system is not flexible at the designed level. It takes abnormal time to cope with the changing situation.

vi) The reforms in the financial system have been more capital market centric in nature.

vii) Foreign capital flows and foreign exchange reserves have increased but the actual absorption of foreign capital is quite low.

viii) The fiscal deficit has expanded, leading to a deteriorating fiscal scene.

ix) The spreading of the sub-prime mortgage crisis, high inflation and depreciating rupee has put a pressure on the GDP growth rate.

x) Lack of adequate competition amongst various banks and financial institutions is another weakness of Indian financial system.

STOP TO CONSIDER

Two prominent polar designs can be identified among the variety that exists. At one extreme is the bank-dominated system, such as in Germany, where a few large banks play a dominant role and the stock market is not important. At the other extreme is the market dominated financial system as in the US where financial markets play an important role while the banking is much less concentrated. The other major industrial countries fall in between these two extremes.

1.7 STRUCTURE OF INDIAN FINANCIAL SYSTEM:

The structure is a framework or pattern or design, which is made by its different components as parts. Hence, the structure of India financial system can be described with its various components as shown in the following chart.

A. Formal Organized sector: Organized sector of Indian financial system is under controlled of the different regulatory bodies, such as the Reserve Bank of India, the Government of India, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA) etc. Under these regulatory bodies, following components of Indian financial system perform their respective activities.

i) Financial Institution: Financial Institutions or intermediaries are firms that provide products and service in the financial markets for the benefits of customers, individuals and firms. They help in pooling resource form individuals and firms and promote making best use of these financial resources. Three important roles played by financial intermediaries' are-Bringing suppliers and demanders of funds together, Transformation of funds and Reduction of Risk.

ii) Financial Instruments and Assets: Generally an asset represents possession of something that has exchange value. The common characteristic possessed by all assets is their potentially to provide services or economic benefit (cash flows). Assets may be classified into tangible and intangible. Tangible assets have physical existence and include land, building plant and property, furniture and fixture, cash and bank. On the other hand Goodwill, patents, copyrights, trademarks franchises are examples of tangible assets. Financial assets or instruments are intangible assets that represent future cash flows; they are traded in the financial market and include the following-

- Cash and bank balance (coins, notes, bank deposits)
- Securities which include
    - -Debt (Short term debts such as bank loans and trade credit and long term debts such as loan and debenture) and
    - -Equity

iii) Financial Market: In a market place, there are buyers and sellers to trade in goods and services. In the financial market, the parties are borrowers and suppliers individuals, companies, banks, financial institutions, mutual funds and the governments. These players create financial products or assets which are traded in financial markets. For example- a company can borrow from a financial institution the supplier and they borrow directly as through financial intermediaries, viz. a financial institution or mutual funds. Financial markets play an important role in the economy as they bring together parties (both individual and firms) who have surplus funds available for investment and those who have a shortage of funds for borrowing. There are two main arms of the financial markets the money market and the capital market. The money market deals with shore- term debt instrument whose maturity does not generally exceed one year. Commercial banks financial institutions and the Indian Postal Department dealing with product having maturity not exceeding one year are examples of the key players in the money market.

iv) Financial Services: Any activity that facilitates individual economic agents to exchange resources to be available at different points of time and firms to acquire investible resources, can be defined a financial service. Financial service is an essential segment of financial system. Financial system facilitates the transformation of savings of individuals' government as well as business into investment and consumption. It consists of financial intermediaries, financial markets and financial assets. In the changing economic scenario with increase in financial deregulation and industrial liberalization, the role of the financial sector is increasing manifold. The financial service sector has thus emerged as the fastest growing sunrise industry. These institutions like merchant banks, leasing companies, venture capital companies, factoring companies and mutual funds etc. have expanded the range of financial services available.

Merchant banks are financial intermediaries. They act as intermediaries in the process of transfer of capital from those who own it to those who use it. Recently the tendency of the commercial banks and other financial institutions to act as leasing intermediaries and to dominate the lesser market is increasing dramatically. Apart from the private leasing companies, the banks and financial institutions also started participating in the leasing business. With a view to encouraging healthy growth of lease financing activity in India, RBI has issued policy guidelines in respect of the role of commercial banks in this regard. Mutual funds originated in the U.K during the last century essentially as a means of mobilizing house hold savings for housing finance. Now these are important elements in the development of capital market world over. Mutual Fund is an idea alternative for a small saver who is handicapped with inadequate resources for diversified portfolio, lack of time, expertise and market knowledge.

Factoring is a business activity where in the Factor (a bank) purchases the receivables of the seller of goods (clients) and reimbursement is obtained later on from the buyer of goods. This service is intended to provide much critical input of credit to both buyers and sellers of small scale and medium industries.

Under credit card system credit is accommodated to the card holder for a specific period of time without obtaining any security. The credit card service has been introduced as an integral part of better customer services and the bank is also able to make increased earnings by way of commission from dealers and interest on credit offered.

Establishment of credit rating agencies forms an important step in the process of financial reforms. CRISIL was promoted in 1987 by the industrial credit and investment corporation of India (ICICI) and Unit Trust of India (UTI). The ICRA was promoted in 1991 by the industrial finance Corporation of India (IFCI); Life Insurance Corporation of India (LIC), SBI and 17 other banks.

The introduction of Commercial paper (CP) from January 1, 1990 has been one of the important policy initiatives of the RBI and it intends to bring the high credit worthy corporate borrowers and the investors into direct contact through the scheme of Commercial Paper (CP). Commercial Papers are issued by the public utilities, insurance companies, bank holding companies and finance companies etc. purchases of CPs are banks and financial institutions.

Commercial banks have entered into housing finance to facilitate middle and low income groups, purchase as construct houses or flats. Setting up of NHB in 1988, an apex body for housing finance has given a boost to banks. Banks like SBI, Canara Bank, PNB have already set up separate subsidiaries for housing finance.

Venture capital is the response of to capitalize on an opportunity to earn very high return as compared to conventional securitizing backed lending by enabling high risk but high promote projects to realize, their full potential. The growth of venture capital is typically the response to demand created for more risk bearing funds to finance commercialization of new technologies and innovative market solutions.

B. Informal or Unorganized Sector: Informal or unorganized financial system covers moneylenders, local bankers, traders, landlord, pawa, broke etc. these are not under the regulation of Reserve Bank of India and Securities and Exchange Board of India. Money lenders entirely depend on their own funds for the working capital, merchants, traders, artisans; goldsmiths, village shopkeepers, sardars of labourers etc. are examples of money lenders, Money lenders may be classified as rural money lenders, urban money lenders, and professional money lenders. Generally financially weaker sections of the society are the clients of money lenders. The loans granted by money lenders are highly exploitative as because they charge very high rates of interest. The operations of money lenders are wholly unregulated. From ancient times indigenous banking system has been in existence in India. The Indigenous banks lend money act as money changers and finance internal trade by means of internal bill of exchange. Generally these banks are family concerns. By own capital these banks grant loans against securities such as Gold, Jewellery, land, promissory notes etc. These banks also buy and sell remittances and discount hundies.

STOP TO CONSIDER

Improving the efficiency of the financial system is one of the basic objectives of regulations. An efficient financial system is one which allocates savings to the most productive uses. Besides allocating financial resources, it also ensure the following-

- Information arbitrage efficiency i.e when market prices reflect all the available information.
- Fundamental valuation efficiency i..e whether company valuation are reflected in stock prices.
- Full Insurance efficiency i.e. whether economic agents can insure against all future contingencies.

Check Your Progress 1.3

Q: 1 Name four regulatory bodies which control organized sector of India financial system.
Q: 2 Name seven different categories of financial institutions.
Q: 3 Name two arms of financial market.
Q: 4 Name two types of Capital market.
Q: 5 Name nine financial innovations in India.

1.8 RELATION BETWEEN FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT:

Surplus spending economic units are units whose consumption and planned investment are less than their income. Surplus spending of economic units having surplus savings as they do hold these savings in the form of cash balance or acquire financial assets.

Deficit spending economic units are units whose consumption and planned investment exceeds income. The deficit spending economic units have negative savings they finance their needs by borrowing or by decreasing their stocks by financial assets.

The surplus savings of the surplus spending household units has to be transferred to the deficit spending economic units.

Financial intermediaries issue secondary securities, like deposits, insurance, policies units end on the ultimate lenders. The ultimate barrowers may acquire funds either by issuing primary securities to financial intermediaries on by issuing primary securities in the financial markets. This transfer of funds from the surplus spending sector to the deficit spending sector through the financial system leads to capital formation and economic growth. Economic growth, in simple terms, is the increase in the real national product or output overtime. Besides linking savings and investment, the financial system helps in accelerating the rate of savings and investment by offering diversified financial services and instruments.

STOP TO CONSIDER

Research on Relation between Financial System and Economic Development

Gurley and Shaw (1995, 1961) and *Goldsmith* (1969) which indicate the self financed capital investment, as economic develop, first gives way to bank-intermediated debt finance and later to the emergence of equity markets as an additional instrument for raising external finance. *Kumar and Tsetseko* (1992) argued that substitutability and complementarily between banks and securities market appear to be sensitive to the level of economic growth. According to *Hicks* (1969) new technological inventions did not set off the industrial revolution in England in the eighteenth century. Rather, move liquid financial moments made it possible to develop projects that required large capital injections for long periods before the projects ultimately yielded results.

Self-Asking Questions

Q:1 What do you suggest to remove the prevailing weaknesses of Indian financial syste?

Q:2 Do you think that there is a close relationship in between financial system and economic growth? Give reason in support of your answer.

1.9 SUMMING UP:

1. A financial system is a complex, well integrated set of sub-system of financial institutions, markets, instruments and serving which facilitates the transfer and allocation of funds efficiently and effectively.
2. Nature of financial system-

a. Financial system forms part of the overall economic environment.
b. Financial system consist financial instrument, financial markets financial institutions and financial services.
c. Elements of financial system are closely interrelated and do change continuously.
d. Financial system facilitates growth and economic development through savings and investment.
e. Co-existence and co-operation between formal and informal financial sector is an important feature of financial system of most developing country.

3. Functions of financial system:
    i. Helps the flow of funds form surplus sector to the deficit sector
    ii. Act as an intermediary
    iii. Channelize funds
    iv. Payment system
    v. Transfer of financial resources
    vi. Controlling risks and uncertainly
    vii. Generate information
    viii. Financial structure
    ix. Monitor corporate performance
    x. Portfolio adjustment
    xi. Financial deepening and borrowing
4. Weakness of Indian Financial System
    i. High level of NPA in banks and financial institutions
    ii. Disciplinary issues with NBFC
    iii. Govt. high domestic debt and borrowing
    iv. Volatilizing in financial market
    v. Absence of yield curve
    vi. Fail to meet the need of SSI
    vii. Low quality of FI
    viii. Unorganized capital market
    ix. Fail to motive small entrepreneur
    x. Not flexible
    xi. Reform is capital centric only
    xii. Crisis in FI
    xiii. Low Foreign Capital
    xiv. Increase fiscal deficit
    xv. Pressure on GDP growth rate
    xvi. Low rate of competition amongst banks and FI
5. Structure of Indian Financial System: Structure of Indian financial system is made with both formal and informal sector. Formal sector is controlled by RBI, Govt. of India, SEBI and IRDA. Informal sector covers money lenders, local bankers, prodders, land lord, pawn broker etc.
6. Relationship between financial system and economic development: It can be described under the following points- mobilization of savings, capital formation, functional efficiency of medium of exchange, financial markets, by providing financial services, link with international finance system and transfer of surplus savings.

1.10 References and Suggested reading:

1. Pathak, Bharati (2018). *"Indian Financial System (5e)"*; Pearson Education New Delhi

1.11 Model Questions:

i. What is Financial System?
ii. Explain the various nature of financial system?
iii. What are the components/elements of Financial System?
iv. Describe the various functions of Financial System?
v. Discuss the various weakness of Financial System?
vi. Describe the structure of Indian Financial system?
vii. Describe the relation between economic development and financial system?

1.12 Answer to Check Your Progress

1.1 Answers:

1. The four elements of financial system are: Financial Institution, Financial markets, financial instrument and financial services

2. Five nature of Financial system are:
   a) Financial system is a Sub-system
   b) Elements of financial system
   c) Formal and informal financial sector
   d) Accelerating savings
   e) Means and mechanism of transferring resource

1.2 Answers: 1. i) Savers, ii) Capital
2. Diversification of risk, Insurance and Hedging
3. Five functions of financial system are-
   i) Acts as intermediary
   ii) Channelize funds
   iii) Payment system
   iv) Transfer of financial resources
   v) Controlling risk and uncertainty

1.3 Answers:

1. The four regulatory bodies which control organized sector of India financial system are: Reserve Bank India, Govt. of India, Securities Exchange Board India And Insurance Regulatory Development Authority
2. i) Commercial Banks, ii) Development Banks, iii) Agricultural finance institution, iv)Housing finance institution, v) Mutual Funds and Trust, vi) Insurance companies, vii) Non banking financial institutions
3. Money market and Capital market
4. Primary and Secondary market
5. i) Merchant banking, ii) Leasing, iii) Mutual funds, iv) Factoring, v) Credit cards, vi) Credit Rating, vii) Commercial Paper, viii) Housing finance, ix) Venture capital

BLOCK I : Unit-2

Component of Financial System- Financial Markets, Financial Instruments, Financial Institutions and Financial Services

Unit Structure:

2.1 Introduction:

The financial system of our country works through the financial markets and the financial institutions. The financial markets deal with the financial assets of different types, currency deposits, cheques, bills, bonds, etc. Financial markets permit the transfer of funds (purchasing power) from one agent to another for either investment or consumption purposes. Financial markets provide vehicles by which prices are set both for newly issued financial assets and for the existing stock of financial assets. In attempting to characterize the way financial markets operate, one must consider both the various types of financial institutions that participate in such markets and the various ways in which these markets are structured. In India the Money market is regulated by RBI. Hence, the instruments traded and the players in the market require to be approved by RBI.

2.2 Objectives:

This unit is an attempt to analyse the ideas of Financial Market. After going through this unit you will be able to-

• explain the types and functions of Financial Markets.

• discuss about the nature and scope of Money Market.

• explain the structure of Money Market and its relation with Reserve Bank of India.

• discuss the types of money market instruments.

2.3 Financial Market – its Types and Functions

Financial markets are credit markets which cater to the credit needs of individuals, firms and institutions. Since credit is required and supplied for short period and long period, the financial markets are broadly divided into two types:

(a) Money Market;

(b) Capital Market.

(a) Money Market: Money market deals with the short period borrowing and lending of funds. In the money market, the short term securities are exchanged. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months and against different types of instruments, such as bill of exchange, bankers' acceptances, bonds etc. called 'near money'.

(b) Capital Market: Capital market deals with the long period borrowing of funds. In the capital market, long term securities are exchanged. Capital market can again be categorised into: (a) primary market and (b) secondary market. Primary market is a market in which newly issued credit instruments are sold and purchased. Secondary market, on the other hand, is a market in which previously issued credit instruments are bought and sold.

2.4 Functions of Financial Market:

The important functions of the financial markets can be summed up in the following way:

(1) They create and allocate credit.

(2) They serve as intermediaries in the process of mobilisation of saving.

(3) They provide convenience of benefits to lenders as well as borrowers.

(4) They enable economic units to exercise their time preference.

(5) They help in the separation, distribution, diversification and reduction of risk.

(6) They provide transformation of financial claims so as to suit the preference of both savers and borrowers.

(7) They provide efficient payment mechanism.

(8) They increase liquidity of financial claims through securities trading.

(9) They provide better portfolio management.

(10) They promote economic development through a balanced regional and sectoral allocation of investable funds.

Stop to Consider

Financial markets are credit markets which cater to the credit needs of individuals, firms and institutions. Financial markets can broadly be categorised into two: i.e. money market and capital market. Money market deals with the short term period borrowing and lending of funds and Capital market deals with the long term period borrowing of funds. Financial market serves as intermediaries in the process of mobilisation of savings.

Check your Progress

Q.No 1. What is Financial Market?
Q.No.2. What are the main functions of Financial Market?
Q.No 3. Mention two types of Financial Market.
Q. No 4. What is Money Market?
Q.No 5. What is Capital Market?

Self Asking Questions

Q.No 1. Explain briefly the differences between the Money Market and Capital Market.
QNo 2. Explain about the near money.

2.5 Money Market: Nature and Scope

The term money market is used in a composite sense to mean financial institution which deal with short-term funds in the economy. It refers to the institutional arrangements facilitating borrowing and lending of short-term funds. The money market brings together the lenders who have surplus short-term investible funds and the borrowers who are in need of short-term funds. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months and against different types of instruments, such as bill of exchange, banker's acceptances, bonds etc. called 'near money'. Thus, money market has been defined by Crowther as 'the collective name given to the various firms and institutions that deal in the various grades of near money'.

The Reserve Bank in India describes the money market as, 'the centre for dealings, mainly of a short term character, in monetary assets; it meets the short-term requirements of borrowers and provides liquidity or cash to the lenders'. The borrowers in the money market are generally merchants, traders, manufacturers, business concerns, brokers and even government institutions. The lenders in the money market, on the other hand, include the Central Bank of the country, the commercial banks, insurance companies and financial concerns.

The organization of the money market is formed. There is no definite place or location where money is borrowed and lent by the parties concerned. It is not necessary for the borrowers and the lenders to have a personal contact with each other. Negotiations between the parties may be carried through telephone, telegraph or mail. Thus, money market is simply an arrangement that brings about a direct or indirect contact between the lender and borrower. The term money market should be distinguished from the capital market. Money market in essence, is a short-term credit market that deals only in short-term finances, the capital market, on the other hand, is the market for long-term funds. However, the two markets are closely related as the same institution may many times deal in both types of funds.

2.6 Features of Money Market:

Following are the features of money market:

1. Money market has no geographical constraints as that of a stock exchange. The financial institutions dealing in monetary assets may be spread over a wide geographical area.

2. Even though there are various centers of money market such as Mumbai, Calcutta, Chennai, etc., they are not separate independent markets but are inter-linked and interrelated.

3. It relates to all dealings in money or monetary assets.

4. It is a market purely for short-term funds.

5. It is not a single homogeneous market. There are various sub-markets such as Call money market, Bill market, etc.

6. Money market establishes a link between RBI and banks and provides information of monetary policy and management.

7. Transactions can be conducted without the help of brokers.

8. Variety of instruments are traded in money market.

2.7 Objectives of Money Market:

Following are the objectives of money market:

1. To cater to the requirements of borrowers for short term funds, and provide liquidity to the lenders of these funds.

2. To provide parking place for temporary employment of surplus fund.

3. To provide facility to overcome short term deficits.

4. To enable the central bank to influence and regulate liquidity in the economy.

5. To help the government to implement its monetary policy through open market operation.

2.8 Money Market Institutions:

The commercial banks, non-bank financial institutions, bill brokers, acceptance houses and the central bank of the country are the major institutions of the money market.

(a) **Commercial Banks:** The commercial banks are the most constituents of the money market. They form one of the major constituents of the money market. They use their short term deposits for financing trade and commerce for short periods. The commercial banks invest their funds in the discounting of bills of exchange, i.e. both exchange bills or commercial bills and treasury bills or government bills to facilitate trade and commerce by mobilising the flow of money. The commercial banks lend against promissory notes and through advances and overdrafts. The call money loans are also provided by these banks to the bill brokers and dealers in the stock exchange market. The commercial banks put their excess reserves in different forms or channels of investments which satisfy their conflicting principles of liquidity and profitability. Commercial banks always try to maintain a balance between liquidity and profitability.

(b) **Central Bank:** The Central Bank is the top-most financial institution in the money market. It is regarded as the lender of the last resort, banker to the government, banker's bank and controller of the money market. As a lender of the last resort, the central bank gives temporary financial assistance to commercial banks by rediscounting their eligible bills. The central bank controls the money market with two main instruments, namely, the bank rate and the open market operations.

(c) **Non-Bank Financial Institutions:** In addition to commercial banks, there are non-banking financial intermediaries who resort to lending and borrowings of short term funds in the money market. In non- banking financial intermediaries we include savings banks, investment houses, insurance companies, building societies, provident funds and other business corporations like chit funds.

(d) **Acceptance Houses:** Acceptance house and bill brokers are the important constituents of the money market in developed countries. The institution of acceptance houses developed in England where merchant bankers transferred their headquarters to London Money Market in the late 19th and the early 20th century. They function as intermediaries between importers and exporters, and between lenders and borrowers in the short period. In the London Money Market the acceptance houses performed a very useful role as merchant bankers. These houses specialised in the acceptance of trade bills/commercial bills. They accepted those bills which were drawn on merchants whose financial standing was not known in order to make the bills negotiable in the London Money Market. In this way, they handled the international transactions without any problem a noteworthy point is that by accepting a trade bill, they guaranteed the payment of the bill on maturity. For this guarantee, these houses charged a commission.

The discounting of such accepted bills was done by another specialised agency known as **'discount houses'**. This institution was an important segment of the London Money Market in the past but now its importance has declined because the commercial banks have undertaken the business of acceptance houses.

(e) Bill Brokers: In the developed money market like the London Money Market and the New York Money Market, private companies act as discount houses. The main function of these companies is to discount bills on behalf of others. Besides these companies, there are bill-brokers who work as intermediaries between the borrowers and lenders by discounting bills of exchange at a small commission. In an under-developed money market, bill brokers are quite important intermediaries.

Stop to Consider

Money market is a market for short-term funds. We define the short-term as a period of 364 days or less. In other words, the borrowing and repayment take place in 364 days or less. Money Market refers to the institutional arrangements facilitating borrowing and lending of short-term funds. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months and against different types of instruments, such as bill of exchange, banker's acceptances, bonds etc. called 'near money'. The commercial banks, non-bank financial institutions, bill brokers, acceptance houses and the central bank of the country are the major institutions of the money market.

Check your Progress

Q.No 1. Define Money Market.
Q.No 2 What are the features of money market?
QNo 3 Mention the objectives of money market.
Q.No 4.Discuss the major institutions of Money Market.

Self Asking Questions

Q.No.1. Explain the role of commercial banks to maintain the balance between liquidity and profitability.

2.9 Structure of Money Market

In India the money market plays a vital role in the progress of economy. But, it is not well developed when compared to American and London money markets. In this market short-term funds are borrowed and lent among participants permitted by RBI.

Structure of Indian Money Market:

Broadly speaking, the Money Market in India comprises two sectors- (a) Organised Sector, and (b) Unorganised Sector.

a) Organised Sector: The organised sector consists of the Reserve Bank of India, the State Bank of India with its seven associates, nationalised commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and Regional Rural Banks. It is called organised because its part is systematically coordinated by the RBI.

Non-bank financial institutions such as the LIC, the GIC and subsidiaries, the UTI also operate in this market, but only indirectly through banks, and not directly.

Quasi-government bodies and large companies also make their short-term surplus funds available to the organised market through banks.

Cooperative credit institutions occupy the intermediary position between organised and unorganised parts of the Indian money market. These institutions have a three-tier structure. At the top, there are state cooperative banks. At the local level, there are primary credit societies and urban cooperative banks. Considering the size, methods of operations, and dealings with the RBI and commercial banks, only state and central, cooperative banks should be included in the organised sector. The cooperative societies at the local level are loosely linked with it.

b) Unorganised Sector: The unorganised sector consists of indigenous banks and money lenders. It is unorganised because activities of its parts are not systematically coordinated by the RBI.

The money lenders operate throughout the country, but without any link among themselves. Indigenous banks are somewhat better organised because they enjoy rediscount facilities from the commercial banks which, in turn, have link with the RBI.

2.10 Importance of Money Market:

The money market is a market for short term transactions. Hence it is responsible for the liquidity in the market. Following are the reasons why the money market is essential:

a) It maintains a balance between the supply of and demand for the monetary transactions done in the market within a period of 6 months to one year.
b) It aids in the implementation of monetary policies.

c) It helps develop trade and industry in the country. Through various money market instruments, it finances working capital requirements. It helps develop the trade in and out of the country.
d) The short term interest rates influence long term interest rates. The money market mobilises the resources to the capital markets by way of interest rate control.
e) The current money market conditions are the result of previous monetary policies. Hence it acts as a guide for devising new policies regarding short term money supply.
f) It helps in the functioning of the banks. It sets the cash reserve ratio and statutory liquidity ratio for the banks. It also engages their surplus funds towards short term assets to maintain money supply in the market.

2.11 Money Market and Reserve Bank of India

The Reserve Bank of Indian has taken various measures to improve the existing defects and to develop a sound money market in the country. Important among them are:

(i) Through the introduction of two schemes, one in 1952 and the other in 1970, the Reserve Bank has been making efforts to develop a sound bill market and to encourage the use of bills in the banking system. The variety of bills eligible for use has also been enlarged.

(ii) A number of measures have been taken to improve the functioning of the indigenous banks. These measures include- (a) their registration; (b) keeping and auditing of accounts; (e) providing financial accommodation through banks; etc.

(iii) The reserve bank is fully effective in the organised sector of the money market and has evolved procedures and conventions to integrate and coordinate the different components of money market. Due to the efforts of the Reserve Bank, there is now much more coordination in the organised sector than that in the unorganised sector or that between organised and unorganised sectors.

(iv) The difference between various sections of the money market has been considerably reduced. With the enactment of the Banking Regulation Act, 1949, all banks in the country have been given equal treatment by the Reserve Bank as regards licensing, opening of branches, share capital, the type of loans to be given, etc.

(v) In order to develop a sound money market, the Reserve Bank of Indian has taken measures to amalgamate and merge banks into a few strong banks and given encouragement to the expansion of banking facilities in the country.

(vi) The Reserve Bank of India has been able to reduce considerably the differences in the interest rates between different sections as well as different centres of the money market. Now the interest rate structure of the country is much more sensitive to changes in the bank rate. Thus, the Reserve Bank of India has succeeded to a great extent in improving the Indian money market and removing some of its serious defects. But, there are certain difficulties faced by the Reserve Bank in controlling the money market: (i) The absence of bill market restricts the Reserve Bank's ability to withdraw surplus funds from the money market by disposing of bills. (ii) The existence of indigenous bankers is the major hurdle in the way of integrating the money market. (iii) Inadequate development of call money market is another difficulty in controlling the money market. The banks do not maintain fixed ratios between their cash reserves and deposits and the Reserve Bank has to undertake large open market operations to influence the policy of the banks.

2.12 Types of Money Market Instruments:

Money market ensures that institutions which have surplus funds earn certain returns on the surplus. Otherwise these funds will be idle with the institutions. Similarly, the money market ensures funds for the needy at reasonable interest. This way liquidity position is assured by money market operations. In India the Money market is regulated by RBI. Hence, the instruments traded and the players in the market require to be approved by RBI. The instruments currently traded are as follows:

Instruments Traded in Indian Money Market

- Call Money and Notice Money
- Commercial Bills
- Treasury Bills
- Commercial Papers
- Certificate of Deposits
- Inter-Bank Participation Certificates
- 'Repo' Instruments
- Inter Corporate Deposits

Let us now discuss the various money market instruments in India.

(i) **Call Money:** Call money is a method of borrowing and lending for one day. This is also called overnight money. The rate of interest used to be decided by RBI earlier. After 1989, the interest rate was deregulated and now the liquidity position (availability of funds) determines the rate of interest. The lender issues a cheque or pay order on its account maintained with RBI in favour of borrower. Accordingly RBI transfers funds by debit to lender's account to the borrower's account. On repayment, the process is reversed through RBI. In times of tight money, situation or liquidity crunch, the call money interest rate goes up even beyond 50 per cent per annum. Only permitted organisations like scheduled commercial banks, large co-operative banks, DFHI, Primary dealers, NABARD are permitted to borrow funds through call money market. However, funds can be provided or lent even by other entities like LIC, GIC, large corporates, big mutual funds, etc.

(ii) **Notice Money/Short-term Money:** Under Notice/Short-term Money Market, funds are borrowed and lent for a maximum period of 14 days. Repayment requires a formal notice or demand from the lender. Interest rate is decided by the market forces. The market is similar to call money market explained above.

(iii) **Treasury Bills:** It is the most important money market instrument for the central government. Treasury bills are short-term promissory notes issued by RBI on behalf of Central Government for raising funds to meet shortfalls in revenue collections, i.e., to meet revenue expenditure. These are issued at discount to face value, RBI auctions, these Treasury Bills at regular periodical intervals, i.e., weekly and fortnightly. These days five types of Treasury Bills depending upon their maturity are auctioned by RBI. These are 14 day Treasury Bills, 28 day Treasury Bills, 91 day, 182 day and 364 day Treasury Bills. Any person can invest in Treasury Bills. These are very high liquid and safe instruments. Treasury Bills are approved securities for investment by banks under SLR requirement.

(iv) **Commercial Bills:** Banks are discounting Commercial Bills drawn by business entities/organisations. Banks can get such discounted bills rediscounted in Money Market. It is not necessary for banks to rediscount each and every discounted bill. Banks can certify the large number of bills intended to be rediscounted through a single document known as 'Derivative Usance Promissory Note' (DUPN). In other words, 'DUPN' is a money market instrument backed by genuine commercial bills. Banks can get the value of DUPN discounted and obtain funds. This way banks can borrow funds without transferring the bills. It is necessary that the original bills in the portfolio of banks should not be drawn for period exceeding 120 days. The maturity of DUPN, however, should not exceed 90 days.

(v) **Commercial Paper:** Commercial Paper (CP) is a short-term money market instrument issued by eligible corporates for funds to meet working capital needs, It was introduced in 1989. The CP is in nature of negotiable usance promissory notes issued at a discount to face value. The CP should have fixed maturity period of not less than 30 days and not more than one year. Commercial Paper (CP) can be issued by a listed company which has a net worth of at least Rs. 10 crores and a working capital limit of not less than Rs. 25 crore. CPs will be issued in multiples of Rs. 25 lakhs subject to the minimum size of an issue being Rs. 1 crore. Their maturity ranges from three months to six months. They will be freely transferable by endorsement and delivery. The company issuing CP will have to obtain every six months a specified rating from an agency approved by the Reserve Bank. The company can raise money through CP upto a maximum amount equivalent to 20% of its working capital limits. Banks will not be permitted to either underwrite or co- accept the issue of CP.

(vi) **Certificate of Deposits:** It is another form of short-term time deposit. The receipt issued for such a deposit is called Certificate of Deposit. The Certificates of Deposit (CD) can be issued only by the scheduled commercial banks in multiple of Rs. 25 lakhs subject to the minimum size of an issue being Rs. 1 crore. Their maturity will vary between three months and one year. CDs will be issued at discount to face value and the discount rate will be freely determined. They will be further freely transferable by endorsement and delivery. CDs will, however, be subject to reserve requirements. Banks will neither be allowed to grant loans against CDs, nor can they buy their own CDs.

(vii) **Inter-Bank Participation Certificates:** Inter-Bank Participation Certificates or simply Participation Certificates (P.C.) are short term papers issued by scheduled commercial banks to raise funds from other banks against big loan portfolios. When banks are short of liquidity to carry on their immediate operations and need short-term funds, they may approach other banks to share/participate in their lending portfolios. In other words, part of the specified loans and advances of the borrowing bank will be passed on to the lender-bank against cash. This will have the effect of reducing the exposure of borrower bank on its particular loan portfolio and increase in the portfolio of lender-bank when the participation is without recourse basis. Borrower-banks can have access to the facility only, up to certain percentage (currently 40%) of their standard or performing assets, i.e., Loans and Advances which are being serviced without default. P.Cs. can be issued only for a maximum period of 180 days and not less than a 90 days period.

(viii) **Inter-Corporate Deposits**: Inter-Corporate Deposits or ICD is another money market instrument for corporates to park their temporary surplus funds with other corporates. What a participation certificate for banks is an inter-corporate deposits between corporates. Under ICD, corporates lend temporary funds generally to their own group companies, otherwise the credit risk will be higher. Any corporate can issue the instrument without there being any prescription about minimum size of such lending and borrowings. This market is not well-regulated for want of adequate information.

(ix) **'Repo' Instruments:** RBI conducts 'Repo' transactions to influence short-term interest level in money market. By Repo operation the RBI transmit interest rate signals to the market. When it announces a fixed rate Repo for certain number of days/period it conveys its intention to the market about the desirable level of a short-term interest rate. Due to greater level of integration among money market, foreign exchange market and Treasury Bill Market, the Repo transactions ensure stability of short-term rates in all the three markets. At the same time Repo transactions of RBI provide an opportunity to banks to part their surplus funds with a minimum rate of return. You may understand that when RBI conducts 'repos', the short-term interest rate in the money market may not go below the RBI repo rate as, if rate of interest is lower in other markets, holders of funds may go for 'Repos' with RBI. The RBI also provides liquidity support, i.e. infusion of funds into the market by conducting Reverse Repo transactions with Primary Dealers against Government Securities

Stop to Consider

Money market ensures funds for the needy at reasonable interest. This way liquidity position is assured by money market operations. In India, the Money market is regulated by RBI. Hence, the instruments traded and the players in the market require to be approved by RBI. The Money Market in India comprises two sectors- (a) Organised Sector, and (b) Unorganised Sector.

In order to develop a sound money market, the Reserve Bank of Indian has taken measures to amalgamate and merge banks into a few strong banks and given encouragement to the expansion of banking facilities in the country

Check your Progress

Q.No 1 What is Repo instrument?
Q.No 2 What is treasury bills?
Q.No.3 What is commercial paper?
Q.No.4 What is certificate of deposits?
Q No.5. What is notice money or short term money?
Q.No.6 What is inter - bank participation certificate?

Self Asking Questions

Q.No.1.Discuss the organizational structure of money market.
Q.No.2.Explain the relation between the money market and Reserve Bank of India.

1.13 Summing Up

Money market is a market for short-term funds. We define the short-term as a period of 364 days or less. In other words, the borrowing and repayment take place in 364 days or less. The market where such short-time finance is borrowed and lent is called 'money market'. The most important function of the money market is to bridge this liquidity gap. In simple words, the money market is an avenue for borrowing and lending for the short-term. While on one hand the money market helps in shifting vast sums of money between banks, on the other hand, it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used (at a cost) by banks, corporations and other institutions which need short-term money. The government bonds, corporate bonds and bonds issued by banks are examples of money market instruments, where the instrument has a ready market like the equity shares of a listed company. The money markets refer to the market for short-term securities (one year or less in original maturity) such as treasury bills, certificates of deposits, commercial paper etc. Money market instruments are more liquid in nature.

The money market form an important part of the financial system by providing an avenue for bringing equilibrium of the surplus funds of lenders and the requirements of borrowers for short periods ranging from overnight up to a year.

1.14 References and Suggested Readings

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1.15 Model Questions:

Q.No 1 What is Financial Market?
Q.No.2 What are the main functions of Financial Market?
Q.No 3 Mention two types of Financial Market.
Q. No 4 What is Money Market?
Q.No 5 What is Capital Market?
Q.No 6 What is Repo instrument?
Q.No 7 What is treasury bills?
Q.No.8 What is commercial paper?
Q.No.9 What is certificate of deposits?
Q No.10 What is notice money or short term money?
Q.No.11 What is inter - bank participation certificate?
Q.No 12 What is Repo instrument?
Q.No 13 What is treasury bills?
Q.No.14 What is commercial paper?
Q.No.15 What is certificate of deposits?
Q No.16. What is notice money or short term money?
Q.No.17 What is inter - bank participation certificate?
Q.No 18 Explain briefly the differences between the Money Market and Capital Market.
Q No. 19 Briefly outline about the importance of money market.
Q.No.20 Discuss the organizational structure of money market.
Q.No.21 Explain the relation between the money market and Reserve Bank of India.

BLOCK I : Unit-3

Financial Development and Economic Development, Flow of Funds Accounts, Indicators of Financial Development

Unit Structure:

3.1 Introduction
3.2 Objectives
3.3 Pillars of an efficient financial system
3.4 Flow of funds accounts
3.4.1 Principle of flow of funds
3.4.2 Sources of data
3.4.3 Importance of flow of funds accounts
3.5 Indicators of financial development
3.6 Summary
3.7Bibliography/Suggested Readings
3.8 Model questions

3.1 INTRODUCTION

A well-developed financial system contributes significantly towards the growth and development of an economy. The components of the financial system have a bearing on the economic prosperity of nations and their long-term development. Over the years, human civilization has stood witness to the evolving dimensions of the financial system such as modes of investment, types of securities offered for investment, and importantly, the increasing participation of people in the financial system across the globe. The government too has been playing an active role in promoting financial literacy amongst its citizens. In India, for example, the government has been actively involved in promoting financial inclusion by promoting zero-balance accounts under the 'Pradhan Mantri Jan Dhan Yojana scheme and brought a large stratum of the populace into the financial umbrella. Such initiatives throw light on the increasing importance of financial know-how and growth as a tool for achieving overall economic growth and development. We shall now try to explore some key aspects of the above-mentioned areas and their inter-dependency which forms the basic foundation of this unit.

3.2 OBJECTIVES

After going through this unit, students should be able to:-

* Analyze the inter-dependency between financial development and economic development;
* Understand the Flow of Funds Accounts framework and its significance in economic development;
* Assess various indicators that are considered important for financial development.

The nexus as to whether a well-developed financial system aids in economic development has been a topic of debate for policymakers as well as academia for many years now. However, many studies across the globe have highlighted the positive impact that a sound financial system has on the economic growth of a region. At this point, it becomes essential to explore the various parameters of a well-developed financial system and how it drives economic development.

3.3 PILLARS OF AN EFFICIENT FINANCIAL SYSTEM:-

1) Financial deepening: -

Financial deepening refers to the increase in access to financial services. The key aspect underlying financial deepening is that it fosters economic growth through the expansion of financial services to those with inadequate financial resources. Financial deepening encompasses factors such as the presence of financial intermediaries, increased liquidity, the flow of credit to the private sector, stock market capitalization, etc. which are crucial for economic growth in the long run. In an underdeveloped financial system, access to funds is limited and people have to resort to informal sources such as money lenders, etc. which bears a relatively higher cost compared to formal sources of funds. Promoting a financial system with adequate financial depth enhances capacity building in an economy and supports inclusive economic development.

2) **Efficiency of financial services: -** An efficient financial system helps in mobilizing savings from the investors and allocates them to their most productive use in the economy thereby facilitating the easy exchange of goods and services and reducing unnecessary costs at the same time. Studies have found that financial markets and institutions that channel society's savings to productive use more efficiently experience faster economic growth. The importance of an efficient financial system also lies in its ability to allocate a greater share of the investment into relatively faster-growing sectors thereby providing the basis for the continuous restructuring of the economy that is vital for sustained economic growth. An efficient financial system enables the participants (borrowers and lenders) to share risks and enhance economic performance. On the contrary, an inefficient financial system could impose unnecessary costs on households and businesses by misallocating financial resources over time.

3) Financial stability: -

Though there are different outlooks on financial stability, broadly speaking, financial stability refers to a financial system whereby the financial markets and intermediaries are resistant to economic shocks and are in a state of performing their basic functions such as intermediation of financial funds and arrangement of payments, etc. in a sound manner. Factors such as inefficient resource allocation, weak supervision, and inadequate accounting and auditing regulations are common indicators of an unstable financial system. The aforementioned financial crises could not necessarily emerge collectively but also individually and on a random basis which is why analyzing financial stability is considered to be a complex task. The stability of the financial system is an essential prerequisite not only for maintaining overall price stability but also for ensuring economic growth and development. Financial instability could entail heavy costs on the participants and push the financial institutions towards a possible state of bankruptcy which in turn will impede economic growth.

4) Financial innovation: -

The financial system has been constantly evolving and as such, financial innovation plays a crucial role in sustaining the efficient functioning of the system. How transactions are settled, the diverse sets of operations to be performed by institutions, the emergence of new financial instruments, etc. are all examples of financial innovation. In a rapidly changing world, the financial system also underwent a lot of changes, and financial innovation needed to follow suit. Financial innovation has been a constant phenomenon in the financial system. In India for instance, the emergence of venture capital firms, microfinance, e-banking services, etc. have completely changed the manner in which financial transactions were settled earlier, at least in terms of volume and quantum. Financial innovation plays a significant role in promoting social welfare and ease of doing transactions and has emerged as a key area in promoting sustained economic development.

STOP TO CONSIDER:-

- A sound financial system lays the foundation for the development of the economy.
- Financial deepening, the efficiency of financial services, financial stability, and financial innovation are the pillars of an efficient financial system that drive economic growth and development.

The financial system today is characterized by rapid innovation and faster settlement of claims, especially with the advent of affordable internet services and supporting technology. Although the fold of people falling under the ambit of financial services has increased exponentially, one may as well consider the negative implications that it brings along with it. Financial frauds such as deceptive and misleading schemes on offer, investment frauds, etc. have increased substantially with wider financial coverage. While investing in the stock market has boiled down to a few clicks on the phone, the responsibility of the government towards prohibiting financial frauds has also increased manifold. Creating a healthy investment ecosystem based upon transparent and legit terms, efficient risk assessment practices, etc. are a few areas that can certainly be prioritized to limit financial frauds.

CHECK YOUR PROGRESS:-

1. What do you mean by financial deepening? How does it contribute to the economic growth of the nation?
2. Write the meaning of financial innovation. Explain with examples how financial innovation helps in improving the efficiency of financial services.
3. What is the 'Pradhan Mantri Jan Dhan Yojana'? How does it contribute towards financial inclusion?

3.4 FLOW OF FUNDS ACCOUNTS:-

Flow of funds refers to financial reports or accounts that illustrate the inflow and outflow of funds to and from various sectors in an economy. The FOF accounts examine the flow of fund in an economy across six sectors, viz. households, government, private corporations, banks, other financial institutions (OFI's) and rest of the world. The flow of funds accounts are compiled and published by the respective central banks of different countries on a periodical basis. The Reserve Bank of India has been publishing the flow of funds accounts for the Indian economy since 1964. In fact, India has been one of the early adopters of a domestic Flow of funds framework. The flow of accounts system was suggested as an alternative to the erstwhile national accounts system in 1947 by Morris Copeland. The flow of funds accounts is an approach whereby the flow of funds to and from different sectors (as mentioned above) is analyzed in order to assess the depth and maturity of a financial market in an economy. Let us now explore the fundamentals of the flow of funds framework and its significance:-

3.4.1 PRINCIPLE OF FLOW OF FUNDS: -

In simple words, the flow of funds reflects the transactions that include buying and selling of goods and services along with the transfer of assets (uses of fund) and liabilities (sources of fund) between different sectors at a particular point in time. It includes crucial information on various sectors of the economy and aids policymakers in decision-making. By showing the sectoral presentation of the flow of funds and their usage, this accounting framework addresses a major problem that was encountered in the national income accounting system that was in use previously. The flow of funds accounts captures the timing, pattern, and duration of money flows within an economy thereby providing an effective measure of the nature of financial claims in an economy.

The flow of funds framework uses the double-entry accounting system in order to assess the flow of funds or to track the changes in assets and liabilities across various sectors of the economy viz. households, government, private corporations, banks, other financial institutions (OFI's) and rest of the world. The flow of funds matrix will reveal the sources and uses of funds for each of the above -mentioned sectors at different point in time. The changes in assets are recorded as the use of funds and changes in liabilities as the source of funds. In the case of uses of funds, a positive figure denotes an increase in the asset while a negative figure will denote a decrease in the value of asset. On the other hand, in sources of funds, a positive figure denotes an increase in liability or savings while a negative figure will denote repayment of a debt or dissavings. It is worth noting that in the case of a single sector, the value of its liability may not tally with the value of its total financial assets. In other words we can say that there can be imbalances in assets and liabilities on an individual sectoral basis, but when it comes to the entire economy, the total liabilities must be equal to the total assets. Also known as financial stocks and flows, they are compiled and presented in a tabular form often referred to as a matrix in order to efficiently depict the sources and uses of funds across various sectors of the economy. The basis of presenting the sectoral flow of funds on a tabular basis is also referred to as 'FWTW' (From whom to whom) basis.

Let us now have a look at a sector-wise presentation of financial assets and liabilities across different sectors as has been released by the Reserve Bank of India:-

Table: Sectoral Financial Net Worth
(Percent of Net National Income at current market prices)

YEAR	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20#**
Assets									
1 Financial Corporations	222.7	225.4	227.1	229.3	229.9	228.9	233.3	233.0	239.4
2 Non-Financial Corporations	132.7	123.9	123.2	122.9	117.1	106.7	94.3	90.6	89.5
2.a Public Non-Financial Corporations	18.1	17.1	16.2	15.3	11.9	11.6	12.2	11.1	10.8
2.b Private Non-Financial Corporations	114.6	106.8	107.0	107.5	105.2	95.0	82.1	79.5	78.7
3 General Government	31.5	30.9	30.3	28.8	30.0	30.1	30.3	29.9	30.6
4 Household Sector	135.9	132.5	129.8	130.1	129.4	128.3	130.1	131.3	134.5
5 Rest of the World	46.0	48.0	50.1	50.6	49.7	45.6	45.2	40.8	45.8
Liabilities									
1 Financial Corporations	189.3	190.8	192.2	194.1	194.8	193.2	197.5	197.2	204.0
2 Non-Financial Corporations	110.0	105.0	106.1	107.2	103.6	94.5	85.3	83.2	83.6
2.a Public Non-Financial Corporations	19.6	20.4	21.3	22.1	20.8	21.5	22.2	21.8	23.0
2.b Private Non-Financial Corporations	90.4	84.6	84.8	85.1	82.8	73.0	63.0	61.4	60.6
3 General Government	77.8	77.5	77.3	76.8	78.8	78.8	79.6	79.6	82.6
4 Household Sector	39.1	38.4	37.7	37.4	36.9	36.6	37.8	38.3	39.1

5 Rest of the World	23.3	22.4	23.8	24.5	24.6	22.3	22.7	21.8	25.3
Financial Net Worth									
1 Financial Corporations	33.4	34.6	34.9	35.2	35.1	35.7	35.8	35.8	35.3
2 Non-Financial Corporations	22.6	18.8	17.2	15.6	13.5	12.1	9.1	7.4	5.9
2.a Public Non-Financial Corporations	-1.5	-3.3	-5.0	-6.8	-8.9	-9.9	-10.0	-10.7	-12.2
2.b Private Non-Financial Corporations	24.2	22.1	22.2	22.4	22.4	22.0	19.1	18.1	18.1
3 General Government	-46.3	-46.6	-47.1	-48.0	-48.8	-48.7	-49.2	-49.7	-52.1
4 Household Sector	96.8	94.1	92.2	92.7	92.5	91.6	92.3	93.0	95.4
5 Rest of the World	22.7	25.6	26.3	26.1	25.1	23.3	22.5	18.9	20.5
Note: Financial net worth is calculated as the difference between outstanding assets and liabilities (excluding shareholders' equity).									
Source:- Reserve Bank of India website (www.rbi.org.in)									

Note: Financial net worth is calculated as the difference between outstanding assets and liabilities (excluding shareholders' equity).Due to the lag in availability of balance sheet data, data from 2020-21 and onwards is not included herein.

3.4.2 SOURCES OF DATA:-

The data required for compiling the FOF (Flow of funds) accounts has to be collected from various sources such as published balance sheets, statements published from concerned institutions and data available from surveys etc. However, it is to be noted that independent accounts for the household sector is not available and are prepared based on data related to the other sectors within the FOF accounts framework. A detailed description of the various sources of data for preparing the flow of funds accounts have been mentioned below:-

SECTOR	**SOURCES OF DATA**
1.Banking 1.1 RBI	1. Statement of affairs of the Reserve Bank of India as on March 31st. 2. Returns from regional offices of the RBI and Government and Bank Accounts.
1.2Commercial Banks	1. Data on certain items of assets and liabilities of scheduled commercial banks as on last reporting Friday. 2. Survey of investments of scheduled commercial banks as at the end of march.
1.3 Co-operative banks and credit societies	1. Assets and liabilities of co-operative banks and credit societies

2. Other financial institutions 2.1 Development financial institutions 2.2 UTI (Unit Trust of India) 2.3 Finance and Investment companies	 1. Balance sheets of development financial institutions. 1. Balance sheet of Unit Trust of India. 2. Special information giving scheme wise details of UTI's balance sheet. 1. Studies on finances of financial and investment companies. 2. Articles on growth of deposits with non-banking companies.
3. Private corporate business 3.1 Non-government financial companies 3.2 Co – operative Non- credit societies	 1. Published articles relating to assets and liabilities of medium and large public limited companies. 2. Data on global paid up capital from Department of Company Affairs, Government of India. Assets and liabilities of co-operative non-credit societies; published in statistical statements etc.
4. Government 4.1 Central Government 4.2 State governments and union territories 4.3 Local Authorities	 1. Economic and functional classification of central government budget. 2. Finance Accounts of the union government. 3. Budget documents of the central government. 1. Consolidated finances of state governments and union territories. 2. Finance accounts of state government/combined finance and revenue account of the union and state governments in India. 3. Ownership pattern of state government securities. 1. Assets and liabilities of port trusts.
5. Rest of the world	Special information on payments and receipts under private capital, official miscellaneous capital and banking capital from balance of payments accounts published by RBI.
6. Household	Data for household sector is derived from all the other sectors mentioned above. There is no separate published source for household sector. Assets/uses of funds in these sectors represent liabilities/sources of fund from household. Similarly, liabilities/sources of funds from the other sectors represent assets/uses of funds in the household sector.

Source: - www.rbi.org.in

CHECK YOUR PROGRESS:-

4. What is the significance of double -entry system of bookkeeping in the preparation of flow of funds accounts?
5. Is the flow of funds framework representative of the informal sector also? Name the nodal agency which is responsible for compiling and presenting data related to the informal sector of our country.

3.4.3 IMPORTANCE OF FLOW OF FUNDS ACCOUNTS:-

The significance of flow of funds accounts can be analyzed from the following points:-

(1) By presenting the flow of funds across various sectors, it helps in highlighting the role played by the financial sector towards the development of a nation;

(2) They facilitate a thorough analysis of the economic data pertaining to borrowings, savings and lending across vital sectors of the economy;

(3) Serves as an information tool for the central banking authority and aids in formulation of fiscal and monetary policy;

(4) They help in assessing the behavior of individual financial institutions operating in the economy;

(5) They provide useful insights as to how the government finances its surplus and deficit budget;

(6) They help in measuring the economic activities which in turn aids in predicting changes in GDP (Gross Domestic Product).

Despite advantages linked to the flow of funds accounts framework one has to as well take into consideration the limitation associated with this framework. A major drawback of the flow of fund accounts framework is that it does not provide a complete representation of the transactions that occur in the informal/unorganized sector. One has to acknowledge the contribution made by the informal sector towards economic growth of a nation but owing to certain technical issues, the financial transactions occurring in the informal sector are not adequately represented in the flow of funds accounting framework. Some of the difficulties associated with the measurement of the informal/unorganized sector have been listed below:-

(a) The data of actual workforce engaged in this sector is not conclusive which is why any efforts on the part of authorities concerned to extract information in this regard shall not be entirely representative;

(b) Majority of the transactions that occur within the informal sector are primarily settled on cash basis and hence unaccounted for. Simply stated, the extent of expenditure incurred in the informal sector can be assessed but, the amount of income generated through such transactions remain unaccounted as they are not settled through a formal institution such as a bank but in cash;

(c) The enterprises engaged in this sector comprise of enterprises owned by individuals or households that do not have a separate existence from their owners. As such, there is no separation of financial activities of the owner and the enterprise which is why it is difficult to derive a complete set of financial information from the firms engaged in the informal sector.

CHECK YOUR PROGRESS

6. State the meaning of flow of funds accounts? Who is responsible for compiling and presenting the data related to flow of funds accounts in an economy?

7. What are the various sectors on which the flow of funds accounts is based?

3.5 INDICATORS OF FINANCIAL DEVELOPMENT:-

As discussed above, we can now understand that the financial system of a country comprises of many sectors (both banking and non-banking institutions). As such, the financial health of a nation is dependent on the efficient functioning of the different financial sectors encompassing the financial system. It is important to understand that in order to comment on the status of financial development of any economy, one needs to thoroughly assess the functioning of all the sectors and sub-sectors operating within an economy which can be a very arduous and exhaustive task in itself. Financial development facilitates economic growth by mobilizing savings and optimum allocation of capital etc. We shall therefore focus on those aspects which are reflective of the level of development taking place in the financial sector as a whole, or so as to say are considered indicators of financial development:-

1) Lower interest rates: - The rate of interest prevailing in an economy plays an important role in determining the flow of credit and savings generated during a span of time. When the interest rates are lower, there is an increase in demand of people seeking credit from the banks and as such financial resources from one section can be mobilized towards the ones in need of it and used efficiently. Whereas, during times of high interest rates, banks find it hard to pass on the financial resources as there will be relatively lesser demand for it owing to higher interest rates. An economy characterized by lower interest rates will see more borrowing, spending and consumption which in return contribute to the growth of the economy.

2) Real GDP growth rate: - A positive growth in GDP of a nation is often considered to be an important indicator of the financial health of the economy. GDP or Gross Domestic Product

refers to the final value of goods and services produced in a country during a certain period of time i.e. quarterly, half yearly or annually. This also includes the output produced by foreign companies operating within the country as a result of foreign direct investment. Output produced within the physical boundary of a country is considered for GDP calculation. The GDP of a country across different time spheres are calculated on the basis of current/nominal prices, and as such one cannot compare the GDP growth rate of two different time periods without adjusting for inflation. A statistical tool called GDP deflator is used to adjust the value of GDP from nominal to constant prices. An increase in real GDP is a general indicator that the economy is performing efficiently owing to factors such as higher employment avenues and increased consumption level amongst the participants.

3) Increased employment avenues: - Increase in employment opportunities has always been a matter of great significance especially from the macro- economic perspective. When unemployment prevails in an economy, there will be less spending by the individual which is not a motivating scenario for the business houses. When there is lesser spending in the economy, the businesses will not be motivated to produce more which in turn may lead to economic slowdown or recession. During times when the economy performs well, the capacity of various sectors to absorb additional labour also increases simultaneously as a result of economic growth which is why, increased employment avenues is often considered to be a by-product of financial development.

CHECK YOUR PROGRESS:-

8. What is the difference between real GDP and nominal GDP?

9. Which sector has the highest share of contribution towards the GDP of Indian economy?

3.6 SUMMARY

After considering different aspects of the financial system, we can say that there is a direct relationship between financial development and economic development. Factors such as financial deepening, financial innovations etc. have a direct bearing on the state of economic affairs of a country. However, it is also important to note the differences between economic growth and development. Economic growth is a short-term aspect and economic development on the other hand, is a result of sustained economic growth over a certain period of time. Economic growth may be defined as the positive change in the real output of the country over a particular span of time reflected through measures such as GDP (Gross Domestic Product) and GNP (Gross National Product). It refers to the rate of growth in real output over population growth for a particular span of time. Economic Development is on the other hand, a manifestation of the welfare of the residents in a country driven by increase in economic wealth of the country. This ultimately leads us to believe that economic growth is an important but not the only attribute for attainment of Economic Development. Efficient functioning of the financial system aids in economic growth which in turn results in economic development. While economic growth is characterized by improvement in factors such as human and natural resources, capital formation and technological development etc. economic development on the other hand is characterized by improvement in factors such as Life expectancy rate, Maternal mortality rate, Rate of employment etc.

The Flow of funds accounts framework and its significance in the economy as a tool for promoting growth can hardly be overlooked. It refers to compiling and presenting data from six vital sectors of the economy in order to assess the depth and maturity of the financial system of an economy. The central banking authority is responsible for publishing data related to flow of fund accounts on periodic intervals. It also assists the central bank in policy formulation and proper planning as per the needs of the economy.

As discussed above, economic development is a result of sustained efforts towards economic growth for a longer period of time. While there are a different set of parameters that define them, both economic growth and development are crucial for the healthy growth of the economy. The financial system represents the deep end of the financial system. A stable and resilient financial system stimulates capital flow and accelerates economic growth. A sound financial system is vital for economic transformation as achievement of broader national objectives is also dependent on the efficiency of the financial system.

CHECK YOUR PROGRESS:-

10. What are the differences between economic growth and economic development?

11. Does financial development promote economic growth? Explain briefly.

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3.8 MODEL QUESTIONS:-

Q1) Explain with examples the importance of financial innovation in promoting an efficient financial system.

Q2) What do you mean by Financial Net worth? How is it calculated?

Q3) How is the flow of funds data derived for the household sector within the flow of funds framework?

Q4) What do you understand by financial development? Explain the indicators that are considered vital for financial development.

Q5) How does an efficient financial system promote capital formation in an economy? Explain with suitable examples.

ANSWERS TO CHECK YOUR PROGRESS QUESTIONS:-

Q1) What is 'Pradhan Mantri Jan Dhan Yojana'? How does it contribute towards financial inclusion?

Ans:- The Pradhan Mantri Jan Dhan Yojana' is an ambitious financial program of the government of India which aims at expanding the access to financial services such as bank accounts, remittance of loans, direct benefit transfers etc. With additional features such as no minimum or zero balance accounts and provision of overdraft facility it has been a huge success amongst the people and the deprived section in particular. By allowing such financial services to the people who were left out the financial coverage this program has contributed immensely towards financial inclusion. As per the latest finance ministry data, a total of 44.23 crore bank accounts have been opened under the Pradhan Mantri jan dhan yojana thus bringing a large section of people under the financial fold.

Q2) What do you mean by financial deepening? How does it contribute towards economic growth of the nation?

Ans: - Financial deepening refers to increase in access to financial services and greater capital accumulation. Financial deepening includes factors such as increased flow of credit and stock market capitalization etc. which in turn aids in long-term economic growth.

Q3) Write the meaning of financial innovation. Explain with examples how financial innovation helps in improving the efficiency of financial services.

Ans: - Financial innovation refers to newer and innovative methods of settling transactions in the financial system. The financial market is constantly evolving and so have the means to cater to the changes and settlement that have taken place. RTGS, NEFT, online trading through smart phones etc. are few examples of innovation in the financial sector. Financial innovation has introduced smarter ways to transact and promote timely settlement of dues and while doing so, have reduced the gap between the market and the investors. This ensured greater participation of people, early settlement of claims and hence one can conclude that financial innovation has improved the efficiency of financial services.

Q4) What is the significance of double entry system of recording transactions in the preparation of flow of funds accounts?

Ans: - Under double entry system of recording transactions, every transaction will affect at least two accounts. That is, each account has to be supported by the simultaneous and equivalent amount recorded in the account with the opposite effect. These improves the transparency quotient of transactions and are convenient for further use also since data relating to both the parties/sectors/accounts are simultaneously recorded and can be verified as and when the need arises. Double entry system helps in projecting an accurate and true and fair view of the transactions between various sectors that are recorded under the flow of funds framework and helps in avoiding statistical discrepancies.

Q5) Is the flow of funds framework representative of the informal sector also? Name the nodal agency which is responsible for compiling and presenting data related to the informal sector of our country.

Ans: - No, the flow of funds framework does not entirely represent the data related to the informal sector. The Central Statistical Organization (CSO) is the nodal agency which is responsible for compiling data related to the informal sector of our country.

Q6) State the meaning of flow of funds accounts? Who is responsible for compiling and presenting the data related to flow of funds accounts in an economy?

Ans: - Flow of funds accounts is a framework that illustrates the inflow and outflow of funds to and from various sectors of the economy. It reflects the transactions that include buying and selling of goods and services along with transfer of assets (uses of fund) and liabilities (sources of fund) between different sectors at a particular point of time. The Central Banking authority of a country is responsible for publishing the data related to flow of funds in an economy.

Q7) What are the various sectors on which the flow of funds accounts is based?

Ans: - There are six sectors based on which the data related to flow of funds accounts is compiled in an economy viz. households, government, private corporations, banks, other financial institutions (OFI's) and rest of the world.

Q8) What is the difference between real GDP and nominal GDP?

Ans: - Under Real GDP, prices of goods and services are calculated using constant prices and are adjusted for changes in inflation, money supply and changing interest rates. Whereas, under nominal GDP prices of goods and services are calculated using current prices which does not account for inflationary and other changes as have been mentioned above.

Q9) Which sector has the highest share of contribution towards the GDP of Indian economy?

Ans: - The services sector has the highest share of contribution towards the GDP of Indian economy.

Q10) What are the differences between economic growth and economic development?

Ans: - Some key differences between economic growth and economic development are as follows:-

1) Economic Growth is an element of Economic Development, but not the only one. Economic Development on the other hand is a broader and an all inclusive concept which also includes the welfare of the resident population.
2) Economic Growth is a short-term process which takes into consideration yearly growth rates. On the other hand, Economic Development is a long term process which is attained by sustainable and result-oriented planning on the part of the policy makers which ought to be reflected in the way of living of the common population.
3) While Economic Growth is a completely quantitative process; Economic Development encompasses both quantitative as well as qualitative attributes.
4) Economic Growth is a process indicated by GDP, per capita income etc. Economic Development on the other hand is represented by factors such as increased Life expectancy Rate, rate of employment, Maternal Mortality Rate etc.

Q11) Does financial development promotes economic growth? Explain briefly.

Ans: - Based on the empirical evidence from past studies, it can be said that there exists a relationship between financial development and economic growth. Improvement of financial services ensures greater participation and investment in the financial market which in turn aids in capital formation. Such capital formation leads to efficient allocation of resources which in turn aids in development of the economy. Therefore, one may conclude that development of the financial system aids in the growth of the economy.

BLOCK I : Unit-4

Reforms in the Indian Financial System

Unit Structure:

4.1 Introduction

Financial system in any country is a changing phenomenon. Generally, according to changing of trade, business, industry along with their market position, the financial system is to be changed. That is why according to changing these facts and circumstances the financial system should be reformed so that it can suit with the economic environment and can provide sufficient support for growth of financial activities. In case of Indian financial system also it is observed that since the last three decades, a sizeable number of significant changes have been taken place and subsequently various reforms have been made. The main purpose of this unit is to discuss various aspects of financial reforms in Indian financial system, which mainly includes regulatory reform, banking sector reforms, financial market reforms and insurance sector reform.

4.2 Objectives

This unit is an attempt to analysis the Reforms in the Indian Financial System.

After going through this unit you will be able to:

- Define financial reforms.
- Highlight the main aspect of International financial crisis of 2008.
- Explain Liberation of financial system.
- Discuss regulatory reform of Indian financial system.
- Describe banking sector reform.
- Explain financial market reform.
- Elucidate insurance sector reform.

4.3 Meaning of financial sector reforms

Financial sector reforms means to improve the allocative efficiency of resources and ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. The main purpose of financial sector reform is to increase the return of investment and accelerate economic growth through efficient allocation of resources. In other words, financial sector reforms are policy measures designed to deregulate the financial system and transform its structure with the view to achieving a liberalized market-oriented system within an appropriate regulatory framework. At global level, financial sector reforms have been driven by two apparently contrary forces. The first is a thrust towards liberalization, which seeks to decrease, if not eliminate a number of direct controls over banks and other financial market participants. The second is a thrust in favour of strict regulation of the financial sector. This dual approach is also apparent in the reforms tried in India.

4.4 Major delineations of the financial sector reforms in India

The major delineations of the financial sector reforms in India were found as under:

- Removal of existing financial repression is one of the major delineations
- Transforming the financial sector towards more efficient, productive and profitable
- With a view to improving efficient allocation of resource, it enabled the process of price discovery by the market determination of interest rates
- Entrusting more operational as well as financial autonomy to the institutions
- Improving as well as reforming financial system for enhancing international competition
- Allowing the external sector in a regulated way.
- Promoting financial stability in the perspective of domestic and external shocks.

4.5 International financial crisis of 2008 and Indian Financial system

Regarding origin of 2008 crisis it is to be mentioned that it can be traced to the delinquency in the repayment of mortgage loans extended in US after mid-2005 to individuals for residential houses who had poor credit history. It was believed by the Mortgage originators that house prices would continue to rise and the market would be liquid enough to palm the mortgages off. In the US financial system the crisis had occurred in the backdrop of an exceptional boom in credit growth and leverage. The rates of real interest were at a historically low level along with low financial volatility as well as abundant liquidity.

As a result of falling in liquidity the losses on mortgage loans were aggravated. Further Underwriting standards were tightened with fewer households which are qualified for subprime loans. The turmoil which erupted in the US subprime market gradually deepened and spilled over to other market segments, leading to a surge in liquidity demand.

It was rescued the mortgage banks by the process of securitization of loans. Being Securitization as a process which, transformed the bull rings into quantitative power houses, came to the rescue of originating banks. Securitization is a process of transforming mortgages, credit card, receivables and other financial assets into marketable securities, spawned innovation in structured products. Beside, investor appetite for higher returns encouraged the undertaking of higher risks which stimulated innovations for unbundling and distributing risks, boosting demand for a range of high yielding and complex financial products such as collateralized debt obligations (CDOs) and credit default swaps. Both Banks and financial firms supported the process by establishing off-balance-sheet funding.

With the objective of protection of reference obligations of one or more entities to credit events related to securitize of home equity lines of credit, recent innovations in credit default swaps have been extended. Based on Collateralized Debts Obligations (CDOs), have been forged for converting huge illiquid mortgage securities and corporate bonds owned by local investors into liquid financial instruments. In case of bundling of pools of mortgages or assets into CDOs demanded, cash flows from the assets be filtered through several layers; the AAA investors and next in line and so on until equity investors. A typical CDO might receive income from hundreds of sources. In this regard it was warned by James Tobin in 1984 that these instruments, while offering the advantages of liquidity and negotiability, came at the expenses of facilitating *n*-th degree of speculation.

Banks were helped by the securitization process in abandon the earlier model of 'originate and hold' in which banks held loans on their balance sheets until maturity and shifts to 'originate and distribute' model. This process was provided by the issue of bonds tied to cash flows from large pool of loans of the US government sponsored mortgage banks. Mortgage lenders repackaged 56 per cent of outstanding residential mortgages including two-thirds of subprime loans issued in 2006. The rating agencies were asked by issuers of CDOs to assets their quality. The rating agencies were quite liberal so far as their assessment and rating of the CDOs is concerned, because they were paid by sellers of CDOs and not investors. Generally it is assumed by the investors that good rating would be a guarantee of strength. In order to cater investors demand for higher yield, leading banks developed new structures and instruments. In fact, Balance sheets of banks are design and managed in such a way with securitization, so that, selling repackaged loans across the world frees up capital. It was generally chosen by the banks that their CDOs so much that they held on to a lot of their issues although they were supposed to sell them.

Too much large shadow banking system comprising the investment banks, hedge funds and non-banks developed. It was parked by them that their normal business in CDOs and CDs to get around regulatory. They parked their normal business in CDOs and CDs to get around regulatory requirements such as capital adequacy and disclosures. As these institutions grew enormously in size, they became systematically important. As a consequence of failure of one of them would lead to failure of the entire system.

In evolution process, regulation has miserably failed with the shadow banking system. It could be regarded as a nexus of private equity, hedge funds and auction rate securities, non-banks such as GE capital and new securities such as CDOs and Credit Default Swaps. The expectations of both higher return as well as the avoidance of the cost of regulatory capital made the market look for ways to work around regulations.

Both the central banks in the US as well as other allied economics in European countries injected liquidity in the month of August of 2007 with a view to stabilizing interbank markets. Open market operations of enhancing volume as well as maturity were adopted. Securities with mortgage were permitted for using borrowing by Federal Reserve and European Central Bank. Commercial papers with assets accepted as collateral by Federal Reserve System (FED). Several measures by central banking authorities were undertaken across Europe and US. In the US, a wider pool of collateral promoted improved financing conditions across financial markets. FED, however, while playing the role of lender of last resort, should have ensured that appropriate incentives were in place to discourage excessive risk-taking and the under pricing of risk in order to avoid a crisis.

STOP TO CONSIDER

According to Paul Krugman and Hank Paulson, the financial crisis ought to be traced to global imbalances, the phenomenon of huge current account surpluses in China and a few other countries coexisting with the unsustainably large deficits in USA. Global imbalances have been caused by the propensity of countries with high saving rate to park their savings in US. The flood of money from these countries into the US kept the interest rate low fuelled the credit boom and inflated real estate another asset prices to unsustainable levels. The bubble burst eventually, precipitating financial crisis. The remedy suggested is to unwind imbalances by posting import surpluses by countries like China.

4.6 Liberation and financial system

As a result of adopting and implementing liberalization policy in 1991 the Indian Financial System has undergone massive changes. This new economic liberalization policy transformed Indian economic from closed economy to open economy. Apart from various changes this Liberalization policy also changes financial system. Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken. The focus of reforms in the financial markets has been on removing structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to broaden and deepen them. Reforms in the government securities market sought to smoothen the maturity structure of debt, raising of debt at close to market rates and improving the liquidity of government securities by developing an active secondary market. In the capital market, the focus of reforms has been on strengthening the disclosure standards, developing the market infrastructure and strengthening the risk management systems at stock exchanges to protect the integrity and safety of the market. Element of the structural reforms in various market segments are introduction of free pricing of financial assets such as interest rate on government securities, pricing of capital issues and exchange rate, enlargement of number of participants and introduction of new instruments.

Improving financial soundness and credibility of banks is a part of banking reforms undertaken by the RBI, the regulatory and supervisory agency over commercial banks under the Banking Companies Regulation Act, 1949. The improvement of the financial health of banks is sought to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision bad debts. The removal of external constraints in norms of pre-emption of funds, benefits and prudential regulation and recapitalization and writing down of capital base are reflected in the relatively clean and health balance sheets of banks. The reform process have however, accentuated the inherent weaknesses of public sector dominated banking system. There is a need to further improve financial soundness and to measure up to the increasing competition that a fast liberalizing and globalization economy would bring to the Indian banking system.

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

Regarding Non-Banking Financial Companies (NBFC), the Reserve Bank of Inda has issued several measures aimed at encouraging disciplined NBFC which run on sound business principles. The measures seek to protect the interests of depositors and provide more effective supervision, particularly over those that the access public deposits. The regulations stipulate an upper limit form public deposits which NBFCs can accept. This limit is linked to credit rating by an approved rating agency. An upper limit is also placed on the rate of interes on deposits in order to restrain NBFCs from offering incentives and mobilizing excessive deposits which they may not be able to service. The heterogeneous nature, number, size functions (deployment of funds) and level of managerial competence of NBFCs affect their effective regulation.

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

CHECK YOUR PROGRESS 1.1

Answer very briefly:

1. In which year SEBI was established?
2. Define NBFCs.
3. On what does capital market reform focus mainly?
4. Which part of banking reform was undertaken by the RBI?

5. In which area of secondary market reform was made?

4.7 Various aspects of Indian financial reforms

Below some important aspects where Indian financial reform has taken placed are discussed:

4.7.1 Regulatory reform

The Ministry of Finance has been formulating various strategies in the financial sector of India. Moreover it is being acknowledged by the Government that the important role to be played by regulators. On the other hand against becoming the Reserve Bank of India (RBI) more independent, Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) are important institutions. Of course some opinions are also provided that there should have a super-regulator with a view to providing quality financial services in lieu of existing multiplicity of regulators.

During the past times, SEBI has implemented a regulatory framework in accordance with modern technology and efficient rules and regulations for the purpose of controlling the behavior of main market participants which includes stock exchanges, brokers, merchant bankers, and mutual funds. Further, SEBI has controlled various activities of both takeovers and insider trading for investor protection. The structure of governing body of stock exchanges has been also reconstituted for formation of an efficient board. The purpose of newly constituted regulatory framework is to protect investors with all necessary disclosure and transparency in place of direct control. Being a supervisor of the system the SEBI is undertaking supervision of the activities of various participants along with stock exchanges and mutual funds. Of course, violation of any rules leads to punishment to be imposed by SEBI.

4.7.2 Indian Banking Sector and Financial Reforms

The main purpose Indian banking sector reform is to remove the deficiency of banking operation. The banks in India lack autonomy because the wages across all the bank employees is the same irrespective of the health of the bank. That is the reason as why financial and banking reforms are brought upon in the banks of India. Since the liberalization in 1991 there has been a lot change in the Indian banking sector. During the last decades there has been a considerable difference in the financial sector in India. A substantial difference is found in liberalization and transformation of the whole financial system.

The principal purpose reforming banking sector was to uphold a diversified, efficient and competitive financial system with the aim of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional solidification.

In the Month of August, 1991, a high level Committee on the Financial System (the Narasimham Committee) was constituted by the Govt. of India for monitoring all facets of the financial system and make comprehensive recommendations for improvements. The Report of the Committee submitted in November 1991, has put forwarded several recommendations in connection with reforms in the field of banking sector as well as in the capital market. Immediate after this report, the Govt. of India had announced broad acceptance of the approach of the Narasimham Committee and a process of step by step reform in the banking sector and in the capital market which is still under way for more than six year.

In time of reforming banking sector reform, it was observed that banks have experienced strong balanced growth during the time period of post-reform in aspects of creating an environment of operational flexibility. Improvement of the financial health of banks was reflected in significant improvement in capital adequacy as well as improved asset quality. It is to be noted that this progress has been depicted despite of the espousal of international best practices in prudential norms. Both competitiveness as well as productivity have gain and which ultimately enabled banking sector by technological deepening and flexible human resource management. These significant gains have been achieved in spite of renewing goals of social banking viz. maintaining the wide reach of the banking system and directing credit towards important but underprivileged sectors of society.

4.7.3Financial market reform

Financial market reform is here discussed, both the reform taken place in Capital market and Money market:

Capital Market Reform

In a very simple language Capital market is a financial market provides long term financial needs and works as a channel for demand and supply of debt and equity capital. Capital market channelizes the money provided by savers and depository institutions such as banks, credit unions, insurance companies, etc. to borrowers and investees. In this regard it is to be mentioned capital market channelize fund through a variety of financial instruments which include bonds, notes, shares etc. A capital market is itself a highly decentralized system consists of three major parts viz. stock market, bond market, and money market. Further capital market acts as an exchange for trading existing claims on capital in the form of shares. The Capital Market deals in varieties long-term capital Securities such as Equity or Debt offered by the private business companies and also governmental undertakings of India.

Two important policies initiated in 1993 related to the opening of the capital market to foreign institutional investors (FIIs) and allowing Indian companies to raise capital abroad by issue of equity in the form of global depository receipts (GDRs).Major developments occurred in trading methods which were highly antiquated earlier. As an automated electronic exchange, the National Stock Exchange (NSE) was established in 1994. It empowered brokers in 220 cities throughout India for the purpose of linking up with the NSE computers via VSATs and trade in a unified exchange with automatic matching of buy and sell orders with price time priority with a view to ensuring maximum transparency for investors. The initiation of electronic trading by the NSE generated competitive pressure which forced the BSE to also introduce electronic trading in 1995.

The settlement system was old-fashioned with the system of physical delivery of share certificates to the buyer who then had to deliver them to a company registrar to record change of ownership after which the certificates had to be returned to the buyer. Two demerits of this process are (i) time consuming and (ii) significant risks for investors. Under this process the first step towards paperless trading was put in place by enacting legislation which allowed dematerialization of share certificates with settlement by electronic transfer of ownership from one account to another within a depository. In the year 1996, the National Securities Depository Ltd (NSDL) opened for depository and investment business.

At present, the mutual funds industry is being monitored and controlled by the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI rules, the industry had a framework for the setting up both Indian and foreign firms. The Unit Trust of India is the biggest mutual fund which presently is controlling a quantity of nearly Rs.70,000 crores, but its share is going down. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds became widespread. The foreign owned AMCs are the ones which are now setting the pace for the industry. They are introducing new products with new types of distribution such as, setting new standards of customer service, improving disclosure standards and experimenting.

4.7.4 Reform of the Insurance Sector

The Insurance sector in India is presently being directed mainly by the four regulatory body pertaining to insurance business. They are (i) Insurance Act, 1938, (ii)the Life Insurance Corporation Act, 1956, (iii) General Insurance Business (Nationalisation) Act, 1972 and (iv) Insurance Regulatory and Development Authority (IRDA) Act, 1999. The basis of liberalizing the banking system and encouraging competition among the three major participants' viz. public sector banks, Indian private sector banks, and foreign banks also applicable equally to insurance. As a step of liberalization policy, the public sector monopoly in insurance was ended and opening it up to private sector participants subject to some condition as laid down in concern regulation.

It is supported by Cross-country data that contractual savings institutions are highly significant determinant of the aggregate rate of savings. In this regards, both insurance and pension schemes are the most important form of contractual savings. The main duty of a competitive insurance industry is to provide diversified insurance products with a view to fulfilling differing customer needs, which can help in increasing savings subject to having enough situational and allocative needs. Both the insurance as well as pensions industry have long-term liabilities which is to be matched by investing in long-term secure assets.

Especially for providing infrastructure finance a healthy insurance is urgently required as an important source of long-term capital in domestic currency. The overall development of insurance sector is immensely important for strengthening the capital market at the long-term end by adding new companies. Reforms in insurance are likely to create a flow of finance for the corporate sector if people can simultaneously make progress in reducing financial deficit.

The Malhotra Committee had suggested opening up the insurance sector to new private companies as early as 1994. It took five years to build an agreement on this issue and legislation to open up insurance, allowing foreign equity up to 26 per cent was finally submitted to Parliament in 1999.

Overall Approach to Reforms

During the last many years it is observed that there have seen major improvements in the functioning of various financial market contributors. The government and the regulatory authorities have been adopting a step-by-step approach. The entry of Multi-National Companies has helped in the start of international practices and systems. Technology developments have enhanced customer service. In spite of happening so, few gaps are still remaining such as lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market. Since 1991, the cumulative effect of the developments has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.

In fine, it can be concluded that the financial sector is the principal element of the Indian economic system. It is suggested by many financial experts that there is a need for effective reforms for the purpose of ensuring that this remains competitive and attractive for investors from throughout whole world. The economic reforms have preferred the need for changing the policy objective to promotion of industries and the formation of more integrated infrastructural facilities. Financial sector reforms are centre point of the economic liberalization that was introduced in India in mid-1991. Financial Liberalization in India has brought about the deregulation of interest rates, dismantling of directed credit, improving the banking system, enhancing the functioning of the capital market that include the government securities market. In order to improve economic conditions of India, more emphasis was given by regulators and economic experts on banking reforms. There by it enabled the people to access numerous facilities. Basic purpose of financial sector reforms in the 1990s was to create such a capable competition that can provide steady contribution for greater progression.

4.8 Summing Up

- Financial sector reforms means to improve the allocative efficiency of resources and ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency.

- Removal of existing financial repression, transforming the financial sector towards more efficient, of price discovery by the market determination of interest rates, more operational and financial autonomy to the institutions, Improving and reforming financial system, allowing the external sector in a regulated way and Promoting financial stability are the major delineation of financial reform in India
- In the US financial system the crisis had occurred in the backdrop of an exceptional boom in credit growth and leverage. It was rescued the mortgage banks by the process of securitization of loans. Being Securitization as a process which, transformed the bull rings into quantitative power houses, came to the rescue of originating banks. With the objective of protection of reference obligations of one or more entities to credit events related to securitize of home equity lines of credit, recent innovations in credit default swaps have been extended.
- The focus of reforms in the financial markets has been on removing structural weaknesses and developing the markets on sound lines. Improving financial soundness and credibility of banks is a part of banking reforms undertaken by the RBI, the regulatory and supervisory agency over commercial banks under the Banking Companies Regulation Act, 1949.
- Various aspects of Indian financial reforms such as Regulatory reform, Indian Banking Sector and Financial Reforms, Financial market reform and insurance sector reform.

4.9 References and Suggested reading:

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3. Batra, G.S. (2001). *"Financial Services and Markets."; Deep & Deep Publications Pvt. Ltd New Delhi*

4. Gupta, Shashi.K., Aggarwal, Nisha. and Gupta, Neeti. (2015). "Indian Financial System" (3rd ed): Kalyani Publishers New Delhi

4.10 Model Questions:

i. What is Financial System?
ii. Mention few major delineation of financial reform in India.
iii. Explain about International financial crisis of 2008 in context of Indian financial system.

iv. Discuss liberation policy adopted in 1991 in reference to financial reform system?
v. Describe regulatory reform of Indian financial system?
vi. Write about banking sector and financial reform.
vii. Mention some major reform in financial market.
viii. Write a short notes on Insurance sector reform

4.11 Answer to Check Your Progress

Answers:

1. 1992
2. Non banking financial companies
3. On strengthening the disclosure standard developing the market infrastructure and strengthening the risk management system.
4. Improving financial soundness and credibility
5. Measure to control volatility and transferency in dealing, laying down insider regulation, uniform settlement.

BLOCK II : Unit-1

Financial Markets

Unit Structure:

1.1 INTRODUCTION

Every business unit requires fund for smooth running the business. The fund requirement may be short-term as well as long-term to meet their working and fixed capital requirements from time to time. Thisnecessitates not only the ready availability of such funds but also a transmissionmechanism with the help of which the providers of funds (investors/ lenders) can interactwith the borrowers/users (business units) and transfer the funds to them as and whenrequired.The investors also need a market which provide liquidity/marketability to their investment.

Financial market is a place/system which take care of transfer of fund from the savers to the investors and also make investment liquid by providing marketability of the security.

In this unit we will discuss functions of financial market and different types of financial markets.

1.2 OBJECTIVES

This unit is an attempt to give the concept of financial markets. After going through this unit, you will be able to-

- Know the meaning of financial market

- Explain the functions of financial market
- Know about various types of markets in the financial market

1.3 MEANING OF FINANCIAL MARKET

Financial markets are component of financial system.Efficient financial markets are essential for speedy economic development. Avibrant financial market enhances the efficiency of capital formation. Itfacilitates the flow of savings into investment. Financial markets bridge one setof financial intermediaries with another set of players. Financial markets are thebackbone of the economy. This is because they provide monetary support for thegrowth of the economy. The growth of the financial markets is the barometer ofthe growth of a country's economy.

A financial market is a market where financial instruments are exchanged or traded. The primary function of the financial markets is to facilitate the transfer of funds from surplus sector(lenders) to deficit sector(borrowers). Financial marketsfacilitate the flow of funds inorder to finance investments by corporations, governments and individuals. Financialinstitutionsare the key players in the financial markets as they perform the function of intermediation and thus determine the flow of funds.They trade either directly or through brokers and dealers.

Financial markets are mechanism enabling participants to deal infinancial claims. Financial markets deal in financial securities (or financial instruments) andfinancial services through which funds are traded. Financial markets are the centres or arrangements thatprovide facilities for buying and selling of financial claims and services. Financial markets exist wherever financial transactions take place. Financialtransactions include issue of equity stock by a company, purchase of bonds inthe secondary market, deposit of money in a bank account, transfer of fundsfrom a current account to a savings account etc.

Money market and capital market are the organized financialmarkets in India. Money market is for short term securities while capitalmarket is for long term securities. Primary market deals in new issues, thesecondary market is meant for trading in outstanding or existing securities.

1.4 FUNCTIONS OF FINANCIAL MARKETS

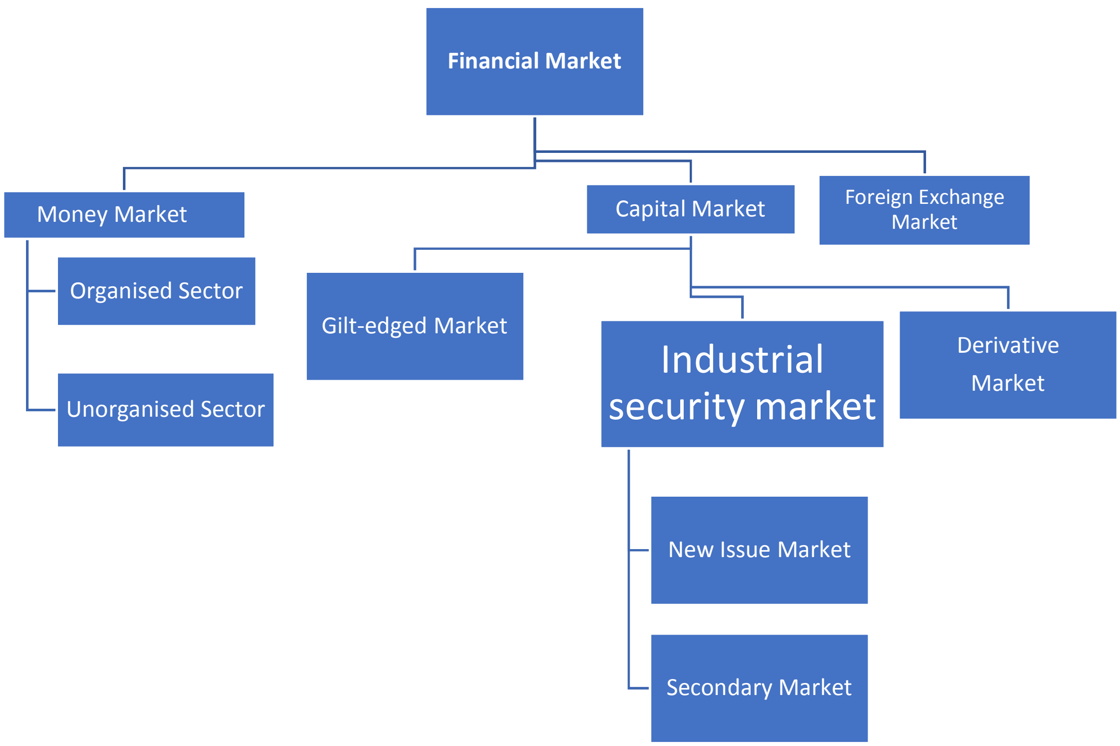
Financial markets provide the following majoreconomic functions:

1) Mobilisation of fund
2) Price discovery
3) Liquidity
4) Reduction of transaction costs

1) **Mobilisation of fund:**A well designed financial system promotes growth through effective mobilisation of savings and their allocation to the most productive uses.Financial marketsfacilitate mobilisation of Savings and channelizing them for most productive use. Financial markets act as a link between savers and investors. It gives the platform through which savers can transfer his savings to most appropriate investment opportunities.
2) **Price discovery:** Price of anything depends upon the demand and supply factors. Demand and supply of financial assets and securities in financial markets help in deciding the prices of various financial securities. Price discovery in financial market means that transactions between buyers and sellers offinancial instruments in a financial market determine the price of the traded asset. At thesame time the required return from the investment of funds is determined by theparticipants in a financial market. The motivation for those seeking funds (deficit units)depends on the required return that investors demand. It is these functions of financialmarkets that signal how the funds available from those who want to lend or invest fundswill be allocated among those needing funds and raise those funds by issuing financialinstruments.
3) **Liquidity:** Financial markets provide liquidity to the securities by providing a ready market.In financial markets financial securities can be bought and sold easily so financial market provides a platform to convert securities in cash. Without liquidity, an investor would be forced to hold a financial instrumentuntil conditions arise to sell it or the issuer is contractually obligated to pay it off. Debtinstrument is liquidated when it matures, and equity instrument is until the company is either voluntarily or involuntarily liquidated. All financial markets provide some form ofliquidity. However, different financial markets are characterized by the degree of liquidity.
4) **Reduction of Transaction Costs:** The function of reduction of transaction costsis performed, when financial marketparticipants are charged and/or bear the costs of trading a financial instrument. In marketeconomies the economic rationale for the existence of institutions and instruments isrelated to transaction costs, thus the

surviving institutions and instruments are those thathave the lowest transaction costs.Financial market provides complete information regarding price, availability and cost of various financial securities. So investors and companies do not have to spend much on getting this information as it is readily available in financial markets.

1.5 STRUCTURE OF FINANCIAL MARKET



1.6 TYPES OF FINANCIAL MARKET

Though the money market and capital market are the main markets of the financial market, there are different other markets in financial market. In the following paragraphs we will discuss different types of financial market-

1.6.1 Money Market

Money Market is that segment of the financial market where borrowing andlending of short-term funds take place. It is a market for short-term funds with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes of money.

There are two segments in Indian money market, namely organized sector and unorganizedsector. The organized sector consists of Reserve bank of India, commercial banks, financial intermediaries such as Unit Trust of India, Life Insurance Corporation of India, Cooperative Banks, Insurance companies, brokers etc. The organized sector of Indian money market directly comes under the preview of the Reserve Bank of India. The RBI is the most important constituents of Indian money market which control and regulate the money market.The unorganized sector of Indian money market consists of indigenousbankers, money lenders, traders and unregulated non-banking financial institutions.

Money market transactions could be both secured and unsecured, *i.e.,* without collaterals.Money market has no physical location,but is an activity conducted over thetelephone and through the internet. Itenables the raising of short-term fundsfor meeting the temporary shortages ofcash and obligations and the temporarydeployment of excess funds for earningreturns.

The money market performs three broad functions. *One,* it provides an equilibrating mechanism for demand and supply of short-term funds. *Two,* it enables borrowers and lenders of short- term funds to fulfil their borrowing and investment requirements at an efficient market clearing price. *Three,* it provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.

Thegovernment bonds, corporate bonds and bonds issued by banks are examples of money marketinstruments. Various players in the money market are banks, financial institutions, government agencies, and at times even corporates.

Money market deals with a number of instruments like treasury bills, repos (and reverse repos),commercial papers, certificates of deposits, and bill rediscountingare traded in money market and there are various sub-markets of money market like Call/Notice Money Market, Term Money Market, Treasury Bill market etc.(we will discuss money market in details in the next unit).

Check Your Progress

Fill in the blanks:

a) Financial markets are market that deal in ——————and debt instruments.
b) The market for short term fund is called ——————.

c) _________ facilitate the transfer of funds from savers to the borrowers.

1.6.2 Capital Market

Capital market is the market for medium and long term funds. It refers to all the facilities and theinstitutional arrangements for borrowing and lending term funds (medium-term and long-term funds).The demand for long-term funds comes mainly from industry, trade, agriculture and government.The supply of funds comes largely from individual savers, corporatesavings, banks, insurance companies, specialized financial institutions and government. Adequate capital formation isindispensable for a speedy economic development. Capital market plays a significance role in capital formation. The main function of capital market is thecollection of savings and their distribution for industrial development. This stimulates capitalformation and hence, accelerates the process of economic development.

Various functions and significance of capital market arediscussedbelow;

i. Link between Savers and Investors: The capital market functions as alink between savers and investors. It plays an important role in mobilizingthe savings and diverting them in productive investment. In this way,capital market plays a vital role in transferring the financial resourcesfrom surplus and wasteful areas to deficit and productive areas, thusincreasing the productivity and prosperity of the country.

ii. Encouragement to Saving: With the development of capital, market,the banking and non-banking institutions provide facilities, whichencourage people to save more. In the less - developed countries, in theabsence of a capital market, there are very little savings andthose whosave often invest their savings in unproductive and wasteful directionsandconspicuousconsumption.

iii. Encouragement to Investment: The capital market facilitates lendingto the businessmen and the government and thus encourages investment. Itprovides facilities through banks and nonbanking financial institutions.Various financial asset s, e.g., shares, securities, bonds, etc., induce saversto lend to the government or invest in industry. With the development offinancial institutions, capital becomes more mobile, interest rate falls andinvestment increases.

iv. Promotes Economic Growth: The capital market not only reflects thegeneral condition of the economy, but also smoot hens and accelerates theprocess of economic growth. Various institutions of the capital market, like nonbank financial intermediaries, allocate the resources rationally inaccordance with the development needs of the country. The properallocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growthin the country.

A sound and efficient capital market facilitates the process of capital formation and thus contributesto economic development. Broadly capital market has two segments which are briefly discuss bellow-

A) **Industrial Security Market:**Industrial security market refers to the market for shares and bonds of the existing companies as well as the new companies. This market is further divided in to primary market and secondary market. Primary market or new issue market is the market for fresh securities issued by new and existing companies.

   The new issue market is used by the corporate houses for raising capital. Secondary market or stock exchanges are the market for second hand securities i.e., the securities which are all ready traded in the new issue market or securities which are already available in the market. The secondary market gives liquidity to the existing securities. If a company wants to trade its shares in the security market, they need to get themselves registrar with a stock exchange for listing of their securities. Securities are allowed to trade in the secondary market only after it is get listed with the stock exchange. Capital market is discussed in detail in Block-3.

B) **Government Securities Market or Gilt-edged Market:** The term gilt edged means the best quality.Government securities are called gilt edged security in the sense of liquidity and risk involved. This is the market where securities issued by central government and state governments are traded. Securities guaranteed by the government are also traded in this market.

   As a segment of capital market government securities market is very important as it provides a mechanism for management of public debt and open market operations to the Reserve Bank of India. Government securities market has a strong bearing on the formulation of the fiscal policy of the government of India and the monetary policy of the Reserve Bank of India.

   Government securities market has two segments. Treasury bill market and Government bond market. Treasury bill market (discussed in the next unit) is a source of short-term fund for the government and the government bond market is a source of long term fund for the government. Government bonds are dated securities which are floated to raise medium and long term loans in the open market. It is significant to note that it is generally the buyers in the government bonds markets are primarily institutions. Individuals are found to be reluctant to invest their funds in government bonds as it carries lower interest rate, long maturity period and high face value. Institutions like commercial banks, LICI,GIC buy government bonds to build up their asset portfolio. These institutions invest in government bonds as they are required by law to invest a minimum portion of their total fund in government securities. In the supply side RBI as a manager of the public debt operates in the government bond market. At the end of the subscription period RBI holds the stocks of unsold government bonds and keep them selling on its own account.

This is a confined market. In the year 1995 the RBI launched a system of primary dealers for expanding the government securities market. The Securities Trading Corporation of India (STCI) was established in in 1994 and was among one of the first Primary Dealers in the country. In 2006 STCI was renamed as STCI Finance Ltd.

Primary dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.

The PDs are created to promote transactions in government securities market. A facilitating arrangement is essential for selling of government securities as government is the single largest borrower in the market who borrows through the issue of its securities – treasury bills and bonds.

The RBI instructs PDs to have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation etc to ensure that they are active in supporting the trade in government securities. PDs are active in the stock market also for enhancing the trading of government securities.

The objectives of the PD system are:

i. To strengthen the infrastructure in the government securities market in order to make it vibrant, liquid and broad based.

ii. To ensure development of underwriting and market making capabilities for government securities outside the RBI so that the latter will gradually shed these functions.
iii. To improve secondary market trading system, which would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of government securities amongst a wider investor base.
iv. To make PDs an effective conduit for conducting open market operations (OMO).

Eligibility conditions

As per Reserve Bank of India following are the eligibility criterion for a primary dealer:

The following classes of institutions are eligible to apply for Primary Dealership:

i. Subsidiary of scheduled commercial bank/s and all India financial institution/s dedicated predominantly to the securities business and in particular to the government securities market.
ii. Company incorporated under the Companies Act, 1956(Now Companies Act,2013) and engaged predominantly in the securities business and in particular the government securities market.

(iii) Subsidiaries/ joint ventures set up by entities incorporated abroad under the approval of Foreign Investment Promotion Board (FIPB).

The applicant shall have net owned funds of a minimum of Rs. 50 crore. The owned funds will consist of paid-up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets. From this the aggregate of the following items will be deducted

i. accumulated balance of loss;
ii. deferred revenue expenditure; and
iii. other intangible items

Distinction Between Capital Market and Money Market

Points	Money Market	Capital Market
Participants	Major participants are financial institutions, bill brokers, money dealers, commercial banks, central bank, etc.,	Financial institutions, banks, corporate entities, foreign investors, brokers, underwriters and ordinary retail investors(individuals).
Instruments	Commercial Papers, Treasury Certificate of Deposit, Bills, Trade Credit, etc.	Equity shares, debentures, bonds and preference shares, Euro Issues, etc.
Duration	Instruments usually have a maximumtenure of one year and may even beissued for a single day.	Deals in medium and long term securities such as equity share and debentures
Risk	Money markets have low riskand are safer since the issuers mostly are the agencies of the Government and also because of the shorter duration.	Capital markets are riskier in comparison to money market because of the long duration and may be the issuing companies fail to perform as per the projection shown during issue.
Amount required	Transactions require huge sums of money and are quite expensive	Do not require a huge financial outlay. The value of units of securities is generally low i.e. Rs. 10, 100 and minimum trading lot of shares is kept small as 50 or 100 units.

Check Your Progress

Fill in the blanks:

d) The market for medium- and long-term fundsis called ——

e) Compared to money market the risk in capital market is …………

1.6.3 Foreign Exchange Market

The foreign exchange market is a market in which currencies arebought and sold against each other. In other words, foreign exchange marketis the market where the currency of one country is exchanged for thecurrency of another country. The market is an over the counter market.There is no single market place or an organized exchange (like a stockexchange) where traders meet and exchange currencies. According toKindelberger, "Foreign exchange market is a place where foreign moneyare bought and sold."Foreign exchange market is the largest financial market. Foreignexchange markets were primarily developed to facilitate settlement of debtsarising out of international trade. The largest foreign exchange market isLondon followed by New York, Tokyo, Zurich and Frankfurt. The marketsare situated throughout the different time zones of the globe in such a waythat when one market is closing the other is beginning its operations. Thus,at any point of time one market or the other is open. Therefore, it is statedthat foreign exchange market is functioning throughout 24 hours of the day.

There are two foreign exchange markets. Viz. the retail market andthe wholesale market.In the retail foreign exchange market, Retail traders buy or sellcurrency for their genuine business/personal requirements. Individuals liketourists, foreign students, patients traveling to other countries for medicaltreatment; small companies, small exporters and importers operate in theretail foreign exchange market. Money transfer companies are also majorplayers in the retail market. The wholesale foreign exchange market is alsocalled the inter-bank market. In the wholesale market Commercial banksare the market makers. This market serves to smoothen the excessivepurchases or sales made by individual banks.

It is pertinent to mention here the 'Hawala Market' extensively operating in India before economic liberalization of 1992.During pre-liberalization period RBI was strictly controlling exchange rate. This created a parallel black market of foreign exchange popularly known as 'Hawala Market'. Hawala market is nothing but illegal foreign exchange market where trading of foreign exchange take place at rate which is different from the rate prescribed by the RBI.

Functions of Foreign Exchange MarketThe foreign exchange market performs the following three functions:

a)Transfer function: The foreign exchange market transfer purchasingpower between two countries. It is the primary function of this market.Various instruments such as telegraphic transfers, bank drafts andforeign bills are used for transferring the purchasing power.

b)Credit function: Another function of foreign exchange market is to providecredit for promotion of foreign trade. Foreign exchange market providecredit by discounting bills of exchange arising out of foreign trade. Billsof exchange, with maturity period of three months, are generally usedfor international payments. Credit is required for this period in order toenable the importer to take possession of goods, sell them and obtainmoney to pay off the bill.

c) Hedging function: The third function of foreign exchange market is tohedge foreign exchange risk. The exchange rates (price of one currencyexpressed in another currency) under free market situation can go upand down. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilitieswhich are to be met in foreign currency. Through hedging, the foreignexchange market tries to protect the interest of the persons dealing inthe market from any such unforeseen changes in the exchange rate.

Dealers in Foreign Exchange Market

Following are the important dealers of foreign exchange market inIndia:

Banks: Commercial banks operate in the foreign exchange market eitherat retail level for individual exporters and corporations or at wholesalelevel in the interbank market. The banks dealing in foreign exchangemaintain substantial foreign currency balances to serve the need of thecustomers. These banks discount and sell foreign bills of exchange,issue bank draft, make transfer etc.

Central Bank: Central banks of the country intervene in the foreign exchange market in order to maintain the exchange rate within a certainrange. The central banks also execute the policies of the government.

Brokers: In the foreign exchange market banks do not deal directlywith each other. The brokers bring together the buyers and sellers offoreign exchange. If a bank wants to buy or sell foreign exchange, itinforms the broker the amount. If the broker succeeds in carrying outthe transaction, he receives a commission from the selling bank.

Acceptance Houses: Acceptance houses also operate in foreignexchange market. They accept bills on behalf of their customers andhelps in foreign remittance.

Check Your Progress

f) In which year RBI launched the system of primary dealers for expanding the government securities market.
g) Who is the market maker of wholesale foreign exchange market? Commercial banks

1.6.4 Derivatives Market

Derivative market is the market for derivative instruments/contracts like future, forward etc. A derivative is a financial instrument whose value is derived from an underlying asset or group ofassets. They are a contract between two or more parties. The value of this contract depends on changes in thevalue of the asset that the derivative's value is derived from.The underlier can come in many forms including, commodities, mortgages, stocks, bonds, or currency.

Derivatives can either be exchange-traded or traded over the counter (OTC).Exchange refers to the formally established stock exchange wherein securities are traded and have a defined set of rules for the participants.Whereas OTC is a dealer-oriented market of securities, which is an unorganized market where trading happens by way of phone, emails, etc.Derivatives traded on the exchange are standardized and regulated.On the other hand, OTC derivative constitutes a greater proportion of derivatives contracts, but it carries higher counterpart risk and is unregulated.Exchange traded derivative markets have better price transparency than OTCmarkets.derivative trades in OTC markets are bilateral in nature. All contract terms suchas delivery quality, quantity, location, date and prices are negotiable between the two parties.Transactions can be arranged by telephone or other communication means. Prices are notreported publicly.

Basic Derivative Instruments

The three basic kinds of derivative securities are forwards and futures; swaps; and options.

Forwards

A forward contract is one in which two parties (referred to as the "counterparties" to the transaction) commit to the terms of a specified trade to be carried out on a specified date in the future. Forward contracts are bilateral or "over the counter" (OTC) contracts, i.e., they are negotiated directly between buyer and seller. On the positive side, this means they are customizable in terms of the maturity date, the specific quality (grade) to be delivered, etc. On the other hand, each party also takes on the risk of the other counterparty's default.

Futures

A futures contract is, in essence, a forward contract that is traded on an organized exchange rather than negotiated bilaterally. Futures contracts grew out of forward contracts in the mid-19th century. Futures contract terms (maturity dates, deliverable grade of the underlying,etc.) are standardized, and the exchange guarantees performance on the contract. Participantsin futures markets are required to post "margin," which is essentially collateral against default.

Swaps

Swaps, like forwards, are over-the-counter contracts. In a forward, the two counterparties commit to a single trade or single exchange of cash flows. In a swap, the counterparties commit to multiple exchanges of cash flows over several dates in the future.1 Swaps are most common in the interest-rate derivatives market, where the typical contract has the parties exchanging oneinterest index for another computed on a given notional principal amount. (For example, onecounterparty in the swap may make floating-rate payments indexed to Libor, while the othermakes fixed-rate payments on the same principal amount.) They are also popular in the currencymarket, where the swap involves an exchange of principal and currency in one exchange forprincipal and currency in another.

Options

An option is a financial security that gives the holder the right, but not the obligation, to take part in a specified trade. There are two basic kinds of options (and a great many variants onthese structures). In a call option, the holder of the option has the right, but not the obligation,

to buy the specified underlying asset at a price specified in the contract (called the "strike price").In a put option, the holder of the option has the right to sell the underlying asset at the specifiedstrike price.The holder of the option is also variously referred to as the long position in the option or thebuyer of the option. The other counterparty in option trade—who has an obligation to take partin the trade if the option buyer should decide to exercise his right—is called the seller or writer of the option or the short position in the option. In exchange for providing the option holder withoptionality concerning the trade, the option writer receives an up-front fee called the option priceor the option premium.Options trade both on organized exchanges and in the over-the-counter (OTC) market.Exchange-traded options exist on equities, equity indices, currencies, and interest rates and bonds,among others. Exchange-traded options are standardized in terms of expiry dates and strike prices.OTC options are customizable and exhibit a great deal more variety.Credit Derivatives Credit derivatives are derivatives written on the credit risk of an underlyingreference entity. By far the most popular form of credit derivative is the credit default swap orCDS. Akin to insurance against default, a CDS references a specific credit obligation issued by aspecified entity (for example, a specific bond issued by Ford Motor Company). One counterpartyin the CDS contract (the "buyer of protection") makes a regular periodic payment to the othercounterparty (the "seller of protection"); in exchange the protection seller agrees to pay theprotection buyer any loss in value on the specified reference obligation if a "credit event" (e.g.,default) were to occur during the life of the CDS contract.

Functions/Needs of Derivative Market

Derivative contracts may be employed to satisfy a variety of needs and it performs various functions

i. **Transfer/Hedging of Risk**: This is the most important use of derivative which helps in transferring risk from risk-averse people to a risk-seeking investor. The risk-seeking investor can enter into a risky contrarian trade to gain short-term profits. While the risk-averse investor can enhance the safety of their position by entering into a derivative contract.

   Derivative contracts help in hedging risk against unfavourable price movements of an underlying asset. By entering into a forward contract, the buyer and seller agrees to complete the deal at a pre-decided price at some specific date in the future. Any unexpected price hikes or drop will not influence the contract value, thereby providing protection against these types of risks.

ii. **Price Discovery**: Derivative market serves as an important source of information about prices. Prices of derivative instruments such as futures and forwards can be used to determine what the market expects future spot prices to be. In most cases, the information is accurate and reliable. Thus, the futures and forwards markets are especially helpful in future as well as currentprice discovery mechanism.
iii. **Linked to cash markets:** Derivatives, due to their inherent nature,are linked to the underlying cash markets. With the introduction ofderivatives, the underlying market witnesses higher trading volumes becauseof participation by more players who would not otherwise participate for lackof an arrangement to transfer risk.
iv. **Check on speculation:** Speculation traders shift to a more controlledenvironment of the derivatives market. In the absence of an organisedderivatives market, speculators trade in the underlying cash markets.Managing, monitoring and surveillance of the activities of variousparticipants become extremely difficult in these kinds of mixed markets.

Participants in the Derivative Market

Hedgers

In investment decisions the investor always try to transfer the risk from one party to another. Hedge is a position taken for the purpose of reducing exposer to risk. Hedging is a market mechanism by which an investor protects erosion of asset value due to an adverse price movement. Hedgers therefore, use derivatives especially during market volatility.A hedger uses futures markets to reduce risk causedby the movements in prices of securities, commodities, exchange rates,interest rates, indices, etc. As such, a hedger will take a position in futuresmarket that is opposite a risk to which he or she is exposed.

Speculators

Speculators, in a way are the exact opposite of hedgers. Rather They are extremely high-risk seekers who anticipate future price movement in the hope of making large and quick gains. The motive here is to take maximum advantage of the price fluctuations. They play a very key role in the market by absorbing excess risk and also provide much-needed liquidity in the market when normal investors do not participate.

Speculators usually trade in the futures markets to earn profit on the basis ofdifference in spot and futures prices of the underlying assets. Hedgers use thefutures markets for avoiding exposure to adverse movements in the price ofan asset, whereas the speculators wish to take position in the market basedupon such expected movements in the price of that asset.

Arbitrageurs

Arbitrageurs are another important group ofparticipants in futures markets. They take advantage of price differential oftwo markets. An arbitrageur is a trader who attempts to make profits bylocking in a riskless trading by simultaneously entering into transactions intwo or more markets. The arbitrage opportunities available in the different markets usuallydo not last long because of heavy transactions by the arbitrageurs where suchopportunity arises.

1.6.5 Over-the-Counter Market

OTC markets are electronic networks that allow two parties to trade with each other using dealer-broker as a middleman.In Over-the-Counter (OTC) market trading of securities between two counterparties executed outside the formal stock exchange. Companies that list their securities on over-the-counter markets may not meet the requirements for listing on an exchange, and therefore turn to this alternative market to raise capital. Stocks that are traded over-the-counter usually belong to small companies that lack the resources to be listed on formal exchanges. However, stocks of many big companies are also traded over-the-counter.In OTC market prices of the securities/products are not always published to the public.

Financial products traded in OTC market include stocks, debt securities, commodities and derivatives. Derivatives represent a substantial part of over-the-counter trading, which is especially crucial in hedging risks using derivatives.Most OTC trading happens at two primary networks: OTC Markets Group and Over-the-Counter Bulletin Board (OTCBB).

The typical trading process in an OTC market is as under:

1. An investor opens an account at a brokerage firm, which is needed to execute trades in an OTC market.
2. The investor chooses a security to buy from one of the major OTC markets.
3. The investor places either a limit order or a market order. A limit order allows the investor to state the exact price they're willing to trade a security for, while a market order instructs the broker-dealer to execute the trade immediately at the best price.
4. The broker-dealer facilitates the order, either internally from its own trading accounts or externally with another broker-dealer.
5. The broker-dealer confirms the trade with the investor, and settles the trade by delivering the funds and securities to the appropriate parties.

Check Your Progress

h) Name two participants in the derivative market.
i) What is mean by OTC market?
j) What is derivative?

1.7 SUMMING UP

In this unit we come to know the following:

- The primary function of the financial markets is to facilitate the transfer of funds from surplus sector(lenders) to deficit sector(borrowers).
- Besides money market and capital market are the main markets of the financial market, there are different other markets in financial market.
- Money Market is that segment of the financial market where borrowing and lending of short-term funds take place.
- Capital market is the market for medium and long term funds.
- Capital market has two segments-Industrial securities market and Government securities market.
- Industrial securities markethas two segments- primary market and secondary market.
- The foreign exchange market is a market in which currencies arebought and sold against each other.
- Derivative market is the market for derivative instruments/contracts like future, forward etc. A derivative is a financial instrument whose value is derived from an underlying asset or group ofassets.

- In Over-the-Counter (OTC) market trading of securities between two counterparties executed outside the formal stock exchange.

1.8 REFERENCES AND SUGGESTED READINGS(including possible links to online & e-contents sources)

1. Bharati V Pathak, *The Indian financial system*. New Delhi: Pearson.
2. JaydebSarkhel and Seikh Salim,*Indian financial system*. McGraw Hill India

1.9 Model Questions

Q.No.1. What is financial market? Discuss the functions performed by financial market.

Q.No.2. Explain the concept of capital market.

Q.No.3Explain the concept of money market.

Q.No.4Define foreign exchange market. Also discuss the dealers in the foreign exchange market.

Q.No.5 What is derivative? Discuss different types of derivative instruments.

Q.No.6Write a note on OTC market.

1.10 Answer to check your progress

Ans to Q No. a. Equity

Ans to Q No. b. Money market

Ans to Q No. c. Financial market

Ans to Q No. d. Capital market

Ans to Q No. e. High

Ans to Q No. f. 1995

Ans to Q No. g. Commercial bank

Ans to Q No. h. Hedgers and Speculators.

Ans to Q No. i. OTC markets are electronic networks that allow two parties to trade with each other using dealer-broker as a middleman.

Ans to Q No. j. A derivative is a financial instrument whose value is derived from an underlying asset or group ofassets.

BLOCK II : UNIT-2

Structure of Money Market; Money Market and Reserve Bank of India

Unit Structure:

2.1 LEARNING OBJECTIVES

After going through this unit the learners will able to:

- State the meaning and functions of money market
- Interpret features of developed money market
- Enumerate the components and structure of money market
- Explain the structure and functions of Indian money market
- Discuss the characteristics and defects of Indian money market
- Enumerate the recent trends and development of Indian money market

2.2 INTRODUCTION

Financial market deals in financial instruments (securities) and financial services. Financial markets are classified into two, namely, money market and capital market**.** Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. This unit will discuss the meaning, characteristics, constituents, functions and instruments of money market. It will also discuss about the recent trends of Indian Money market as well as the importance of a developed money market in the economy.

2.3 MEANING AND DEFINITIONS MONEY MARKET

Money market is a very important segment of financial market. It is a market for short term funds. Monetary assets of short-term nature with maturity period up to one year and financial assets that are close substitutes for money are dealt in the Money Market. Money Market
instruments have the characteristics of - liquidity, minimum transaction cost and no loss in value.

It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitute of money. These instruments help the business units, other organisations and the Government to borrow the funds to meet their short-term requirement.

Money Market enables suppliers and users of short-term funds to fulfill their investments and borrowings requirements respectively.It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity, surplusesand deficits. The process of money market enables the central bank to administer its monetary policy. The Money Market is one of theprimary mechanism through which the Central Bank (RBI) influences liquidity and the general level of interestrates in an economy.

This is a market for borrowing and lending of short-term fund. Money market does not imply to any specific market place. Rather it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to borrowers. Most of the money market transactions are taken place on telephone, fax or Internet. The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the leader of the money market in India. Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC, GIC, UTI, etc. also operate in the Indian money market.

According to Crowther, *"Money market is a collective name given to various firms and institutions that deal in the various grades of near money*". Money market is not a place. It is an activity. It includes all organizations and institutions that deal in short term financial instruments. However, sometimes geographical names are given to the money market according to the location, e.g. Mumbai Money Market.

2.4 FEATURES OF MONEY MARKET

Following are some important features of Money Market:

1. The Money Market is a wholesale market where the volumes of transactions is very large and is settled on adaily basis.
2. Money market comprises of various sub markets like call money, treasury bill, commercial bill etc. and each market is concerned to deal in particular type of asset. All the sub markets in money market are closely interlinked.
3. Trading in the Money Market is conducted over the telephone, followed by written confirmationthrough e-mails, texts from the borrowers and lenders.
4. There are a large number of participants in the Money Market such as commercial banks, mutual funds, investmentinstitutions, financial institutions and finally the Reserve Bank of India.
5. The Central Bank occupies a strategic position in the Money Market. The Money Market can obtain funds from the central bank either by borrowing or through sale of securities. The central bank influences liquidity and interest rates by open market operations, REPO transactions changes in Bank Rate, Cash Reserve Requirements and by regulating access to its accommodation.
6. Indian money market has a dichotomic structure consisting both organised money market and un organise money market. The organised money market consist of commercial banks and other financial institutions controlled by RBI. The unorganised sector consist of indigenous bankers, moneylenders etc. who remains outside the control of RBI.
7. In Indian money market demand for fund is seasonal. Being an agricultural economy, during the harvesting season (October to April) demand for fund is high.
8. In Indian money market the supply of instruments such as commercial bills, treasury bills, certificates of deposits etc. is limited.

9. A well-developed Money Marketcontributes to an effective implementation of the monetary policy.

2.5 IMPORTANCE OF MONEY MARKET

Money market plays an important role in an economy. It makes necessary provisions for suppling short term funds in the economy. A developed money market helps in smooth functioning of the financial system in any economy in the following ways:

1. Development of Trade and Industry: Money market is an important source of finance to trade and industry. Money market finances the working capital requirements of trade and industry through bills, commercial papers etc.

2. Development of Capital Market: Availability funds in the money market and interest rates in the money market influencesupply of funds in the capital market. Hence, the development of capital market depends upon the existence of a developed money market.

3. Helpful for Commercial Banks: Money market helps commercial banks for investing their surplus funds in easily realisable assets. The banks get back the funds quickly in times of need. This facility is provided by money market. Further, the money market enables commercial banks to meet the statutory requirements of CRR and SLR.

4. Helpful to Central Bank: Money market helps the central bank in effectively implementation of its monetary policy. The central bank influences liquidity and interest rates by open market operations, REPO transactions changes in Bank Rate, Cash Reserve Requirements and by regulating access to its accommodation.

5. Formulation of Suitable Monetary Policy: Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the central bank in formulating and revising the monetary policy.

2.6 CHARACTERISTICS OF A DEVELOPED MONEY MARKET

Some of them are highly developed while others are not well developed. A well developed and efficient money market is necessary for the development of any economy. The following are the characteristics or prerequisites of a developed and efficient money market:

1. Highly Developed Commercial Banking System: Commercial banks are the centre of the whole short term funds. They serve as a vital link between the central bank and the various segments of the money market. When the commercial banking system is developed or organized, the money market will be developed.

2. Presence of a strong Central Bank: In a developed money market, there always exists a central bank. The central bank is necessary for direction and control of money market. Central bank absorbs surplus cash during off-seasons and provides additional funds in busy seasons. This is done through open market operations. Being the bankers' bank, central bank keeps the reserves of commercial banks and provides them financial accommodation in times of need. If the central bank cannot influence the money market it means the money market is not developed. In short, without the support of a central bank a money market cannot function.

3. Existence of Sub-markets: Money market is a group of various sub-markets. Each sub market deals in instruments of varied maturities. There should be large number of sub-markets. The larger the number of sub markets, the broader and more developed will be the structure of money market. Besides, the sub-market must be interrelated and integrated with each other. If there is no co-ordination and integration among them, different interest rates will prevail in the submarkets.

4. Availability of Credit Instruments: The continuous availability of readily acceptable negotiable securities (near money assets) is necessary for the existence of a developed money market. In addition to variety of instruments or securities, there should be a number of dealers (participants) in the money market to transact in these securities. It is the dealers in securities who actually infuse life into the money market.

5. **Existence of Secondary Market**: There should be active secondary market in these credit instruments. The success of money market always depends on the secondary market. If the secondary market develops, then there will be active trading of the instruments.

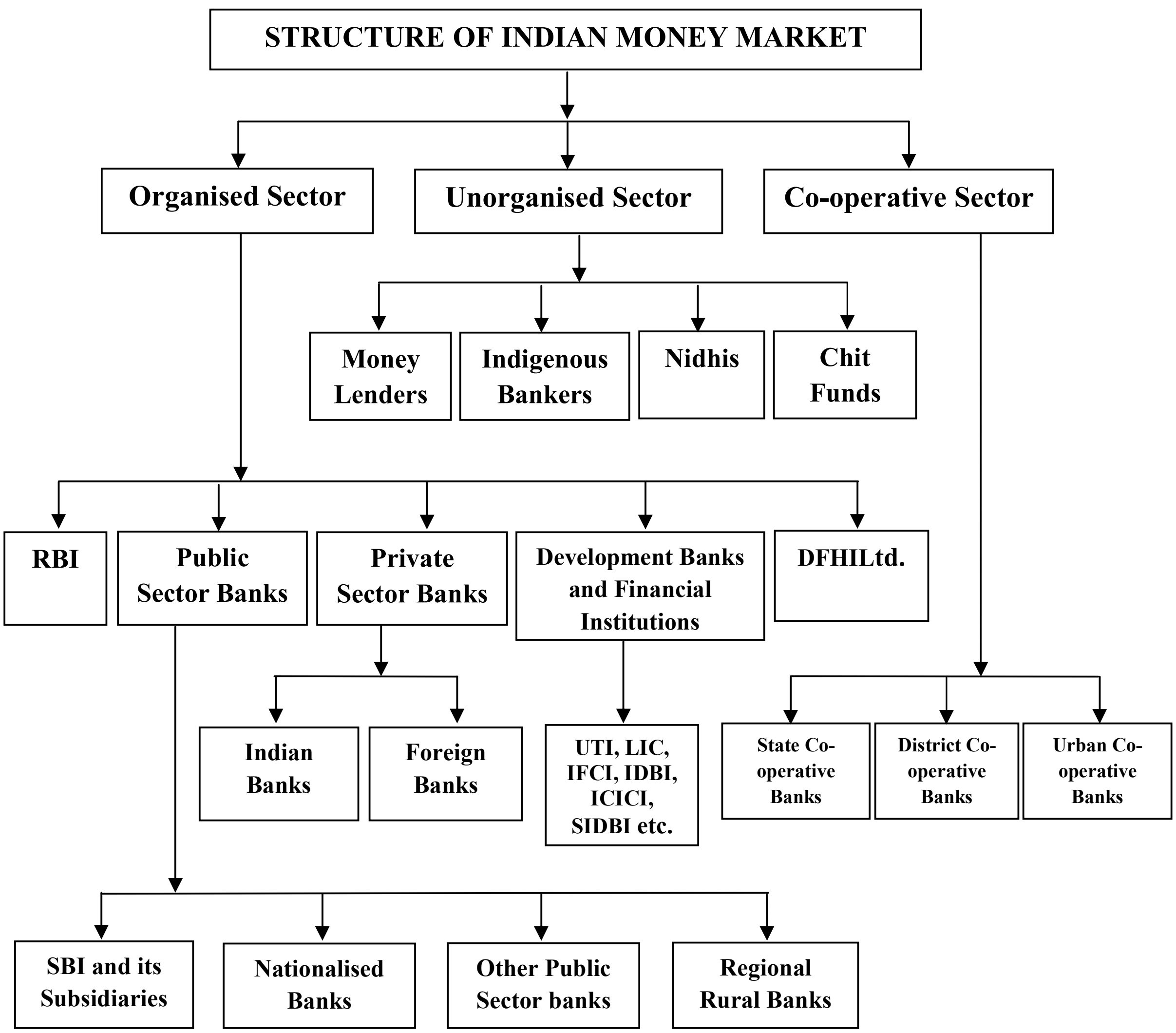
6. **Availability of Ample Resources**: There must be availability of sufficient funds to finance transactions in the sub markets. These funds may come from within the country and outside the country. Under developed money markets do not have ample funds. Thus availability of sufficient funds is essential for the smooth and efficient functioning of the money market.

7. **Demand and Supply of Funds:** Money market should have a large demand and supply of funds. This depends upon the number of participants and also the government policies in encouraging the investments in various sectors and monetary policy of RBI.

8. **Other Factors:** There are some other factors that also contribute to the development of a money market. These factors include industrial development, volume of international trade, political stability, trade cycles, foreign investment, price stabilization etc.

2.7 STRUCTURE OF INDIAN MONEY MARKET

In the Indian money market RBI occupies a key role. It is the nerve centre of the monetary system of our country. It is the leader of the Indian money market. The Indian money market is highly disintegrated and unorganized. The Indian money market can be divided into two sectors-unorganized and organised. In between these two, there exists the co-operative sector. It can be included in the organised sector.



The organized sector of Indian Money Market comes under the control of RBI. This sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions. The unorganised sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI. This is one of the primary reason why Indian money market remains underdeveloped. In the unorganized sector interest rates are much higher than that in the organized segment.

2.8 UNORGANISED SECTOR OF INDIAN MONEY MARKET

The unorganised sector of the money market is largely made up of indigenous bankers, money lenders, traders, commission agents etc., some of whom combine money lending with trade and other activities and some are purely engaged with money lending activity. Following are some players operating in the unorganized sector of Indian Money Market.

A. **Indigenous Bankers:** Indigenous bankers include those individuals and private firms which are engaged in receiving deposits and giving loans. Their activities are not at all regulated. Though with the growth of modern banking indigenous bankers received a setback but even today also it serves a huge population of India and occupy an important place in the Indian money market and play a vital role in financing domestic trade. According to Central Banking Enquiry Committee an indigenous banker is an individual or private firm which receives deposits, deals in hundis or engages itself in lending money. Indigenous bankers are classified into three main groups, i.e., (i) those who deals only in banking business; (ii) those who combine banking business with trade; and (iii) those who mainly associated with trade and also have limited banking business. They are known in different names in different parts of the country like Sahukars, Mahajans, Shroffs, Marwaris, Chettys etc. Gujarati Shroffs are mostly operating in Mumbai, Kolkata and in industrial and trading cities of Gujarat. The Multani or Shikarpuri Shroffs are operating mainly in Mumbai and Chennai. The Chettiars are mostly found in the South. The Marwari are mostly active in Mumbai, Kolkata, tea gardens of Assam and also in different other parts of North-East India. indigenous bankers are different from moneylenders in the sense that moneylender only lends money from his own fund but the indigenous banker lend money and also accept deposit from public.

   The indigenous bankers charge high rate of interest and they are not influenced by any policy of the Reserve Bank of India.

B. **Moneylenders:** Moneylenders advanced loans to small borrowers like marginal and small farmers, agricultural labourers, artisans, factory and mine workers, low paid staffs, small traders etc. at very high rates of interest and also adopt various malpractices for manipulating loan records of these poor borrowers. The area of operation of the moneylenders is very much localised and their methods of operation is also not uniform. Broadly there are three types of moneylenders- (i) Professional moneylenders dealing solely with money lending; (ii) Itinerant moneylenders such as Kabulis and Pathans and (iii) Non-professional moneylenders.

2.9 PARTICIPANTS IN THE ORGANIZED SECTOR OF INDIAN MONEY MARKET

As we already discuss, Indian money market consist of two segments-organized sector and the unorganized sector. The organized sector consists of various financial/non-financial institutions. This sector is controlled by the central bank i.e. the Reserve Bank of India. Following are someinstitutions operates in organized sector of Indian money market-

A. **Reserve Bank of India:**Reserve Bank of India (RBI) is the central bank of India and most important participant of the money market. The RBI implements and monitors the monetary policy and ensures price stability while keeping in mind the objective of economic growth of the country. It regulates the activities and institutions in the money market.

   It comes under the management of the Ministry of Finance, Government of India. RBI is responsible for the issue, control, and maintaining the supply of the Indian currency, the rupee. The RBI manages the foreign exchange reserves of India.

B. **Schedule Commercial Banks:**Scheduled banks are those listed in Schedule II of the Reserve Bank of India Act of 1934 and constitute the majority of banks operating under the central bank. As per the rules, the bank's paid-up capital and raised funds must be at least Rs. 5 lakh. Scheduled Commercial Banks (SCBs) form the core of India's banking system, providing a wide array of financial services to individuals, businesses, and the government. The structure of SCBs in India is intricate, encompassing various layers, components, and functions.

Scheduled Public Sector Banks are the banks in which the government of India owns more than 50% of the stock. As of 2022, there are 12 public sector banks, but there were once 27 banks that have now been merged.

Scheduled Private Sector Banks are the banks in which private entities have the most stake. There are 21 private sector banks in operating in India. In India, there are 45 foreign banks. Foreign banks are which are established in some other country having business in India. Such foreign banks must abide by the rules and regulations of both their home and host countries.

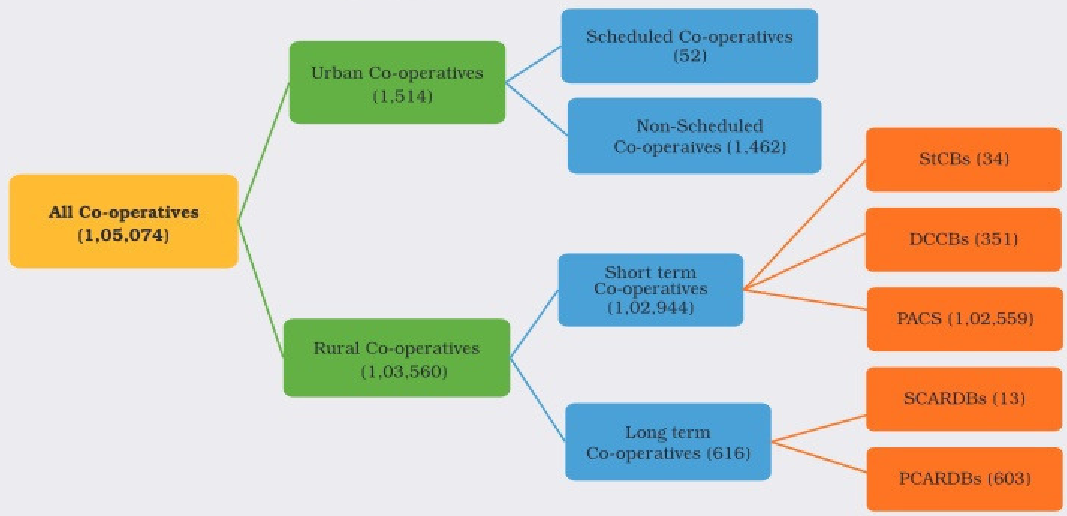
C. **Co-operative Banks:** A Co-operative Bank is a Co-operative Society registered under the States Cooperative Societies Act. The Co-operative banks are also regulated by the Reserve Bank of India (RBI) and governed by the Banking Regulations Act 1949, The Banking Laws (Application to Co-operative Societies) Act, 1965.

Co-operative banks play an important role in meeting the credit requirements of both the urban and rural India. Though in the bank dominated financial system, these institutions account for a small share in the total credit they hold a significant position in credit delivery as they cater to different geographic locations and demographic categories. The wide network of co-operative banks, both rural and urban, supplements the commercial banking network for deepening financial intermediation by bringing a large number of depositors/borrowers under the formal banking network. Demographically, these institutions have enabled access to financial services to low and middle-income groups in both rural and urban areas.

These institutions can be classified into two broad categories- urban and rural. Rural or agricultural credit institutions dominate the entire cooperative credit structure. Rural cooperative institutions are further divided into short-term agricultural credit institutions and long-term agricultural credit institutions. The short-term agricultural credit institutions which cater to the short-term financial needs of agriculturists have three-tier federal structure- (a) at the apex, there is the state cooperative bank in each state; (b) at the district level, there are central cooperative banks; (c) at the village level, there are primary agricultural credit societies.

Long-term agricultural credit is provided by the land development banks. The whole structure of cooperative credit institutions is shown in the chart given.

Structure of Co-operative Banks



Notes: 1. StCBs: State Co-operative Banks; DCCBs: District Central Co-operative Banks; PACS: Primary Agricultural Credit Societies; SCARDBs: State Co-operative Agriculture and Rural Development Banks; PCARDBs: Primary Co-operative Agriculture and Rural Development Banks.
2. Figures in parentheses indicate the number of institutions at end-March 2022 for UCBs and at end-March 2021 for rural co-operatives.
3. DCCBs excluding Tamil Nadu Industrial Co-operative Bank Ltd.

Source: RBI, NABARD and NAFSCOB.

D. Corporate: Corporate houses are very important participants of money market and plays very vital role by creating demand of funds from the banks. Corporate houses issue commercial papers for raising short term funds from the money market. They also accept public deposit and indulge in inter-corporate deposit and investment.

E. Mutual Funds: Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities. It acts as financial intermediaries who collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. It serves as a links between the investors and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns.

Money market mutual fund is set up to invest exclusively in short term money markets instruments like treasury bills, commercial paper, certificate of deposits, etc. The main objective of this fund is generation of income and provides easy liquidity. A money market fund invests in a pool of short-term, interest-bearing securities. Money market funds are most appropriate in situations where you seek to preserve the value of your investment while still earning income. After the remarkable success of mutual funds set up by the banks and financial institutions in India, the Reserve Bank of India (RBI) permitted the establishment of the Money Market Mutual Funds (MMMF) in the year 1992. The basic idea is the deployment of mutual funds' surplus funds in the money market. MMMF ensures high liquidity, adequate surety and high returns. What distinguishes the money market mutual funds from the existing mutual funds is the difference in their investment portfolios. A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments, whereas, a mutual fund largely invests in capital market securities and "parks" its surplus funds in money market instruments for short period.

F. **Insurance Companies:** Both general and life insurance companies are usual lenders in the money market. With the introduction of CBLO (Collateralized Borrowing and Lending Obligations), they have become important investors in the money market. Being cash surplus entities, they do not borrow in the money market. In between capital market instruments and money market instruments, insurance companies invest more in capital market instruments.

G. **Discount and Finance House in India(DFHI):** The DFHI equilibrated the surplus of fund and the deficit amounts of the banks. The DFHI helps in lending and borrowing of funds to the different banks as well as financial institutions. The DFHI was setup jointly by the Reserve Bank of India, public sector banks and financial institutions in the year 1988 as a sequel to Vaghul Working Group recommendations to impart liquidity to money market instruments and help the development of a secondary market in such instruments.

   DFHI since its inception has been actively trading in all the money market instruments (viz. call/notice/term money, commercial bills, treasury bills, certificates of deposit and commercial paper) and its business turnover has grown progressively over the years. With effect from the year 1992-93, DFHI has been authorised to deal in dated Government securities also. In 2004, the Reserve Bank of India (RBI) transferred its total holding to SBI Giltz Limited. Its new name is SBI DFHI. Following are the Objectives of DFHI:

i. to even out the liquidity imbalances in the banking system i.e. to balance the demand with the supply for short term finance in the money market.

ii. to promote secondary market in short term money market instruments i.e. to be an active trader in money market instruments rather than a mere repository, and thereby, impart improved liquidity to short term money market instruments.
iii. to integrate markets at regional centres with the main market at Mumbai, through its network.
iv. Provide safe and risk-free short-term investment avenues to institutions; DFHI being an institution promoted by the public sector banks/financial institutions and RBI, enjoys excellent credit rating in the market.
v. Provide greater liquidity to money market instruments.
vi. Facilitate money market transactions for small and medium sized institutions who are not regular participants in the market.
vii. DFHI provides the 'Constituent SGL' Account facility which enables even those entities which otherwise do not have an SGL Account facility with the RBI to reap the full benefits of investing in government securities.

2.10 DEFECTS OF INDIAN MONEY MARKET

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. The defects of the Indian money market are as follows:

1. **Existence of Un-organised Segment**: The most important defect of the Indian money market is the existence of un-organised segment. The un-organised segment comprises of indigenous bankers, money lenders etc. This un-organised sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the un-organised market.
2. **Lack of Integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. Unfortunately, these sections are loosely connected to each other. There is no co-ordination between the organised and un-organised sectors. With the setting up of the RBI and the passing of the Banking Regulations Act, the conditions have improved.
3. **Disparities in Interest Rates**: Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For example, borrowing

4. rates of government lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions. This disparity in interest rates is due to lack of mobility of funds from one segment to another.
5. **Seasonal Diversity of Money Market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.
6. **Absence of Organized Bill Market:** A bill market refers to a mechanism where bills of exchange are purchased and discounted by banks in India. A bill market provides short term funds to businessmen. The bill market in India is not popular due to over dependence of cash transactions, high discounting rates, problem of dishonour of bills etc. The bill market in India is not well developed. There is a great paucity of sound commercial bills of exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.
7. **Shortage of Funds:** In Indian money market demand for funds exceeds the supply. There is shortage of funds in Indian money market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc. There is also vast amount of black money in the country which has caused shortage of funds. However, in recent years' development of banking has improved the mobilisation of funds to some extent.
8. **Inadequate Banking Facilities**: Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are not covered due to poverty. Their savings are very small and mobilisation of small savings is difficult. The involvement of banking system in different scams and the failure of RBI to prevent these abuses of banking system shows that Indian banking system is not yet a well organised sector.
9. **Inefficient and Corrupt Management**: One of the major problems of Indian money market is its inefficient and corrupt management. Inefficiency is due to faulty selection, lack of training, poor performance appraisal, faulty promotions etc. For the growth and success of money market, there is need for well trained and dedicated workforce in banks. However, in India some of the bank officials are inefficient and corrupt.

10. **Limited Instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.
11. **Limited Number of Participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.
12. **Restricted Secondary Market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.
13. **No Contact with Foreign Money Markets**: Indian money market has little contract with money markets in other countries.

2.11 MEASURES TAKEN BY RBI FOR DEVELOPMENT OF INDIAN MONEY MARKET

The Reserve Bank of India (RBI) has taken several measures over the years to promote the development and efficiency of the money market in India. These measures are aimed at enhancing liquidity, improving market infrastructure, ensuring transparency, and facilitating better price discovery. Here are some of the key measures taken by the RBI for the development of the money market:

1. **Introduction of Treasury Bills (T-Bills):** In the 1970s, the RBI introduced T-Bills as short-term government securities to provide a risk-free instrument for investors and a tool for the government to manage its short-term borrowing requirements.
2. **Development of Call Money Market:** The RBI facilitated the development of the call money market, providing a platform for banks to borrow and lend short-term funds to meet liquidity needs. It introduced the system of daily reporting of call/notice money market transactions.
3. **Development of Certificate of Deposit (CD) Market:** In the 1980s, the RBI introduced CDs, allowing banks to raise funds through unsecured instruments. This step helped diversify banks' sources of funds.
4. **Promotion of Commercial Paper (CP):** In 1989, the RBI permitted the issuance of CP by eligible corporations, further broadening the range of money market instruments.
5. **Introduction of Repo and Reverse Repo:** The RBI introduced the repo (repurchase agreement) and reverse repo mechanisms to provide a reliable avenue for short-term

borrowing and lending of funds. These operations help manage liquidity and influence short-term interest rates.

6. **Liberalization of Interest Rates:** The 1990s marked a period of liberalization of interest rates in India. The RBI has progressively moved toward a more market-determined interest rate regime. It has allowed greater flexibility in interest rate setting for money market instruments, promoting competition and efficiency.
7. **Secondary Market Development:** The RBI has taken steps to develop a vibrant secondary market for money market instruments such as treasury bills, commercial paper, and certificates of deposit. This encourages trading and liquidity in these instruments.
8. **Open Market Operations (OMO):** The RBI conducts OMOs to buy and sell government securities in the secondary market. These operations are used to manage liquidity conditions and influence interest rates.
9. **Market Stabilization Scheme (MSS):** The RBI introduced the MSS to manage excess liquidity arising from capital inflows, especially foreign exchange inflows. It involves the issuance of government securities to absorb surplus funds.
10. **Regulatory Framework:** The RBI has put in place a comprehensive regulatory framework for money market instruments. It prescribes guidelines for the issuance, trading, and reporting of these instruments, ensuring transparency and market integrity. The RBI has continuously updated and enhanced the regulatory framework for money market instruments, ensuring transparency and market integrity. It introduced guidelines for Commercial Paper (CP) in 2017 and for T-Bills in 2020.
11. **Encouraging Money Market Mutual Funds:** The RBI has encouraged the establishment and growth of money market mutual funds (MMMFs). These funds provide retail investors with access to the money market.
12. **Financial Inclusion Initiatives:** The RBI has promoted financial inclusion by encouraging banks to extend their reach into rural and underserved areas. This widens the participation in the money market.
13. **Development of Government Securities Market:** The government securities market was developed further, and the RBI introduced reforms like the negotiated dealing system (NDS) to facilitate electronic trading and settlement of government securities.
14. **Treasury Bill Reforms:** The RBI introduced several reforms in the Treasury Bill (T-Bill) market, including the introduction of 364-day T-Bills, increasing the auction frequency, and allowing non-competitive bidding.

15. **Technology Integration:** The RBI has encouraged the use of technology for trading, settlement, and reporting of money market instruments. This enhances efficiency and reduces operational risks.
16. **Financial Inclusion Initiatives:** The RBI promoted financial inclusion by encouraging banks to extend their reach into rural and underserved areas, widening the participation in the money market.
17. **Liquidity Adjustment Facility (LAF):**The LAF, introduced in 2000, allows banks to borrow or lend funds on an overnight basis, helping them manage their liquidity requirements effectively.
18. **Credit Default Swaps (CDS):** In 2011, the RBI permitted the introduction of CDS in the money market, providing a risk management tool for market participants. The RBI has permitted the trading of credit default swaps in the money market.
19. **Marginal Standing Facility (MSF):** Introduced in 2011, the MSF allowed banks to borrow from the RBI against eligible securities at a penal rate. It provided banks with a means to meet their overnight borrowing needs during emergencies.
20. **Market Surveillance and Oversight:** The RBI conducts regular market surveillance to detect irregularities or market manipulation. It takes prompt action against entities found in violation of regulations.
21. **Communication:** The RBI maintains open communication with market participants, issuing guidelines and notifications to provide clarity on regulatory and operational matters.

These measures collectively aim to foster a well-functioning, efficient, and transparent money market in India. They support the broader monetary policy objectives of the RBI and contribute to the stability and growth of the financial system.

2.12 RBI COMMITTEES / WORKING GROUPS ON MONEY MARKET

The Reserve Bank of India (RBI) has formed various committees and working groups over the years to review and make recommendations on different aspects of the money market in India. These committees have played a vital role in shaping the policies and regulations governing the money market. Here are some prominent RBI committees related to the money market:

- **Chakravarty Committee (1985):** This committee was set up to review the functioning of the money market and recommend measures to improve its efficiency. The committee recommended the development of a more active secondary market for government securities, the introduction of new instruments such as commercial paper and certificates of deposit, and the strengthening of the regulatory framework for the money market.
- **Narasimham Committee-I (1991):** TheNarasimham Committee-I was established in 1991 by FM Manmohan Singh to examine the functioning of banks. In August 1991, a nine-member committee was appointed to suggest reforms to the financial system. The committee submitted its recommendations and the report in December 1991 to the Parliament.
- **Narasimham Committee-II (1998):**In 1998, the Narasimham Committee-II was formed by Finance Minister P Chidambaram to intimate on the banking sector reforms**.** The committee submitted its recommendations to the government in April 1998. The government undertook the report and recommendations as it emphasized more human resource development, technological upgradation, and strengthening of the foundation of the banking system by structure, which was the need of the hour.
- **Working Group on Money Market (1986):** Reserve Bank of India set up a Working Group under the chairmanship of Mr. N. Vaghul in the year 1986 to examine the possibilities of enlarging the scope of Indian money market and to recommend specific measures for evolving other suitable money market instruments.

The Working Group submitted its Report in January, 1987. It has made a number of recommendations for activating and developing the Indian money market.

Some Important recommendations are as follows:

(i) Measures should be taken to improve the operation of the call money market,

(ii) Rediscounting market should be developed with a view to facilitating the emergence of genuine bill culture in the country.

(iii) A short-term commercial paper should be introduced.

(iv) An active secondary market for Government paper, especially a '182 days Treasury Bill' Refinance facility, should be developed.

(v) A Finance House should be set up to deal in short-term money market instruments.

(vi) Banks and private non-bank financial institutions should be encouraged to provide factoring services.

(vii) There should be continuing development and refinement of money market instruments, and every new instrument must be approved by the Reserve Bank.

- **Working Group on Money Market (1998):** This working group was set up to study the feasibility of setting up a unified money market in India. The working group recommended that the RBI should take steps to set up a unified money market by providing a single platform for trading in short-term debt instruments.
- **Working Group on Introduction of Repo and Reverse Repo Transactions (2000):** This working group was set up to study the feasibility of introducing repo and reverse repo transactions in India. The working group recommended that the RBI should introduce repo and reverse repo transactions to help regulate the liquidity in the money market and to manage the RBI's balance sheet.
- **Working Group on Development of a Market for Short-Term Government Securities (2001):** This working group was set up to study the feasibility of developing a market for short-term government securities in India. The working group recommended that the RBI should take steps to develop a market for short-term government securities by providing a liquid secondary market for these securities.
- **Urjit Patel Committee (2018):** This committee was set up to review the liquidity management framework of the RBI and recommend measures to improve it. The committee made several recommendations for improving the liquidity management framework, including setting up a Standing Liquidity Facility (SLF), introducing a term repo facility, and developing a market for government securities of different maturities.

These are just some of the different committees on money market of RBI. The RBI has set up several other committees and working groups to study specific aspects of the money market and recommend measures to improve its functioning. The RBI's committees and working groups have played a significant role in improving the functioning of the money market in India. Their recommendations have helped to make the money market more efficient, liquid, and resilient.

Check Your Progress

1. Write True or False:
   a) The Indian money market does not deal in cash or money but in promissory notes, government paper.
   b) Money market supplies funds for financing working capital of industries.
   c) 'Ad hoc' treasury bills are always issued in favour of the RBI only.
2. Fill in the gaps:
   a) The market for extremely short period is called _________.
   b) ________ are drawn by contractors on the Government Departments for the goods supplied to them. (Fill in the gap)
   c) The bill which does not require any acceptance is called ________.
   d) _______ has been set up mainly to provide a secondary market in Government securities.
3. Choose the correct answer from the given alternatives:
   a) The market for short term loans is called ________.
      i) Call money market ii) Treasury bill market
      iii) Money market iv) Acceptance market
   b) Bills drawn and accepted payables after three months are called _______.
      i) Indigenous bills ii) Usance bills
      iii) Clean bills iv) Supply bills
   c) The market which helps commercial banks to maintain their SLR requirements is _________.
      i) Call loan market ii) Discount market
      iii) Acceptance market iv) Commercial bill market
   d) The certificate which evidences an unsecured corporate debt of short-term maturity is ________.
      i) Short-term loan certificate ii) Certificate of deposit
      iii) Inter-bank participation certificate iv) Commercial paper

CHECK YOUR PROGRESS

4. Write True or False:
   a) LIC and UTI can act as both lenders and borrowers of call loans in India.
   b) 91 days' treasury bills do not carry any fixed rate of discount.
   c) Certificate of deposit can be issued only by commercial banks.
5. The Discount and Finance House of India was set up in the year ________. (Fill in the gaps)
6. The major player in the Indian money market is/are _________.
   i) Co-operative banks ii) Indigenous banks
   iii) Commercial banks iv) Reserve Bank of India

   (Choose the correct answer)

2.13Summing Up

In this unit we come to know the following:

- Money market is a market for short term funds. It deals with all transactions in short term securities. Maturity period of them are one year or less.
- Money market does not imply to any specific market place.
- Central bank is the leader, guide, controller and policy maker of the banking system of a country.
- The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the controller of the money market in India.
- Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market.
- The Indian money market can be divided into two sectors-unorganized and organised.

2.14FURTHER READINGS

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy

2.15ANSWERS TO CHECK YOUR PROGRESS

1. (a) False, (b) True (c) True
2. (a) Call money market, (b) Supply bills, (c) Treasury bill, (d) STCI
3. (a) Money market (b) Usance bills (c) Call loan market (d) Commercial paper
4. (a) False (b) False (c) False
5. 1987
6. Commercial banks

2.16 MODEL QUESTIONS

1. What is Money Market? Discuss the role of money market in the Indian Financial System.
2. Give the structure of Indian money market and point out its deficiencies.
3. Discuss the role of RBI as a regulator of Indian Money Market.
4. Discuss the role of money market in the Indian Financial System.
5. What are the essential characteristics of a develop money market?
6. What steps have been taken in recent years to make the Indian money market a developed one?
7. Discuss the institutions operates in organized sector of Indian money market.

BLOCK II : Unit-3

Types of Money Market Instruments

Unit Structure:

3.1 Introduction

Money market encompassing various sub-markets, each with its unique characteristics, instruments, and functions. Money market instruments are a cornerstone of the global financial system, representing a diverse range of short-term debt securities and financial tools that facilitate the borrowing and lending of funds in the short run, usually with maturities ranging from a single day to one year. These instruments are pivotal in maintaining liquidity, managing short-term financing needs, and enabling smooth monetary operations within an economy.

One of the fundamental money market instruments is Treasury Bills (T-Bills), issued by the government to raise funds and considered among the safest short-term investments. Commercial Paper (CP) is another essential instrument, unsecured and issued by corporations to meet short-term obligations. Certificates of Deposit (CDs), typically offered by banks, are time deposits with fixed maturities, attracting investors seeking low-risk avenues.

Other notable instruments include Repurchase Agreements (Repos) and Reverse Repos, where securities are sold with an agreement to repurchase at a later date at a predetermined price. Additionally, the Call Money market facilitates short-term borrowing and lending primarily among banks.

Money market instruments are crucial for investors, financial institutions, and governments in managing their liquidity, ensuring stability, and optimizing investment portfolios. Their nature, flexibility, and accessibility make them integral components of the broader financial landscape, contributing significantly to economic growth and financial well-being.

In this unit we will discuss various sub markets and instruments of Indian Money Market.

3.2 OBJECTIVES

This unit is an attempt to discuss money market instruments and sub markets of money market. After going through this unit, you will be able to-

- Know the meaning of money marketinstruments
- Explain different money market instrument
- Know about different submarkets of money market

3.3 MONEY MARKET INSTRUMENTS

Money market instruments are financial instruments that help companies, corporations, and government bodies to raise short-term debt for their needs. The borrowers meet their short-term needs at a low cost and the lenders benefit from interest rates and liquidity. The main characteristic of money market instruments is that they can be easily converted to cash, thereby preserving an investor's cash requirements.

The Indian money market is a crucial segment of the broader financial system and plays a vital role in the economic development of the country. It consists of various instruments that help in short-term borrowing, lending, and liquidity management. In this comprehensive explanation, we will delve into each of these instruments, exploring their features, functions, and significance within the Indian financial landscape.

3.3.1 Treasury Bills (T-Bills):

When the government goes to the financial market to raise money, it does so by issuing two types of debt instruments — treasury bills and government bonds. Treasury bills are issued when the government needs money for a short period. These bills are issued only by the central government to reduce the overall fiscal deficit of a country. RBI issues the TBs on behalf of the government and honors them on the date of maturity.Treasury bills were first issued in India in 1917. They are issued at a discount to the face value and have maturities of 91 days, 182 days, and 364 days. T-Bills play a vital role in managing short-term liquidity for the government and are considered virtually risk-free, making them an attractive investment option. This is one of the safest short-term instruments in the money market. At present, treasury bills are issued in three maturities — 91-day, 182-day and 364-day. In 1997 the government also issued 14-day immediate treasury bills.

Treasury bills are issued at a discount to original value and the buyer gets the original value upon maturity. For example, a Rs 100 treasury bill can be availed of at Rs 95, but the buyer is paid Rs 100 on the maturity date.

Features:

a) **Investors:** Eligible participants to invest in T-Bill are the banks, insurance companies like LIC, GIC etc., NABARD and UTI, corporates and Foreign Institutional Investors (FII).
b) **Importance:** The TBs are eligible securities for maintenance of statutory liquidity ratio of banks. In addition, it is also used for the repo operation of the central bank. Corporates also park their funds in TBs because there is no risk of default.
c) **Short-Term Maturity**: T-Bills have short maturities, typically ranging from a few days to one year. Common maturities include 91 days, 182 days, and 364 days.
d) **Issued at Discount**: They are issued at a discount to the face value, and upon maturity, the government pays the holder the face value, resulting in interest earned for the holder.
e) **Backed by Government**: T-Bills are backed by the government, making them virtually risk-free. They are considered one of the safest forms of investment.
f) **Low Denomination**: T-Bills are available in low denominations, making them accessible to a wide range of investors, including individuals, financial institutions, and corporations.
g) **Liquidity**: They are highly liquid and can be sold on the secondary market before maturity, providing an easy exit option for investors.

Advantages:

a) **Safety**: T-Bills are considered extremely safe as they are backed by the government, making them a preferred choice for investors seeking a low-risk investment.
b) **Liquidity**: They are highly liquid, and investors can easily buy or sell them in the secondary market, providing flexibility and a quick exit if needed.
c) **Competitive Returns**: Although the returns are fixed and known upfront, they provide competitive returns compared to other low-risk investment options.
d) **Government Support**: Being issued by the government, they enjoy the implicit support and creditworthiness of the government, enhancing investor confidence.
e) **Portfolio Diversification**: T-Bills can be used to diversify an investment portfolio by adding a low-risk, fixed-income component to balance the overall risk.

Disadvantages:

a) **Fixed Returns**: The returns on T-Bills are fixed and relatively low compared to other investment options, limiting the potential for higher earnings.
b) **Inflation Risk**: T-Bills may not keep pace with inflation, potentially eroding purchasing power over time, especially for longer-term T-Bills.
c) **Interest Rate Risk**: Changes in interest rates can impact the market value of T-Bills if investors choose to sell them before maturity. Rising interest rates can reduce the market value of existing T-Bills.
d) **Limited to Government Issuers**: T-Bills are issued only by the government, limiting the variety of issuers compared to other fixed-income securities.
e) **Tax Implications**: The interest earned on T-Bills is taxable as per the prevailing tax laws, which can reduce the overall effective return for the investor.

3.3.2 Commercial Paper (CP):

Commercial Paper is a short-term, unsecured money market instrument issued by well-established corporations, financial institutions, and primary dealers. It allows companies to raise funds to meet short-term liabilities and working capital requirements. CPs have maturities ranging from 7 days to one year and are typically issued at a discount to face value and is redeemed at face value.

In India, CP made its appearance from January 1990, when the RBI issued detailed guidelines for the issue of CPs. The guidelines undergo a lot of changes now and then. Though there is no secondary market for CP, its importance is growing in the Indian money market.

Features:

a) **Lenders:** The buyers of CPs are other joint stock companies, public sector companies and corporations, banks etc. Insurance companies and term-lending institutions invest in long-term securities. Therefore, they seldom invest in CPs. However, non-corporate bodies, non-resident Indians (NRIs) and foreign institutional investors do invest in CPs.

b) **Unsecured Instrument**: Commercial Paper is not backed by any collateral, making it an unsecured form of borrowing. The creditworthiness of the issuing company determines its acceptance in the market.

c) **Short-Term Maturity**: CPs have a maturity ranging from 7 days to one year. The most common maturities are 30, 60, 90, and 180 days.

d) **Issued at Discount**: Companies issue CPs at a discount to the face value, and the face value is repaid to the holder at maturity, generating the interest for the holder.

e) **Denomination of CPs:** The minimum denomination for a single investor is Rs.25 lakh. Thereafter, it should be in multiples of Rs.5 lakh.

f) **Issued by Creditworthy Companies**: CPs are typically issued by large, creditworthy corporations or financial institutions to meet short-term funding needs. The networth of the issuing company (capital + reserves) should not be less than Rs.4 crore.

g) **Issued in Dematerialized Form**: Commercial Paper is issued and held in a dematerialized form to facilitate ease of trading and transfer.

Advantages:

a) **Cost-Effective Funding**: CPs offer a cost-effective alternative for short-term funding compared to traditional bank loans. The discount at which they are issued effectively lowers the cost of borrowing.

b) **Flexibility**: Companies can tailor the amount, timing, and maturity of the CPs according to their specific financing needs, providing flexibility in managing short-term funding requirements.

c) **High Liquidity**: CPs are highly liquid instruments. Investors can trade them in the secondary market before maturity, providing an exit option if needed.
d) **Wide Investor Base**: CPs attract a diverse range of investors, including banks, mutual funds, insurance companies, and corporate treasuries, providing a broad base for raising funds.
e) **Enhanced Credit Profile**: Successful issuance of CPs enhances the issuing company's credit profile, making it easier and cheaper to raise funds in the future.

Disadvantages:

a) **Credit Risk**: Since CPs are unsecured, investors bear the risk of default by the issuing company. The creditworthiness of the issuer is a critical factor.
b) **Market Risk**: Changes in interest rates and market conditions can impact the market value of CPs if investors decide to sell them before maturity.
c) **Limited to Highly Rated Entities**: CPs are typically accessible to companies with high credit ratings, limiting their availability to lesser-rated or smaller firms.
d) **Restricted Use**: CPs cannot be used for long-term financing needs, limiting their application to short-term funding requirements.
e) **Regulatory Compliance**: Issuers need to comply with regulatory requirements and guidelines set by the Reserve Bank of India, adding to administrative and compliance costs.

3.3.3 Certificates of Deposit (CDs):

CD is a negotiable certificate issued by a bank on the receipt of a large deposit. It is like a fixed deposit receipt issued by the bank on the receipt of a deposit. The ordinary FD receipt is neither negotiable nor transferable. CD is a negotiable certificate payable to bearer. They are unsecured and have fixed maturities, usually ranging from 7 days to one year. CDs provide a source of short-term funds for banks and often offer higher interest rates than regular savings accounts.

CDs appeared in the USA in 1961. In India, the RBI permitted banks to issue CDs from June, 1989. CDs' are meant for large deposits so that administrative expenses of the bank and the depositor are reduced. CD is a short- term security while the ordinary FD can be of either short-term or long-term security.

Features:

1. The issuer of CDs can be any scheduled bank other than RRBs for raising large funds. On receiving the deposit, the banks issue the negotiable receipt which can be transferred or sold in the secondary market. The investors are generally joint stock companies, institutions, high net-worth individuals or any other funds.
2. **Fixed Term**: CDs have a fixed term or maturity period, ranging from a few months to a year. The common tenure is three months. The investor agrees not to withdraw the funds before this maturity period.
3. **Issue Price:** CDs are issued at a discount to the face value. The discount is decided by market forces of demand and supply.
4. **Fixed Interest Rate**: The interest rate is fixed at the time of purchase and remains constant throughout the term of the CD. It is generally higher than the interest rate offered on savings accounts.
5. **Minimum Deposit Amount**: the minimum denomination was Rs.1 crore and in multiples of Rs.5 lakh thereafter. Later on, it was modified as a minimum denomination of Rs.10 lakh and multiples of Rs.5 lakh thereafter.
6. **Penalties for Early Withdrawal**: If an investor withdraws the funds before maturity, they may incur penalties in the form of reduced interest or forfeiture of a portion of the interest earned.
7. **Safety**: CDs are generally considered safe as they are insured by the Deposit Insurance and Credit Guarantee Corporation (DICGC) for up to □5 lakhs per depositor per bank.
8. **Negotiable:** It is negotiable and can be transferred by delivery and endorsement. However, there is an initial lock in period of 30 days during which it cannot be transferred.
9. **Loan against CD:** A depositor can get loans against CDs, except for the permitted explicitly by the RBI. The issuer is given to buy back CDs before maturity at the prevailing market price. The investors could opt for accepting or rejecting the CDs purchased back offer as per wants.

Advantages:

a) **Stable Returns**: CDs provide a guaranteed, stable return on investment, making them a popular choice for conservative investors seeking predictable earnings.

b) **Risk Mitigation**: The fixed interest rate and maturity date eliminate interest rate risk, providing security and predictability to the investor.

c) **Insurance Protection**: CDs offered by banks are covered by deposit insurance, providing protection to the investor's funds up to a specified limit.

d) **Diversification**: CDs offer a way to diversify a portfolio by adding a fixed-income component without exposing the investment to market risks.

e) **High-Interest Rates**: CDs usually offer higher interest rates compared to regular savings accounts, providing an opportunity for higher returns on idle funds.

Disadvantages:

a) **Liquidity Constraints**: Funds are tied up for the duration of the CD, and early withdrawal can result in penalties, making them less liquid than other forms of investments.

b) **Opportunity Cost**: If interest rates rise after purchasing a CD, the investor misses out on the opportunity to invest at the higher rates.

c) **Inflation Risk**: The fixed interest rate might not keep pace with inflation, potentially reducing the real purchasing power of the returns.

d) **Interest Taxation**: The interest earned on CDs is taxable as per the applicable tax laws, reducing the effective return for the investor.

e) **Minimum Deposit**: Some banks require a relatively high minimum deposit amount to open a CD, making it less accessible for small-scale investors.

3.3.4 Call Money

Call money, also referred to as 'money at call,' represents a short-term financial loan that necessitates immediate full repayment upon the lender's request. In contrast to a term loan, which has a stipulated maturity and payment plan, call money lacks a fixed timetable for repayment, and the lender isn't obligated to give prior notice for payback. Call money encompasses short-term, interest-yielding loans that the borrower must promptly settle if demanded by the lender. Call money allows banks to earn interest on their excess funds, which is known as the call money rate (call loan rate/call rate). It consists of overnight money as well as money available on short notice for up to 14 days. The call money market primarily serves to rebalance banks' and other participants' short-term liquidity positions.

Features

a. A call money loan is a short-term, interest-bearing loan made by one financial institution to another.
b. As it is short term in nature, it does not have regular principal and interest payments.
c. The call loan rate is the interest rate charged on a call loan.
d. Brokers use call money as a short-term source of funding to keep margin accounts open for their customers who want to leverage their investments.
e. The funds can be transferred quickly between lenders and brokerage houses. As a result, it is the second most liquid asset on a balance sheet, trailing only cash.
f. The interest rate charged on loans used to purchase securities, known as margin rates, varies according to the call money rate set by banks.

Primary dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buys government securities directly from the RBI (the RBI issues government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.The Primary Dealers system in the government securities market was introduced by the RBI in 1995.

3.3.5 Commercial Bills:

When goods are sold on credit, the seller draws a bill of exchange on the buyer for the amount due. The buyer accepts it immediately. This means he agrees to pay the amount mentioned therein after a certain specified date. After accepting the bill, the buyer returns it to the seller. This bill is called trade bill. The seller may either retain the bill till maturity or due date or get it discounted from some banker and get immediate cash. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by deducting a certain amount (discount) and balance is paid.

A bill of exchange contains a written order from the creditor (seller) to the debtor (buyer) to pay a certain sum, to a certain person after a certain period. According to Negotiable Instruments Act, 1881, a bill of exchange is ‘an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument’.

Features of Commercial Bills

a) These are negotiable instruments.
b) These are generally issued for 30 days to 120 days. Thus these are short term credit instruments.
c) These are self-liquidating instruments with low risk.
d) These can be discounted with a bank. When a bill is discounted with a bank, the holder gets immediate cash. This means bank provides credit to the customers. The credit is repayable on maturity of the bill. In case of need for funds, the bank can rediscount the bill in the money market and get ready money.
e) These are used for settling payments in the domestic as well as foreign trade.
f) The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

Types of Commercial Bills: Many types of bills are in circulation in a bill market. They may be broadly classified as follows:

- **Demand Bills and Time Bills**: Demand bill is payable on demand. It is payable immediately on presentation or at sight to the drawing. Demand bill is also known as sight bill. Time bill is payable at a specified future date. Time bill is also known as usance bill.
- **Clean Bills and Documentary Bills:** When bills have to be accompanied by documents of title to goods such as railway receipts, bill of lading etc. the bills are called documentary bills. When bills are drawn without accompanying any document, they are called clean bills. In such a case, documents will be directly sent to the drawee.
- **Inland and Foreign Bills:** Inland bills are bills drawn upon a person resident in India and are payable in India. Foreign bills are bills drawn outside India and they may be payable either in India or outside India.
- **Accommodation Bills and Supply Bills:** In case of accommodation bills, two parties draw bills on each other purely for the purpose of mutual financial accommodation. These bills are then discounted with the bankers and the proceeds are shared among themselves. On the due dates, the parties make payment to the bank. Accommodation bills are also known as 'wind bills' or 'kite bills'. Supply bills are those drawn by suppliers or contactors on the Govt. departments for the goods supplied to them. These bills are not considered as negotiable instruments.

3.3.6 Promissory Note

The promissory note is the earliest types of bill. It is a written promise on the part of a businessman today to another a certain sum of money at an agreed future data. Usually, a promissory note falls due for payment after 90 days with three days of grace. A promissory note is drawn by the debtor and has to be accepted by the bank in which the debtor has his account, to be valid. The creditor can get it discounted from his bank till the date of recovery.

3.3.7 Repurchase Agreements (Repos) and Reverse Repos:

The Repo Rate is the interest rate at which the Reserve Bank of India (RBI) lend money to commercial banks.Repo Rate full form is Repurchase Agreement or Repurchasing Option. Banks obtain loans from the Reserve Bank of India by selling qualifying securities.The RBI and the commercial bank would reach an agreement to repurchase the securities at a set price. The RBI regulates the repo rate based on the economic situation. The repo rate is utilized by the RBI to manage inflation and control the flow of money in the market. When the market is impacted by inflation, the RBI raises the repo rate. An increased repo rate means that banks borrowing money from the central bank during this period will have to pay more interest. This prevents banks from borrowing money, reducing the amount of money in the market and helping to negate inflation.

As the name implies, reverse repo is the inverse contract to the repo rate. The reverse repo rate is the rate at which the RBI borrows funds from the country's commercial banks. In simple term, the reverse repo rate is the rate on commercial banks' deposits with the central bank. It is the rate where the commercial banks in India park excess funds with the Reserve Bank of India for a short period of time.Most banking organizations choose this safer strategy to secure their funds in the event of a surplus. In other terms, the reverse repo rate is an interest rate paid on cash deposited.

The key distinction between the repo and reverse repo rates is that the repo rate earns income through lending to commercial banks, whereas the reverse repo rate earns interest on funds deposited with the Reserve Bank of India.The differences between Repo Rate and Reverse Repo Rate are based on the lender’s and borrower’s perspectives. It also differs on the impact the change in rates creates. They are:

- Repo Rate and Reverse Repo Rate are contradictory. Banks borrow money from RBI at Repo Rate, and on the other hand, they lend money to RBI at Reverse Repo Rate.
- RBI uses Repo Rate as a mechanism to control inflation and Reverse Repo Rate to manage money flow.
- Repo Rate injects liquidity in the market whereas Reverse Repo Rate absorbs liquidity from the market.
- Usually, Reverse Repo Rate is lower than Repo Rate.

3.3.8 Banker's Acceptance (BA):

Banker's Acceptance is a time draft drawn on and accepted by a bank, representing an unconditional obligation to pay a specified amount at a future date. It states the name of the entity to which the funds need to be transferred, along with the amount and date of payment. Banker’s acceptances are short-term instruments that generally come with a maturity between 30 days and 180 days. BAs are commonly used in international trade transactions, especially in cross-border trade financing.

The issuer of a banker’s acceptance deposits the future payment with a bank. The bank charges a small fee and issues a time draft against the deposit, representing a guaranteed future payment by the bank. Upon acceptance from the bank, the liability transfers from the issuer of the banker’s acceptance and becomes an obligation of the bank. As such, the credit rating of a banker’s acceptance is generally the same as that of the bank that promised the payment.

Check Your Progress

1. What is a key characteristic of money market instruments?
   a) Long-term maturity b) Easy in converting to cash c) High risk d) High denomination
2. Treasury bills are issued by:
   a) Banks b) Government c) Private corporations d) Foreign investors
3. Commercial Paper is typically issued by:
   a) Government agencies b) Banks c) Well-established corporations d) Foreign central banks
4. Certificates of Deposit (CDs) are:
   a) Always secured by collateral b) Unsecured short-term instruments c) Long-term investment options d) Exempt from taxation
5. Call money represents:
   a) Long-term financial loans b) Unsecured money market instruments c) Securities issued by the government d) Collateralized loans
6. Banker's Acceptance (BA) is commonly used in:
   a) Domestic trade transactions b) Long-term financing c) Real estate transactions d) International trade financing

3.4 SUB MARKETS OF MONEY MARKET

Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market. Each sub-market deals in a particular financial instrument. The main components or constituents or sub-markets of money market are as follows:

3.4.1 Call Money Market

Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as cash reserve ratio (CRR). This interbank borrowing has led to the development of the call money market. This is the most active and sensitive part of the organized money market. It deals in one-day loans (called call loans or call money) which may or may not be renewed the next day. The participants are mostly banks. Therefore, it is also called inter-bank call money market. The borrowing side is limited exclusively to banks, which are temporarily short of funds. On the lending side, too, there are mostly banks with temporary excess of cash.

In the call money market, surplus funds of financial institutions and banks are traded. There is no demand for collateral security against call money. In India call money markets are mainly located in big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmadabad. Participants or players in the Call Money Market are scheduled commercial banks and RBI, Non-Scheduled commercial banks, Co-operative banks, Foreign banks, Discount and Finance House of India, Primary dealers etc.

The above players are permitted to operate both as lenders and borrowers. On the other hand participants like LIC, UTI, GIC, IDBI, NABARD, Specific mutual funds, etc. are permitted to operate as lenders.

Among banks, the State Bank of India (SBI), because of its formidable liquid position, is always on the lenders' side of the market. It acts as the 'lender of intermediate resort', whereas the RBI as the country's central bank is the 'lender of last resort'. Call rate is the rate of interest paid on call loans. The call money market operates through brokers who keen in constant touch with banks in the city and bring the borrowing and lending banks together.

3.4.2Commercial Bill Market

Commercial bill market is another segment of money market. It is a market in which commercial bills (short term) are bought and sold. Commercial bills are important instruments. They are widely used in both domestic and foreign trade to discharge the business obligations (or to settle business obligations). From the operational point of view bill market can be classified as-Discount Market and Acceptance Market.

Discount Market

When credit sale take place the seller draw a bill on the buyer who accept it promising to pay the specified sum at the specified period. For getting the payment seller has to wait until the maturity of the bill. But, the presence of bill market enables him/her to get payment against the bill immediately. The seller can ensure payment immediately by discounting the bill with some financial intermediary by paying a small amount of money called discount. On the date of maturity of the bill the intermediary claims the amount of the bill from the person who has accepted the bill. Discounting is the main process in this market. There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. In India, RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in the commercial bill market.

Acceptance Market

Acceptance Market is another component of money market. It is a market for banker's acceptance. In this market short term genuine trade bills are accepted by financial intermediaries. All trade bills cannot be discounted easily because parties to the bills may not be financially sound. If such bills are accepted by financial intermediaries like banks, it earns good reputations and can be easily discounted anywhere. In develop money market there are specialized institutions called acceptance house which accept bills drawn by traders and impart good marketability to such bills.

3.4.3 Treasury Bills Market

Treasury bill market is a market which deals in treasury bills. In this market, treasury bills which are the short-term (i.e., 91, 182 and 364 days) liability of the Government of India. Theoretically these bills are issued to meet the short-term financial requirements of the government. Thus it represents short term borrowings of the government.But, in reality, they have become a permanent source of funds to the government. Every year, a portion of treasury bills are converted into long-term bonds. Treasury bills are of two types: ad hoc and regular.

Ad hoc treasury bills are issued to the state governments, semi- government departments and foreign central banks. They are not sold to the banks and the general public, and are not marketable.

The regular treasury bills are sold to the banks and public and are freely marketable. Both types of ad hoc and regular treasury bills are sold by Reserve Bank of India on behalf of the Central Government.

The treasury bill market in India is underdeveloped as compared to the treasury bill markets in the U.S.A. and the U.K. Indian Treasury bill market has no dealers expect the Reserve Bank of India. Besides the Reserve Bank, some treasury bills are held by commercial banks, state government and semi-government bodies. But, these treasury bills are not popular with the non-bank financial institutions, corporations, and individuals mainly because of absence of a developed treasury bill market.

Advantages of Treasure Bill Market:

Advantages to the Issuer/Government:

- The government can raise short term funds for meeting temporary budget deficit.
- The government can absorb excess liquidity in the economy through the issue of bills in the market.
- It does not lead to inflationary pressure.

Advantages for the Purchaser/Investor:

- It is a ready market for purchasers or investors.

- It is a safety instrument to invest.
- Treasury bills are eligible securities for SLR requirement.
- The market provides hedging facility.

3.4.4 Certificates of Deposits (CD) Market

CD market is a market which deals in Certificate of Deposits (CDs). CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CDs. These are short term negotiable instruments.

Advantages of CD Market:

- It enables the depositors to earn higher return on their short term surplus.
- The market provides maximum liquidity.
- The bank can raise money in times of need. This will improve their lending capacity.
- The market provides an opportunity for banks to invest surplus funds.
- The transaction cost of CDs is lower.

3.4.5 Commercial Paper Market

Commercial paper (CP) market is a constituent of the unsecured money market - in whichcorporates do their fund-raising activity for theiroperational obligations. Prior to the introduction of CPs, Indian corporates had to do a lot of negotiations for borrowing their working capital from commercial banks by pledging inventory as collateral security. The introduction of CPs provided corporates a debt instrument that allowed them to raise funds in the open market with certain conditionality - like tangiblenet worth, minimal credit rating requirement and limits on borrowable amount. These are issued at a discount. Commercial papers can now be issued by primary dealers and all India financial institutions. They can be issued to (or purchased by) individuals, banks, companies and other registered Indian corporate bodies.

The Working Group on Money Market (Vaghul Committee) in 1987 suggested the introduction of the Commercial Paper (CP) in India. As per the recommendation of the committee, the RBI introduced commercial papers in January 1990. The Committee suggested the following:

- CP should be issued to investors directly or through bankers.
- The CP issuing company must have a net worth of not less than Rs. 5 crores.

- The issuing company's shares must be listed in the stock exchange.
- The minimum amount of issue should be Rs. 1 crore and the minimum denomination of Rs. 5 lakhs
- The CPs issuing cost should not exceed 1% of the amount raised.
- RBI is the sole authority to decide the size of issue and timing of issue.
- The instrument should not be subject to stamp duty at the time of issue and there should not be any tax deduction at source.
- The interest on CP shall be a market determined.
- The issuing companies should get certification of credit rating for every six months and 'A' grading enterprises may be permitted to enter the market.

3.4.6Collateral Loan Market

Collateral loan market is another important sector of the money market. The collateral loan market is a market which deals with collateral loans. Collateral means anything pledged as security for repayment of a loan. Thus collateral loans are loans backed by collateral securities such as stock, bonds etc. The collateral loans are given for a few months. The collateral security is returned to the borrower when the loan is repaid. When the borrower is not able to repay the loan, the collateral becomes the property of the lender. The borrowers are generally the dealers in stocks and shares.

Check Your Progress

7. What does the Call Money Market primarily deal with?

   a) Short-term loans b) Long-term loans c) Collateral-backed loans d) Foreign exchange transactions

8. In the Commercial Bill Market, what is the main purpose of discounting a bill?
   a) To delay payment to the seller b) To ensure immediate payment to the seller c) To negotiate a lower payment amount d) To extend the maturity period of the bill
9. What is the main advantage of Treasury Bills for the government?
   a) Absorbing excess liquidity b) Generating long-term funds c) Facilitating foreign trade d) Reducing inflationary pressure

10. What does the Certificates of Deposits (CD) Market primarily deal with?

    a) Short-term deposit instruments b) Long-term bonds c) Real estate transactions d) Foreign exchange transactions

11. Commercial Paper (CP) market is a part of which segment of the money market?

    a) Secured money market b) Unsecured money market c) Foreign exchange market d) Long-term financing market

12. What does the Collateral Loan Market deal with?

    a) Loans secured by tangible assets b) Long-term mortgages c) Foreign exchange transactions d) Unsecured personal loans

3.5 Summing up

In this unit we come to know the following:

- Money market instruments facilitate short-term debt raising for various entities, ensuring low-cost borrowing for borrowers and providing interest rates and liquidity benefits for lenders.
- Money market instruments are easily convertible to cash, preserving investors' cash requirements and ensuring high liquidity.

- The Indian money market is crucial for short-term borrowing, lending, and liquidity management, playing a significant role in the country's economic development.
- T-Bills are short-term, virtually risk-free instruments issued by the government, aiding in managing short-term liquidity and attracting a wide range of investors due to their safety and ease of investment.
- CPs are unsecured, short-term instruments allowing cost-effective funding for corporations, offering flexibility and liquidity to tailor financing according to specific needs.
- CDs provide stable returns, risk mitigation, and insurance protection for investors, but they have liquidity constraints and are subject to taxation.
- The call money market involves short-term, interest-yielding loans, mainly between banks, to manage short-term liquidity positions, and it operates through brokers.
- The commercial bill market involves buying and selling short-term commercial bills, either through discounting or acceptance, aiding trade and business transactions.
- The treasury bill market deals with short-term government debt, providing a source of short-term funds for the government while offering a safety net for investors.
- The collateral loan market involves loans backed by collateral securities like stocks or bonds, providing short-term funding typically for a few months, with collateral being returned upon loan repayment or becoming the lender's property in case of default.

3.6 Model Questions

1. What are the key features and functions of Treasury Bills (T-Bills) in the Indian money market, and how do they contribute to managing short-term liquidity for the government and investors?
2. Discuss Commercial Paper (CP) and Certificates of Deposit (CDs) as short-term financing instruments in the Indian money market.
3. Explain the role and significance of the Call Money Market in the Indian money market.
4. Provide an in-depth overview of the Treasury Bill Market in India, including the types of treasury bills.
5. Discuss various sub markets of Indian money market.

3.7 Answer to check your progress

1. b) Easy in converting to cash
2. b) Government
3. c) Well-established corporations
4. b) Unsecured short-term instruments
5. b) Unsecured money market instruments
6. d) International trade financing
7. a) Short-term loans
8. b) To ensure immediate payment to the seller
9. a) Absorbing excess liquidity
10. a) Short-term deposit instruments
11. b) Unsecured money market
12. a) Loans secured by tangible assets

BLOCK-III : Unit 1

Capital Market- Its Nature, Scope and Functions

Unit Structure:

1.1- Introduction-

Capital Market is one of the important constituent of the Financial Market. A good capital market is an essential pre-requisite for industrial and commercial development of a country. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country.

1.2- Objective-

This unit attempts to highlights the nature, scope and different functions performed by capital market and help the readers get a clear understanding of capital market.

1.3. Capital Market-

The term 'Capital Market' refers to the institutional arrangements for facilitating the borrowing and lending of long term funds. In widest sense, it consists of a series of channels through which the savings are made available for industrial, commercial enterprises and public authorities. It is concerned with those private savings, individual as well as corporate, that are turned into investments through new capital issues and also by new public loans floated by government and semi-government bodies.

A Capital Market may be defined as an organised mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e. individuals or institutional savers to the entrepreneurs (individuals or institutions) engaged in industry or commerce in the business either be in the private or public sectors of an economy.

Capital markets, more commonly referred to as the stock markets have been in existence for centuries. The British East India Company was the first company to invite the public to buy shares in the company. Since then, over the years, markets have gone through tremendous changes. The way the market works, the asset classes, the framework of the exchanges and everything has been evolving over time. The changes have been brought in gradually according to the convenience of the investors and market participants. Also in order to prevent market participants to take undue advantage of information in order to gain monetary benefits, the Securities Regulatory bodies over the world have surveillance methods for mitigation of such acts.

1.3.1.

Stop to Consider

The term 'Capital Market' refers to the institutional arrangements for facilitating the borrowing and lending of long term funds. A good capital market is an essential pre-requisite for industrial and commercial development of a country. The money market caters to the short term capital needs whereby the capital market caters the long term capital needs.

1.3.2.

Check Your Progress

1. Define Capital Market.
2. Write a brief note on Capital Market and its effectiveness in the economy of a country.
3. Capital Market deals in _________________ term capital.

1.4. Nature & Scope of the Capital Market-

An efficient capital market is a pre-requisite of economic development. An organised and well developed capital market operating in a free market economy, i) ensures best possible coordination and balance between the flow of savings on the one hand and the flow of investment leading to capital formation on the other; ii) directs the flow of savings into most profitable channels and thereby ensures optimum utilisation of financial resources.

Thus, an ideal capital market is one where finance is used as a handmade to serve the needs of the industry. The capital market must facilitate the movement of capital to the point of highest yield. Hence a capital market strives for –

i) Mobilisation or concentration of national savings for economic development and

ii) The mobilisation and import of foreign capital and investment to augment the deficit in the required financial resources so as to maintain the expected rate of economic growth.

1.4.1.

> **Stop to Consider**
>
> An ideal capital market is one where finance is used as a handmade to serve the needs of the industry. Mobilisation or concentration of national savings for economic development and directs the flow of savings into most profitable channels and thereby ensures optimum utilisation of financial resources.

1.5. Features of Capital Market:

The important features of the Capital Market are as follows-

1. **Serves as a link between Savers and Investment Opportunities:**
Capital market serves as a crucial link between saving and investment process as it transfers money from savers to entrepreneurial borrowers.

2. **Long term Investment:**
It helps the investors to invest their hard earned money in long term investments.

3. **Helps in Capital formation:**
Capital market offers opportunities for those investors who have surplus amount of money and want to park their money in some type of investment and also take the benefit of the power of compounding.

4. **Helps Intermediaries:**
While transferring of shares and money from one investor to another, it takes helps of intermediaries like brokers, banks etc. thus helping them in conducting their business.

5. **Rules and Regulations:**
The capital market operates under the regulation and rules of the Government thus making it a safe place to trade.

1.5.1.

Check Your Progress

1. State the important features of Capital Market.
2. Discuss the nature and scope of Capital Market.
3. State whether the following statement is true or false-
    a. Capital market helps investors in capital formation.

1.6. Functions of Capital Market

While from a broader perspective, Capital Markets is viewed as a market of financial assets with long or infinite maturity, it actually plays a very important role in mobilizing resources and allocating them to productive channels. So it can be said that the process of economic growth of a country is facilitated by the Capital Markets. The important functions and significance of the markets have been discussed below: –

1. Economic Growth: The Capital Markets help to accelerate the process of economic growth. It reflects the general condition of the economy. Capital Market helps in the proper allocation of resources from the people who have surplus capital to the people who are in need of capital. So, we can say that it helps in the expansion of industry and trade of both public and private sectors leading to a balanced economic growth in the country.

2. Promotes Saving Habits: After the development of Capital Markets, the taxation system, and the banking institutions provide facilities and provisions to the investors to save more. In the absence of Capital Markets, they might have invested in unproductive assets like land or gold or might have indulged in unnecessary spending.

3. Stable and Systematic Security prices: Apart from the mobilization of funds, the Capital Markets helps to stabilize the prices of stocks. Reduction in the speculative activities and providing capital to borrowers at a lower interest rate help in the stabilization of the security prices.

4. Availability of Funds: Investments are made in Capital Markets on a continuous basis. Both the buyers and sellers interact and trade their capital and assets through an online platform. Stock Exchanges like NSE and BSE provide the platform for this and thus the transactions in the capital market become easy.

1.6.1.

Stop to Consider
Economic Growth, Promoting Saving Habits, Stable and systematic security prices and Availability of funds are the important functions of Capital Market. Capital market also serves as an important link between savers and investors and helps in capital formation of the investors. Capital market operates under strict Government rules and regulations.

1.6.2.

Check Your Progress

1. Write a brief note on the different functions of Capital Market.
2. Capital Market helps promotes savings habit among the investors. State the above statement is true or false.
3. State the role of Capital market in the economic growth of the country?

1.7. Summing Up-

This unit will help the reader understand about the concept of Capital market. Readers will also have a clear concept about the nature, scope, feature and functions of capital market. After studying the above unit, readers will have a basic knowledge of Capital market.

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1.9. Model Questions-

1. What is Capital Market?

2. Discuss the important functions of Capital Market.

3. Discuss the nature or objective of Capital market.

4. Highlight the important features of Capital market.

5. Explain how Capital Market helps in achieving high economic growth?

BLOCK III : Unit-2

Types of Capital Market, Equity Market, Debt Market, IPOs and Private Placement

Unit Structure:

1.1.Introduction-

Capital Market being a part of financial market is further sub-divided into two sub market viz- Primary Market or New Issue Market and Secondary Market or Stock Exchange. Both of these two market plays an important role in the entire functioning of the Capital Market

1.2. Objective-

This unit attempt to highlight the types of Capital market, viz Primary market and Secondary market, their functions, advantage and disadvantages of both the markets. This unit will also elaborate on the Equity Market, Debt Market and will explain about IPO and Private Placement of Shares.

1.3.Types of Capital Market-

The capital market is mainly categorized into two sub markets:

- **Primary Market:** The primary market mainly deals with new securities that are issued in the stock market for the first time. Thus it is also known as the new issue market. The main function of the primary market is to facilitate the transfer of the newly issued shared from the companies to the public. The main investors in this type of market are financial institutions, banks, HNIs (High Net worth Individuals), etc.
- **Secondary Market:** It is the market where the trading of the securities actually takes place, thus it is also referred to as the stock market. Here the buying and selling of securities take place whereby the existing investors sell the securities and new investors buy the securities.

2.3 (a) Primary Market or New Issue Market:

The new issue market represents the primary market where new securities i.e. shares or bonds that have never been previously issued are offered. Both new companies and the existing ones can raise capital on the new issue market. The primary market is considered as the most important type of capital market. The prime function of the new issue market is to facilitate the transfer of funds from the willing investors to the entrepreneurs setting up new corporate enterprises or going in for expansion, diversification, growth or modernisation. The companies raise money in the primary market through securities such as shares, debentures, loans and deposits, preference shares etc.

2.3(b) Functions of Primary Or New Issue Market- The functions of primary market are as follows:

Origination: Origination is referred to as examine, evaluate, and process new project proposals in the primary market. It begins prior to an issue is present in the market. It is done with the help of commercial bankers.

Underwriting: For ensuring the success of new issue there is a need for underwriting firms. These are the ones who guarantee minimum subscription. In case, the issue remains unsold the underwriters have to buy. But if the issues are completely subscribed then there will be no liability left for them.
Distribution: For the success of issue, brokers and dealers are given job distribution who directly contact with investors.

2.3.1

Stop to Consider

Capital market is further divided into two markets i.e. Primary Market and Secondary Market. Primary market or the New Issue Market is that market where shares or bonds are issued for the first time by both new and existing companies for raising capital. Primary market is considered as one of the important capital market.

2.3.2

Check Your Progress

1. Discuss the types of Capital market.
2. What is a Primary Market?
3. Primary market is also known as______________________
4. State the basic functions of Primary Market?

2.4 Methods of Raising Funds in the New Issue Market or Primary Market

1] **Offer through Prospectus**

This is a method of public issue. It is also the most used method in the primary market to raise funds. Here the company invites the investors (general members of the public) to invest in their company via an advertisement also known as a prospectus. After a prospectus is issued, the public subscribes to shares, debentures etc. As per the response, shares are allotted to the public. If the subscriptions are very high, allotment will be done on lottery or pro-rata basis. The company can sell the shares directly to the public, but it generally hires brokers and underwriters. Merchant banks are another option to help out with the process, especially Initial Public Offerings.

2] Private Placement

Public offers are an expensive affair. The incidental costs of IPO's tend to be very high. This is why some companies prefer not to go down this route. They offer investment opportunities to a select few individuals. So the company will sell its shares to financial institutes, banks, insurance companies and some select individuals. This will help them raise the funds efficiently, quickly and economically. Such companies do not sell or offer their securities to the public at large.

3] Rights Issue

Generally, when a company is looking to expand or are in need of additional funds, they first turn to their current investors. So the current shareholders are given an opportunity to further invest in the company. They are given the "right" to buy new shares before the public is offered the chance. This allotment of new shares is done on pro-rata basis. If the shareholder chooses to execute his right and buy the shares, he will be allotted the new shares. However, if the shareholder chooses to let go of his rights issue, then these shares can be offered to the public.

4] E-IPO

It stands for Electronic Initial Public Offer. When a company wants to offer its shares to the public it can now also do so online. An agreement is signed between the company and the relevant stock exchange known as the e-IPO. This system was introduced in India some three years ago by the SEBI. This makes the process of the IPO speedy and efficient. The company will have to hire brokers to accept the applications received. And a registrar to the issue must also be appointed.

5] Offer for Sale-

This method of marketing securities is generally adopted in case of large issues by companies. Under this method, the issuing companies sell or agrees to sell the securities for sale to certain issue houses or the specialised financial institutions at a fixed price. The issue house or the financial institutions then issue advertisements making offer for sale of such securities at a price higher than the price at which they obtain the securities from the issuing company. The objective of this method is to ensure success in sale of securities. The main advantages of this method include surety of success of issues and saving in costs of new issues.

2.4 (a) Advantages of Primary Market

- Companies can raise capital at relatively low cost, and the securities so issued in the primary market provide high liquidity as the same can be sold in the secondary market almost immediately.

- The primary market is an important source for mobilisation of savings in an economy. Funds are mobilised from commoners for investing in other channels. It leads to monetary resources being put into investment options.

- Chances of price manipulation in the primary market are considerably less when compared to the secondary market. Such manipulation usually occurs by deflating or inflating a security price, thereby deliberately interfering with fair and free operations of the market.

- The primary market acts as a potential avenue for diversification to cut down on risk. It enables an investor to allocate his/her investment across different categories involving multiple financial instruments and industries.

- It is not subject to any market fluctuations. The prices of stocks are determined before an initial public offering, and investors know the actual amount they will have to invest.

2.4(b) Disadvantages of Primary Market

- There may be limited information for an investor to access before investment in an IPO since unlisted companies do not fall under the purview of regulatory and disclosure requirements of the Securities and Exchange Board of India.

- Each stock is exposed to varying degrees of risk, but there is no historical trading data in a primary market for analysing IPO shares because the company is offering its shares to the public for the first time through an initial public offering.

- In some cases, it may not be favourable for small investors. If a share is oversubscribed, small investors may not receive share allocation.

With this information regarding the primary market, individuals can make a well-thought-out decision regarding investment in the market. It also makes way for the creation of an investment portfolio with diversified risk.

2.4.1

Stop to Consider

Primary market or the New Issue Market adopts the following techniques to raise capital from the public. This techniques or methods are offer through prospectus, private placement, right issue, E-ipo, offer for sale method, etc. One prime advantage of issuing share in the Primary market is that the cost for raising capital is low.

2.4.2

Check Your Progress

1. What is E-IPO?
2. Discuss the different method or techniques adopted for raising capital in the Primary Market.
3. State the advantages of Primary Market.
4. State few disadvantages of Primary Market.
5. What is Private Placement of shares?
6. What is Offer for Sale method?

2.5. Secondary Market or Stock Exchange:

Secondary market or Stock market is the market where trading takes place for existing securities. It is known as stock exchange or stock market. Here the securities are bought and sold by the investors stock exchanges are organised and regulated markets for various securities issued by corporate sector and other institutions. The stock exchange enable free purchase and sale of securities as commodity exchange allow trading in commodities.

Securities Contract (Regulation) Act, 1956 defines stock exchange as "Stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling in securities."

The main point of difference between the primary and the secondary market is that in the primary market only new securities were issued, whereas in the secondary market the trading is for already existing securities. There is no fresh issue in the secondary market. The securities are traded in a highly regularised and legalized market within strict rules and regulations. This ensures that the investors can trade without the fear of being cheated.

2.6. Features of Stock Exchange or Secondary Market-

The common features of secondary market are as follows:

1. Regular information about the value of security
2. Offers liquidity to the investors for their assets
3. Continuous and active trading
4. Provide a Market Place

2.7 Functions of Secondary Market or Stock Exchange-

Some of the Important Functions of Stock Exchange/Secondary Market are listed below:

1. Economic Barometer:

A stock exchange is a reliable barometer to measure the economic condition of a country. Every major change in country and economy is reflected in the prices of shares. The rise or fall in the share prices indicates the boom or recession cycle of the economy. Stock exchange is also known as a pulse of economy or economic mirror which reflects the economic conditions of a country.

2. Pricing of Securities:

The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.

3. Safety of Transactions:

In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company. The companies which are listed they also have to operate within the strict rules and regulations. This ensures safety of dealing through stock exchange.

4. Contributes to Economic Growth:

In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

5. Spreading of Equity Cult:

Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment.

6. Providing Scope for Speculation:

To ensure liquidity and demand of supply of securities the stock exchange permits healthy speculation of securities.

7. Liquidity:

The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want. The investors can invest in long term investment projects without any hesitation, as because of stock exchange they can convert long term investment into short term and medium term.

8. Better Allocation of Capital:

The shares of profit making companies are quoted at higher prices and are actively traded so such companies can easily raise fresh capital from stock market. The general public hesitates to invest in securities of loss making companies. So stock exchange facilitates allocation of investor's fund to profitable channels.

9. Promotes the Habits of Savings and Investment:

The stock market offers attractive opportunities of investment in various securities. These attractive opportunities encourage people to save more and invest in securities of corporate sector rather than investing in unproductive assets such as gold, silver, etc.

2.8. Trading Procedure on a Stock Exchange:

The trading procedure involves the following steps:

1. Selection of a broker:

The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to select a broker who will buy/sell securities on behalf of the investor or speculator.

2. Opening Demat Account with Depository:
Demat (Dematerialized) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form. Second step in trading procedure is to open a Demat account.

The securities are held in the electronic form by a depository. Depository is an institution or an organization which holds securities (e.g. Shares, Debentures, Bonds, Mutual (Funds, etc.) At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.) There is no direct contact between depository and investor. Depository interacts with investors through depository participants only.

Depository participant will maintain securities account balances of investor and intimate investor about the status of their holdings from time to time.

3. Placing the Order:
After opening the Demat Account, the investor can place the order. The order can be placed to the broker either (DP) personally or through phone, email, etc.

Investor must place the order very clearly specifying the range of price at which securities can be bought or sold. e.g. "Buy 100 equity shares of Reliance for not more than Rs 500 per share."

4. Executing the Order:
As per the Instructions of the investor, the broker executes the order i.e. he buys or sells the securities. Broker prepares a contract note for the order executed. The contract note contains the name and the price of securities, name of parties and brokerage (commission) charged by him. Contract note is signed by the broker.

5. Settlement:
This means actual transfer of securities. This is the last stage in the trading of securities done by the broker on behalf of their clients. There can be two types of settlement.

(a) On the spot settlement:
It means settlement is done immediately and on spot settlement follows. T + 2 rolling settlement. This means any trade taking place on Monday gets settled by Wednesday.

(b) Forward settlement:
It means settlement will take place on some future date. It can be T + 5 or T + 7, etc. All trading in stock exchanges takes place between 9.55 am and 3.30 pm. Monday to Friday.

2.8.1.

Stop to Consider
Secondary market or Stock market is the market where trading takes place for existing securities. It is known as stock exchange or stock market. Here the securities are bought and sold by the investors stock exchanges are organised and regulated markets for various securities issued by corporate sector and other institutions. Few important functions of the Secondary Market are as safety of transaction, economic barometer, better allocation of capital, etc.

2.8.2.

Check Your Progress

1. Define Secondary Market.
2. State the important features of Secondary Market
3. Discuss the important functions of Secondary Market
4. Secondary Market is also known as ________________________
5. State the trading mechanism of dealing in the Stock Exchange.

2.9. Equity Market-

An equity market is a platform for purchasing and selling stocks of various listed companies. Various traders conduct buying and selling of a company's stocks with the help of a stockbroker. The first step for trading in stock exchanges is to have a Demat and trading account and select a trusting stockbroker to open a free online Demat Account.

Equity Share Meaning

An equity share, normally known as ordinary share is a part ownership where each member is a fractional owner and initiates the maximum entrepreneurial liability related to a trading concern. These types of shareholders in any organization possess the right to vote.

2.10. Equity Market Trading Procedures

1. **Trading:**

Here, the stock exchanges provide an open trade platform for buying and selling of stocks and securities. This is completely automatic and computerized, and traders can see the trades on a screen before placing orders.

2. **Settlement and clearing:**

Stock exchanges settle the trade during a day's session in a process known as a settlement cycle. In India, stock exchanges have adopted the T+2 settlement cycle. This means that after completion of a day's trading session, traders receive the credits or sale proceeds within two working days.

3. **Risk management:**

To prevent fraudulent activities and mitigate risk to investors, stock exchanges have a sound risk management system in place. Some of them include:

- Margin requirements
- Liquid assets
- Pay-ins
- Voluntary close-out

2.11. Debt Market

When compared to the equity market, the debt market is associated with low risk. The debt market acts as a regular source of income and capital preservation through which the returns from the debt market are generally lower than those from the equity market.

In the equity market, one buy and sell shares. In the debt market, bonds, certificates of deposits, debentures, and government securities are bought and sold.

2.12. Debt Market Instrument

The debt instruments include:

- **Bonds:** Both the government and the company, can issue bonds. Investing in the bonds, you effectively loan money to the issuer of bonds. The issuer then repays this loan, along with interest, for a predetermined period.
- **Government securities or G-secs:** These are issued by the RBI on behalf of the Government of India. These are offered for both the short and long terms. Short term bills with a maturity of less than one year are called Treasury Bills (T-bills) while long term instruments are called Government Bonds or Dated Securities.
- **Debentures:** These are issued solely by the companies and come with a fixed interest rate. You can invest in either convertible or non-convertible debentures.

With these key differences underlined, one can differentiate between the investment types, risks, and returns associated with the debt market and the equity market.

2.12.1

Stop to Consider

Equity market and Debt Market are integral part of the Capital Market. Both these market constitute the Capital Market. Equity Share, Debentures, Bonds are the few of the prime instruments that are dealt in these market. The return is fluctuating in equity market as return largely depends upon the profit they earn, however, the return from debt market is stable and regular as investment are made upon debt instruments.

2.12.2.

Check Your Progress

1. What is Equity Market?
2. What is Debt Market?
3. What instruments are dealt in Debt Market? Explain.
4. Discuss the trading procedures of Equity Market.

2.13 IPO - Definition

IPO is the acronym of Initial Public Offering. By definition, it is the process by which a privately held company offers its shares to the public for the first time to become a publicly traded company. It is a process of offering of either a fresh issue of securities or an offer for sale of existing or both by an unlisted company for the first time to the public. As by issuing the IPO the company gets its name listed on the stock exchange. It's also termed as "going public".

2.14. Types of IPO: -

Fixed price offering: - Under fixed price, the company going public determines a fixed price at which its shares are offered to the investors. The investor knows the share price before the company goes public. To participate in the IPO, the investor must pay the full shares price when making the application.

Book Building Offering: - Under book building, the company going public offer a 20% price band on share to investor. Investor then bid on the share before the final price is settled once the bidding has closed. Investors must specify the number of share they want and how much they are willing to pay. Unlike a fixed price offering, there is a fixed price per share.

The lowest price of share is known as fair price, while the highest share is known as the cap price. The final price is determined by using investor bids.

2.15. Advantages of IPO Offerings

Raises a lot of money:

This is the primary reason for a company for going public. The company may need more money to pay off debts, to expand the business, to improve infrastructure and for many such reasons which they think will help in their future development.

Lower Cost of Capital:

Gives the company a way to gain capital at lower than the market rate. If the company borrows money from banks, they will charge interest on it. But if the company raises capital by issuing shares that there would be no obligation to provide any interest on that raised money.

Increases Liquidity:

Initially, the shareholders of the private company hold their shares in the form of equities. When the company goes public, it is the time when they can convert those equities to real money by selling it at market price.

Helps in Mergers and Acquisitions:

When a larger public company enters into a deal for an acquisition or a merger with smaller competitors, the terms of the deal typically include shares. This way cash flow to the smaller companies gets smoother and effective.

Increases Visibility and Credibility:

Going public increases the visibility and credibility of a company. In a public company, one can expect a better management and more transparency in fiscal data as they have to periodically report it to governing bodies.

Improves Financial Health:

Selling equities to the public would have generated a lot of capital and increases liquidity, which will be used for the better future of the company. Hence, the company will gradually approach towards a better financial situation, to apply for a loan or to negotiate the terms of the loans.

2.16. Disadvantages of IPO Offering-

High Upfront Cost:

Offering shares to the public is not at all cheap; it has a huge upfront cost. It involves underwriter's fees, accounting and legal fees, registration charges, printing charges, and advertising costs etc. Moreover, the accounting system and management have to be upgraded. You also need to find people who are qualified to sit in your company's board.

Loss of Ownership Control:

Going Public means, you could lose ownership control of the business. If you somehow become a minor shareholder, the Board of Directors could even fire you.

Lower Control over Decision Making Process:

In a public company, any major decision needs to be passed by taking approvals from the majority of the shareholders. When you sell too much of your stakes outside the company, and your shareholders elect the majority of the board of directors, decision-making process may take days to complete or even be rejected in case of disagreement between broad of directors.

Increased Liability:

A public company is legally obligated to its shareholders to capitalize on shareholder profits and announce operational data. There is no way you can provide an excuse for any mismanagement. The company and its management can even be prosecuted for misrepresentations of information to shareholders or for omitting information that the country's securities laws require being disclosed.

2.17. Private Placement

Section 42 of the Companies Act, 2013 ('Act') provides that a Company can make a private placement to a select group of persons. Private Placement by companies means offering its securities or inviting to subscribe its securities for a select group of persons other than by way of public issue through a private placement offer letter.

Private placement of securities can be made only to select persons or identified persons (as identified by the board of the company). A company making a private placement cannot offer its securities through any public advertisements or utilise any marketing, media, or distribution agents to inform the public about such an offer.

Under this method the securities are sold by the issuing companies to certain intermediaries such as brokers, issue houses or financial institutions, etc. so as to privately place to their clients and associates. The issuing company may also use their service for private placement to certain individuals or institutions without having sold such securities to the intermediaries.

The main advantage of this method is that it is very cheap way of marketing securities as it saves in issuing costs but the securities are sold to only a selected group of investors.

2.18. Advantages of Private Placement

The following are the advantages of private placement:

1. **Speed in raising finance**: If a company goes in for a fresh issue through public issue there are lot of procedures to be followed which take a lot of time. On the other hand, it is possible to raise resources through private placement within 1 or 2 months.

2. **Low cost**: The company need not spend money in preparation and printing of prospectus, printing of application forms, transporting them to different places, advertisements of the issue in the media etc

3. **Confidentiality**: The Company can maintain strict confidentiality. In the case of issue through prospectus many disclosures have to be made. But in the case of private placement disclosures made are less and they are made to a select few. Therefore confidentiality can be maintained.

4. **Small amounts can be raised**: Even small amounts can be raised through private placement.

5. **Stable market**: The private placement market is more stable when compared to the stock markets. Volatility is less and issues are marketed in a professional manner.

2.18.1.

Stop to Consider

IPO and Private Placement are two important methods adopted by the corporate houses while issuing shares in the Primary market. IPO or Initial Public Offering is the process by which a privately held company offers its shares to the public for the first time to become a publicly traded company. It is a process of offering of either a fresh issue of securities or an offer for sale of existing or both by an unlisted company for the first time to the public.

Private Placement is that method the securities are sold by the issuing companies to certain intermediaries such as brokers, issue houses or financial institutions, etc. so as to privately place to their clients and associates

2.18.2

Check Your Progress

1. Define IPO
2. What do you mean by Private Placement of Shares?
3. Discuss the advantages and disadvantages of IPO.
4. State the benefits for adopting Private Placement of shares by corporate.
5. State the different types of IPO.

2.19. Summing Up-

This Unit will help the readers understand the basic concept of different types of Capital Market and their functionaries. Readers will have a clear insight upon Primary market, Secondary market and their functions along with a brief knowledge of Equity & Debt Market. An elaborate explanation has also been provided regarding IPO & Private Placement.

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2.21 Model Questions-

1 What do you understand by ‘New Issue Market’? Explain the different methods of marketing corporate securities.

2 Define Secondary Market or Stock Exchange. Discuss the different important functions of a Stock Exchange.

3 State the trading mechanism of dealing in the Stock Exchange.

4 What do you mean by IPO. Discuss the advantages and disadvantages of IPO.

5 What do you understand by Private Placement of Shares? State the advantages of Private Placement of shares.

BLOCK III : Unit-3

Capital Market Reforms

Unit Structure:

3.1 INTRODUCTION

The capital market is the market for long-term funds used for investment. The capital market is a source of funds for businesses and governments, as well as a place for savers to invest their long-term savings. The primary and secondary markets are the two segments of the capital market. Any marketplace where buyers and sellers trade assets such as equities, bonds, currencies, and derivatives are referred to as a stock exchange. Transparent pricing, basic trading regulations, costs and fees, and market forces determining the prices of traded securities are all characteristics of financial markets. In economics, the term market refers to the total number of potential buyers and sellers of a particular good or service, as well as the transactions that take place between them. The term "market" is sometimes applied to what are more strictly exchanges, or organizations that facilitate the trading of financial securities, such as a stock exchange or an exchange in finance. Financial Markets enable:

1. The raising of capital (in the Capital Markets)

2. The transfer of risk (in the Derivatives Markets)

3. The transfer of liquidity (in the Money Markets)

4. International trade (in the Currency Markets)

Stop to Consider

Some differences between Money Market and Capital Market

Money Market	Capital Market
Money markets are informal.	Capital markets are formal.
Commercial banks, non-financial institutions, central banks, chit funds, etc.	Stockbrokers, insurance companies, Commercial banks, underwriters, etc.
Money markets are highly liquid	Capital markets are comparatively less liquid.
Money markets have low risk.	Capital markets are riskier in comparison to money markets.
Instruments mature within a year.	Instruments take a longer time to attain maturity
To achieve short-term credit requirements of the trade.	To achieve long-term credit requirements of the trade.
Increasing liquidity of funds in the economy	Stabilizing the economy by an increase in savings

3.2 Objectives

The objectives of this unit are to:

- To discuss the significance of the capital market in the Indian financial system
- To highlight the functions of the Capital Market in India
- To highlight the reforms in the capital market

3.2 Functions of Capital Market

While Capital Markets is viewed as a market for long-term or infinite-term financial assets, it plays a critical role in mobilizing resources and allocating them to productive channels. As a result, Capital Markets can be said to facilitate a country's economic growth process. The following are some of the most important functions and implications of markets: –

1. Economic Growth: Capital markets aid in the acceleration of economic growth. It reflects the state of the economy. The capital market aids in the efficient allocation of resources from those with excess capital to those who require capital. As a result, we can say that it contributes to the expansion of both public and private sector industry and trade, resulting in balanced economic growth in the country.
2. Promotes Saving Habits: After the development of capital markets, the taxation system, and banking institutions, investors are given more opportunities to save. They might have invested in unproductive assets like land or gold if Capital Markets had not existed, or they might have overspent.
3. Stable and Systematic Security prices: Capital Markets assist in the stabilization of stock prices in addition to the mobilization of funds. The stabilization of security prices is aided by a reduction in speculative activities and the provision of capital to borrowers at a lower interest rate.
4. Availability of Funds: Capital Markets investments are made regularly. Throughan online platform, both buyers and sellers interact and trade their capital and assets. Stock exchanges such as the NSE and BSE provide a platform for this, making capital market transactions simple.

3.3 Types of Capital Market:

The capital market is mainly categorized into:

Primary Market: The primary market primarily deals with new securities that are issued for the first time in the stock market. As a result, it's also referred to as the new issue market. The primary market's main purpose is to make it easier for companies to transfer newly issued stock to the public. Financial institutions, banks, HNIs, and other institutional investors are the primary participants in this market.

Secondary Market: The stock market is the market where securities are traded, and it is also known as the stock exchange. Existing investors sell securities here, while new investors buy them.

Stop to Consider

Some differences between Primary Market and Secondary Market

Primary Market	Secondary Market
Also Known as New Issue Market (NIM)	Also Known as After Issue Market (AIM)
It is the market where stocks and other securities are issued for the first time	It is the Market where stocks already issued are traded
In primary market Investment banks, Merchant Bankers acts as intermediaries	Here Brokers acts as intermediaries
In the Primary Market stocks are issued directly by companies to investors	Sold and purchased amongst investors and traders
In the primary market price is fixed at par value or price is determined through book building	Price is determined through the forces of demand and supply
ROI is usually low in the money market	ROI is comparatively high in the capital market

3.4 Reforms in the Capital Market

The 1991-92 securities scam prompted the government to increase the pace of reforms in the capital market. The government has taken several measures to develop the capital market in the post-reform period, since then in both the primary and secondary segments of the equity market. With which thecapital market reached new heights. Some of the important measures which the government undertook to reform the capital market can be divided into Primary market reforms and Capital Market Reforms which are as follows:-

3.4.1 Reforms in Primary Market

- SEBI (Securities Exchange Board of India) was established as a non-statutory body under administrative management in early 1988. The Securities and Exchange Board of India (SEBI) was established in January 1992 with statutory powers to regulate the securities market. Investor protection and orderly capital market development are the two goals outlined in the SEBI Act.

• In May 1992, the capital issues (control) act of 1947 was repealed, allowing issuers of securities to raise capital from the market without the approval of any authority, either for floating or pricing an issue. There were also no restrictions on the right and bonus issues. The debenture interest rate was lowered. However, new capital issues are now subject to SEBI oversight, and issuers must adhere to SEBI disclosure and protection guidelines, which are being strengthened overtime to protect investors' interests.

• With the establishment of a large number of merchant bankers, investing and consulting agencies, and issue registers over the years, the primary capital market's infrastructure has become fairly diversified.

• The primary capital market has expanded and deepened as public sector banks, financial institutions, and infrastructure and power sector enterprises increasingly raise resources from the market via debt and equity.

- As many mutual funds sponsored by banks and financial institutions were set up in 1987-88, the process of institutionalization on the supply side began to gain momentum in the early 1990s when mutual funds were established privately. A total of more than Rs 1 lakh crore is now held by 37 mutual funds operating in the country.
- The requirement to issue shares with a par value of Rs 10 and Rs 100 was canceled. • This allowed companies to set a fixed value for each share of stock. Those companies that have dematerialized their shares can use this service. Shares cannot be issued in decimal rupees, either. Also eligible for splitting and consolidating share values are companies that have already issued shares at a value of Rs 10 or Rs 100.
    - Simplified issue procedures and improved disclosure standards have been mandated. As part of the process of launching public offerings, companies are required to disclose all material facts about their projects, as well as specific risk factors associated with those projects. For public issues, the SEBI does not vet the offer document, but it has introduced a code of advertisement for public issues to ensure fair and truthful disclosures.
    - As a cost-saving measure, the issuer made underwriting optional. However, if an issue is not underwritten and fails to secure 90% of the public offering, the entire sum collected will be refunded to investors.
    - For unlisted companies, the existing requirement of a three-year track record of dividend payment for an IPO has been relaxed under the new norms, the companies will have to demonstrate an ability to pay dividends rather than an actual dividend-paying record.

- Any fund-based activity that is not directly related to the capital market is prohibited for merchant bankers. The term "merchant banker" is no longer used to describe a variety of different types of merchant bankers.
- Other intermediaries, such as mutual funds, portfolio managers' registrars to an issue, share transfer agents, underwriters, and debenture trustees have also been brought under the purview of the Securities and Exchange Board of India.
- Bridge loans to companies against expected equity flows /issues for periods not exceeding one year and loans against shares held by banks to promoters of new companies in anticipation of raising resources have been permitted since 1998-99, within the 5 percent ceiling prescribed for banks investment shares. The bank's board of directors must give their approval. It is no longer necessary to impose a 50 percent minimum margin on personal loans secured by corporate preference shares and debenture bonds. However, the 50 percent margin for equity shares has remained unchanged. Dematerialized securities' minimum margin prescription was reduced from 50% to 25%, and the ceiling amount on advances against shares to individuals has raised from Rs 10 lakh to Rs 20 lakh as a result.
- To avoid misleading the public, mutual funds have been issued with a code of conduct on advertising.
- By modifying the disclosure and investor protection (DIP) guidelines, the entry norms for IPOs have been tightened. There have been three IPOs worth five times the pre-issue value of Rs 1 crore in the past 15 years, according to the new guidelines Book building is the only option for companies with less than five times their pre-issue net worth to raise money through an initial public offering. 60% of the issue must be allocated to qualified institutional investors (QIBs). If the project has been appraised by public institutions and not less than 5% of the project cost is financed by any of the institutions, either jointly or separately, by way of loans and/or equity subscriptions, the requirements of eligibility norms are exempt.
- The SEBI (DIP) (Disclosure and Investor Protection) Guidelines, 2000 have been amended. Permission has been granted to foreign venture capital investors (FVCIs) registered with the SEBI and state industrial Development Corporations to participate in public issues through the book building route as qualified institutional buyers(QIBs). There is a lock-in requirement for the pre-issue capital of an unlisted company held by venture capital funds (VCFs) and FVCIs. Exemption from the public offer requirement in view of a reduction in quantum from 25 percent to 10 percent and restriction of a minimum public issue size of Rs. 25 crores in respect of an IPO through the book building issue have been removed.
- In March 2003, the SEBI introduced sweeping changes in IPO norms to boost investor confidence. It changed the eligibility criteria for IPOs- a track record of distributable profits was replaced by net tangible assets as it felt that profit figures could be fudged. According to the new norms, companies floating IPOs should have

net tangible assets of Rs 3 crore in each of the two preceding two years. Of this, not more than 50percent be held in monetary assets –cash or its equivalent such securities. It is now mandatory for companies to change their names to ensure that a minimum of 50 percent of the total revenues are derived from the business activity suggested by the new name.

- On March 29, 2005, the SEBI redefined the retail individual investor as one who applies or bids for securities of or for a value not exceeding Rs 1 Lakh. It hiked allocation to high net worth individual's book built issue from 25 percent to 35 percent and reduced allocation to high net worth individuals (Non-Institutional) Category. The allocation to high net worth investors was reduced to 15 percent from 25 percent. The market regulator also reduced the bidding period for a book-built issue. The SEBI reduced the bidding period from the current 5- 10 days (including holidays) to 3-7 working days. It has given an option to listed issuers to either disclose price band in a red herring prospectus /an application form/an abridged prospectus or to disclose price band/floor price at least one day before the opening of the bid. To improve the content and ensure uniformity in data display on the websites of the stock exchanges,the data will be available for a further period 3 days after the closure of the bid/issue. The new norms applyto all public issues whose offer documents are filed with SEBI on or after April 4, 2005.
- For issues priced below Rs 500 per share, the face value should mandatorily be Rs 10 per share But if the issue price is 500 or more, the minimum face value should not be below Rs 1
- Shares will now be allotted on a proportionate basis within the specified categories, with predetermined minimum allotment being equal to the minimum application size.
- During 2005-06 SEBI disclosure and investor protection (DIP) guidelines, 2000 relating to book-building issues were amended to introduce a specific allocation of 5 percent for a mutual fund, proportionate allotment to Qualified Institutional Buyer (QIBs), and margin requirement for QIBs.
- To ensure the availability of floating stocks continuously and maintain uniformity for continuous listing, a minimum public shareholding of 25 percent was prescribed by SEBI in the case of all companies barring a few exceptions.
- To assist the retail investors, SEBI gave in-principal approval for grading of IPOs by the rating agencies at the option of the issuers. SEBI will not certify the assessment made by the rating agencies.
- Companies in the IT, telecom, media and entertainment sectors are permitted to raise capital by offering at least 10% of their equity. To be eligible for this route, a public offering must have a minimum issue size of Rs 100 crore, using the book-building method with a 60% allocation to qualified institutional buyers (QIBs), and maintain a continuous minimum floating post-listing stock.

- Only in Demat form can the issuer make a public or rights offering of shares. Both physical and dematerialized securities can be purchased by investors.
- The SEBI issued new guidelines to govern corporate debt security's private placements. These guidelines are designed to increase transparency and protect the interests of investors in debt securities.
- A new IPO price stabilization tool, the green-shoe option facility, was introduced by SEBI.
- The central listing authority was established to ensure that securities are listed on stock exchanges in a uniform and standard manner.
- ECS was made available to all refunds from the public issue to expedite and ease the process of refunds.
- Even after a prospectus for an IPO or public offer has been filed with the regulator, companies are allowed to pursue multiple avenues to raise capital simultaneously. Companies are now only required to update their prospectus with information about additional capital that is being raised through other means. – With this new leniency, businesses will be able to plan their capital-raising campaigns.
- After the initial public offering (IPO), venture capital and private equity firms cannot sell their shares in accompany. If you invested more than a year before the company went public, you are no longer allowed to sell your shares on the market.
- Previously, at least two credit rating agencies were required for public/rights issues of debt instruments. Now, one credit rating agency will suffice. To lower the cost of issuing debt instruments, this was done.
- Investors will be able to purchase bonds that are not rated investment-grade to meet their risk/return preferences. Investment-grade had previously been the minimum standard.
- SEBI amended the DIP guidelines to allow listed companies to raise equity through rights and follow-on issues in a short period. Fast track issues are those involving publicly traded companies, and they are governed by specific rules.
- With the permission of SEBI, companies can now offer discounts of up to ten percent to retail investors in public offerings. This will help companies increase their equity holdings while also generating a positive response from retail investors during this period of stagnant primary market activity.
- The minimum investment in Indian depository receipts (IDRs) has been reduced from Rs 200000 to Rs 20000, making IDRs available to all investors, including retail investors.
- A new payment system called ASBA (Application Supported by Blocked Amount) was launched by SEBI in August 2008 for public and human rights issues.
- PAN is required for all public and civil rights applications, regardless of the amount requested. Mandatory PAN Requirements for opening and operating beneficial owner

(BO) accounts with depository participants and for trading in the cash,the market has been waived in the state of Sikkim by SEBI.

- The minimum offer to the public norms has been revised to make regulatory requirements consistent across companies regardless of post-issue capitalization and to assist mid-sized issuers who may not require large funds.
- Public companies must have at least 25 percent of their shares owned by the general public by August 22, 2017, as a minimum.

SELF ASKING QUESTIONS

i)List down any five important changes that SEBI has brought in the last five years.

…………………………………………………………………………………………
…………………………………………………………………………………………

ii) What do the following stand for?

SEBI : ………………………………………………………………………………….

SIB : ………………………………………………………………………………….

SEC : ………………………………………………………………………………….

iii) Briefly explain the need for self-regulation in monitoring security market dealings.

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3.4.2 Reforms in Secondary Market

- The open outcry trading system, which was in use until 1995, was replaced by online screen-based trading. Approximately 8000 trading terminals are dispersed across the country among the country's 23 stock exchanges.
- Over-the-counter exchange of India (1992), national stock exchange of India (1994), and interconnected stock exchange of India (1995) were all established in the 1990s. (1999)
- In August 1996, the trading and settlement cycles of all stock exchanges were reduced from 14 days to seven days. In January 1998, a dematerialized segment of all companies was introduced to rolling settlement (T+5). Since December 31, 2001, all stocks have been settled on a rolling basis. On April 1, 2002, the settlement cycle was shortened for all securities from T+5 to T+3.
- Additionally, various risk-containment measures such as the market to margin system, intraday trading limit, and trade guarantee fund have been implemented or strengthened. Before declaring members default, the stock exchange is allowed to use

settlement guarantee funds (SGFs) to cover shortfalls caused by non-fulfillment or partial fulfillment of their obligations. The NSE has established a separate corporation, the National Securities Clearing Corporation, to act as a counterparty to all trades executed in the exchange's capital market segment**.**

- Securities dematerialization through the depository system and electronic book-entry transfers are being investigated vigorously to improve investor protection. In November 1996, the National Securities Depositories Limited and the Central Depositories Limited were established to make this possible. Demat accounts are used to hold, trade, and settle all actively traded securities.
- The SEBI Act, 1992, prohibits insider trading and punishes it as a criminal offense, making it a violation of the insider trading regulations.
- To ensure that stock exchange requirements were uniform, the government amended the Securities Contract Regulation Rules in 1957.
- A carry-forward mechanism, based on the Patel and Varma committee recommendations from 1995, was reinstituted in Badla in January 1996. (1996). Mandatory delivery under negotiated deals, securities lending, and continuous net settlement were all implemented to strengthen the cash segment. Following the March 2001 scam, all deferral products, including badla, were halted as of July 2001.
- Under the listing agreement, all listed companies must provide stock exchanges with continuous disclosures and publish quarterly unaudited financial results. There must be public disclosure of material information that could affect a company's ability to operate effectively.
- Corporate governance reform is one of the most significant measures in the secondary education sector. The purpose of corporate governance is to safeguard the interests of the company's various stakeholders. Commitment to values, ethical business practices, and a high level of openness are all key components. All stakeholders must be protected while the interests of shareholders are maximized. The SEBI appointed Kumar Mangalam Birla as chairman of a committee to study Indian corporate governance. Codes for corporate governance were drafted by the committee, and stock exchanges were suggested as the best method of implementation.
- Major structural changes have also been made to stock exchanges. A wide range of interests is represented on the boards of various stock exchanges, rather than just those represented by their members. The Securities and Exchange Board of India (SEBI) has taken over the regulation of stock exchanges, brokers, and sub-brokers.
- Companies are permitted to buy back their shares for capital restructuring, provided that the buyback does not exceed 25% of the company's paid-up capital and free reserves. This buyback has been allowed to improve liquidity and increase shareholder wealth.
- The insider trading regulations have been formulated prohibiting insider trading and making it an offense, punishable following the provision under the SEBI act, 1992.

- Takeover and substantial acquisition of shares are governed by rules that ensure the interests of small shareholders are protected while also increasing transparency in the process.
- Takeovers were revised in September 2002 after SEBI accepted recommendations from the Bhagwati committee. To comply with the new code, an acquirer must make open offers to the stockholders of both companies if it gains control of more than 15% of the shares of a company that already owns 15% of the shares. If management control changes, an open offer will be made even if the equity stake is less than 15%. Withdrawn shares can be sold in the open market or to another acquirer who is willing to pay more for them. It's now mandatory to reveal the percentage of a company's stock that an acquirer holds at various levels of acquisitions. To ensure complete transparency in the acquisition process, the buyer must make disclosures for every 2% increase in the holding's value above the 15% threshold.
- Over-trading and sudden increases in the price of securities have been curbed by an index-based market-wide "Circuit-breaker" system. Additionally, individual scrip-wise bands of 20 percent can be imposed for all securities except those available for stock options at three stages of index movement, at 10%, 15%, and 20%, as an additional safety measure.
- Trade terminals were allowed to be set up outside of the United States in February 1999 to facilitate market participation by non-residents. In February of 2000, online trading became legal in the United States.
- For the sake of greater market transparency, the Securities and Exchange Board of India (SEBI) outlawed negotiated and cross-dealing in 1991. (Where both the seller and buyer operate through the same broker). Furthermore, private off-market transactions in both shares and publicly listed corporate debts were outlawed entirely. There is no other way for these transactions to be completed.
- Futures trading began in June 2000. NSE and BSE have set up proper trading infrastructure and are regularly training programmers in it. With the advent of options trading, the Securities Contracts (Regulation) Act of 1956 was updated. Options contracts based on indexes and stocks were first traded in June and July of 2001, respectively, while stock-based futures contracts were first traded in November of that year.
- Listed companies are required to release their quarterly results. As a result, investors can keep an eye on their portfolios at all times. As of November 2001, the practice of disclosing quarterly results has been followed by the stocks-based futures market.
- Publicly traded companies are required to release quarterly financial results. As a result, investors can keep an eye on their portfolios at all times. The practice of reporting quarterly results in developed countries is consistent with this practice.
- Imposing a client code and a minimum float for continuous listing as a way to check for price manipulation was passed in November 2001.

- Standardization of stock exchange listing requirements was achieved by the government by amending the Securities Contract (Regulation) Rules, 1957.
- On July 2, 2001, a margin system based on 99 percent value at risk (VaR) was introduced for all scrips in the rolling settlement.
- To raise investor awareness and safeguard their interests, the central government has announced the creation of the Investor Education and Protection Fund (IEPF).
- As of July 2, 2001, all deferral products have been banned, so the restriction on short sales that was announced on March 7, 2001, has been lifted.
- A block deal's full specifics must be made public by all brokers. Over 5% of the equity shares of that publicly-traded company are traded in block deals.
- The Securities and Exchange Board of India (SEBI) has allowed corporate brokers with a net worth of at least three crores to extend margin trading facilities to their clients in the cash segment of stock exchanges to increase liquidity in the secondary securities market.
- Shortfalls in settlement can be met by clearing corporations/houses that have been registered with the Securities and Exchange Board of India (SEBI) as an approved intermediary.
- All market participants, including intermediaries, are required by SEBI Regulations, 2003 to apply for allotment of unique identification numbers for themselves and their associated individuals. The goal of this move is to ensure that all market participants have access to up-to-date information. Investors and companies will have to comply with this at a later date.
- Investor complaints received, disposed of, and unresolved by listed companies should be made mandatory by stock exchanges in clause 41 of the listing agreement.
- On April 1, 2003, the clearing and settlement cycle time was further reduced to T+2.
- The Securities and Exchange Board of India (SEBI) has defined the roles of mutual fund CEOs and fund managers to strengthen their positions, specify accountability, and protect the interests of investors. Both for subscriptions and redemptions, a uniform cut-off time for calculating and applying NAVs were stipulated. Additionally, it stipulated a minimum number of investors for a scheme or plan to be successful.
- Securities and Exchange Board of India allowed mutual funds to invest in derivatives. A maximum of $50 million in foreign securities could be invested in each year, up to a maximum of 10% of the net assets on the 31st of January.
- In June 2003, interest rate futures contracts were introduced, and in August 2003, futures and options contracts on sectoral indices were introduced.
- When an IPO goes public, its international securities identification numbers (ISINs) are activated by depositories only at the time of its initial public offering (IPO) debut.

- Depositories/DPs can't change their policies on BOs who transfer their entire portfolios to another branch of the same depository or a different one, as long as both DPs are the same.
- The delisting was made legal in 2004 under the Securities Contract (Regulation) Act to safeguard the interests of minority shareholders. On October 30, 2006, the Department of Economic Affairs published draught delisting rules that require stock exchanges to delist if they fail to meet certain criteria.
- ❖ It has lost money for the last three years in a row, and its net worth is now negative.
- ❖ There has been a six-month suspension in the trading of the securities, or a three-year period of infrequent trading of the securities.
- ❖ A fine of Rs1 crore or punishment of less than three years is a violation of the SCR Act or SEBI Act of the Depositories Act or the rules and regulations thereunder.
- ❖ It disappears or provides a false address, or the registered office is changed without authorization.
- ❖ The public's ownership of the company falls below the bare minimum stipulated in the listing contract.
- All exchange-traded derivative contracts can be invested by FIIs and NRIs.
- Commodity derivative trading is permitted by stockbrokers.
- ADR/GDR programmers sponsored delisting offers for FIIs, and the government disinvested in publicly traded companies.
- The stock exchanges were allowed to provide a separate trading window for block deals under certain conditions to facilitate the execution of large trades without affecting the market.
- As of November 14, 2005, this window was activated by the BSE and NSE.

3.5 Key Terms

- ➢ **Capital Market:** The capital market is the market for long-term funds used for investment. The capital market is a source of funds for businesses and governments, as well as a place for savers to invest their long-term savings.
- ➢ **Money Market:**The money market is an economic component that provides short-term financing. The money market is concerned with short-term loans, typically for one year or less.
- ➢ **Primary Market:** The primary market is the segment of the capital market that involves the issuer directly selling equity-backed securities to investors. Investors acquire previously untraded securities.
- ➢ **Secondary Market:** The secondary market, alternatively referred to as the aftermarket or follow-on public offering, is a financial market in which previously issued financial instruments such as stock, bonds, options, and futures are purchased and sold.

3.5 Summary

In this unit, we have discussed two segmentsof the Indian securities market namely primary market or new issue market and secondary market or the stock market. We have highlighted recent reforms in the primary and secondary market and discussed the steps taken by the government to check and balance the various market players, and trading arrangements that exist in the stock market. To make the trading in securities market more safe and easy and make the market environment more robust.

3.6 ANSWER TO "CHECK YOUR PROGRESS"

Short Questions

1. Briefly explain the Concept of New Issue Market (NIM)
2. What are segments of the capital market?
3. What is a stock exchange?

Long Questions

1. What is a capital market? How does it aid in economic growth? What are the functions of the capital market?
2. List Down the major reforms in the primary and secondary capital market
3. How do primary and secondary markets contribute to economic growth?

1.8 References and Suggested Readings

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BLOCK III : Unit-4

Secondary Market- Stock Exchanges, their functions, Trading Mechanism

*"The stock market is the story of cycles and of the human behavior that is responsible for overreactions in both directions."- **Seth Klarman***

Unit Structure:

4.1 INTRODUCTION

A market is a gathering place for buyers and sellers to exchange goods. This is a universal definition that applies to all markets. We will go over the capital market in greater detail in this course. It is a location where various types of capital are exchanged. Individuals like you are frequently the lenders or suppliers of capital. Borrowers and receivers of capital include businesses and other institutions. The market is divided or organized in a variety of ways. The market is divided into two categories: (a) short-term capital market (money market) and (b) long-term capital market (also, called stock market). The market can also be classified as (a) Institutional Market and (b) Direct Market. As an investor, you have a variety of options for dealing with the market. Let's look at the market from the perspective of an individual.

If you have extra money that you can only use for a short time, you need to look for ways to save money quickly. Because the amount you must save is small in these situations, you need to look for help from institutions. A lot of people don't work with the money market, which deals with short-term capital. Often, people go to an institution for this reason. You can put your short-term savings in a bank account or a mutual fund that has money market schemes.

It's important to look for investments that last more than a few months if you have extra money. If you want long-term products, you can go to an institution, like a bank, or you can buy them directly from the market. You can put your money in a long-term fixed deposit, invest in a mutual funds scheme, or buy stocks and bonds on the open market. To deal with the market on your own, there are two ways. As a result, the markets are split into primary and secondary markets. The primary market is the one where the company tries to get money from people. They can ask for money in the form of debt-equity or both. Today, it's not very hard to do business in the primary market. Like when you open a fixed deposit, you must fill out an application form and deposit the money after you do so. Brokers and sub-brokers usually help you get forms and show you how to fill them out, but this is not always the case. What is important is that you must make sure that your investments work with your goal. Small investors can get help from financial dailies and magazines that write analytical reports on things that happen in the primary market, just like in the United States. After you have filled out the application forms and the company accepts them, you will get a certificate or credit in your bank account as a reward for your work. This is what will happen when there are too many people applying for the job. The company may not accept all of them. In these cases, you will get back the money you put in at the start.

For good issues, there will be a lot of competition. The price in the primary market is already set. Many investors who want to deal directly with the market turn to the secondary market because they don't know if they'll get the money they want to buy. It is a place where one person sells to another person. As a result, the market moves quickly. The prices of securities change depending on how much people want and need them. There are different types of securities that can be traded on the secondary market, like debt, equity, and more. This has also made it easier for people to invest in the secondary market, thanks to new information and computing technologies. Open an account with any stock exchange members that you want. The process of opening an account isn't very complicated, and it's a lot like opening a Savings Bank Account with your banker. You can buy and sell things over the phone, and often you get confirmation of your purchase or sale right away. In today's world, it is also possible for you to buy and sell securities through the web. In this Unit, we'll talk more about how the stock market works and how investors can buy and sell securities in the market.

4.2 Objectives

The objectives of this unit are to:

- To discuss the importance of the secondary market in the Indian financial system
- To highlight the functions of stock exchanges in India

- To analyze the trading mechanism in the stock exchanges

4.2 SECONDARY MARKETS IN INDIA

India's stock market started small and spread out in the 19th century. It has since grown to be one of the largest in the world. By 1990, there were 19 Stock Exchanges in the country, and by 2002, there were 23 Stock Exchanges. Some people might be interested in finding out more about the history of the Indian stock market. It performs what kinds of things. There are a lot of different types of stock exchanges in India. How do these things get done? We'll now talk about these and other things.

A secondary market is a place where existing securities, like stocks, bonds, options, futures, and so on, are sold and bought. Secondary markets in India are made up of stock exchanges that have been approved by the government and the regulator, like SEBI or the RBI. These exchanges operate under bye-laws, rules, and regulations that have been approved by the government and the regulator. The stock exchanges are part of the "organized markets" category. These securities may be made by the Central or State Government, public sector institutions, companies, and more. They can be traded on the stock market.

Instead, most bonds and structured products (customized contracts) are traded in the over-the-counter (OTC) market, which is where they are sold. In this way, all stock markets, as well as over-the-counter markets, are secondary markets that help to reduce the risk of investment and keep the financial system stable. The term "secondary market" refers to the part of the Capital Markets that deals with the trading of already-issued (existing) shares. If you have equity shares, they are put on a stock exchange after they are sold in the Primary Market. Bonds are traded on the Negotiated Dealing System of the RBI when they are traded in the debt market. Investors can get money from secondary markets. Secondary markets usually use either an auction-based system or a dealer-based system to buy and sell things. Unlike the stock exchange, the Over Counter (OTC) market is run by people who work for other people. For the average person, the Secondary Market is a good place to buy and sell securities. The true value of the security is found in the secondary markets, which can lead to either a rise in the price or a fall in the price. Banks help people and businesses buy and sell things in the secondary market by opening direct accounts for them. Banks also lend money against stocks and other assets. If you want to send money, you can also use banks to send money.

Stop to Consider

Some differences between Primary Market andSecondary Market

Primary Market	Secondary Market
Also Known as New Issue Market (NIM)	Also Known as After Issue Market (AIM)
It is the market where stocks and other securities are issued for the first time	It is the Market where stocks already issued are traded
In primary market Investment banks, Merchant Bankers acts as intermediaries	Here Brokers acts as intermediaries
In the Primary Market stocks are issued directly by companies to investors	Sold and purchased amongst investors and traders
In the primary market price is fixed at par value or price is determined through book building	Price is determined through the forces of demand and supply

4.2.1 Origin and Growth

It doesn't matter what kind of organization or institution it is: It's the result of historical events and pressures. The events keep changing and/or reforming the existing organizations so that they can be used in today's world. Because we need to know a little about the stock market in India's history, we'll do that now.

In 1800, the Indian stock exchanges were in a very basic form. Since then, they have gone through six broad stages.

1800-1865: The East India Company and a few commercial banks sold shares a few times a year through a small group of brokers, but it was very rare. If you read an old newspaper, there were only about six people who were known as brokers in Bombay between 1840 and 1950. The year 1850 was a big change. Company flotations took over the market. The number of brokers jumped from 30 to 60. PremchandRoychand, a legendary figure in the world of finance, was the backbone of industrial growth and the boom in share flotation that came with it.In 1860, the stock market had a unique history. This is known as "share mania," and it took over the whole market. The American Civil War made cotton hard to find. Indian cotton manufacturers took advantage of this and sent a lot of cotton to other countries. The rise in export earnings made it easier for people to invest in shares. There were a lot of new businesses coming up. There were a lot of speculation and people bought things without thinking. This craze lasted until 1865. In Indian stock exchange history, this is the end of the first phase. When the Civil War came to an end, demand for Indian cotton dropped quickly.

The share became worthless pieces of paper that were not worth anything. Exactly, on July 1, 1865, there were no more shares because all-time contracts that had come due could not be met.

During 1866-1900, we see a different phase. There was a lot of mania at the stock exchange in Bombay for the last 25 years. There was also a regular market for securities that was built up because of it above all. Since the market was first set up in Bombay, it quickly became and still is the most important and most well-run stock exchange in India. It was formed in 1887 by a group of stockbrokers who wanted to help each other. It was called the Native Share and Stockbrokers Association. The brokers made rules for how they should do business and got private money to help the economy grow. It also raised money for government bonds (gilt-edged bonds), especially for the Bombay Port Trust and the city of Bombay. The same thing happened in Ahmedabad in 1894.

Political changes from **1901 to 1913** gave a big boost to share investment. During the Swadeshi Movement, led by Mahatma Gandhi, the indigenous trading and business class were urged to start businesses in manufacturing. As a result, Calcutta became another important place to buy and sell stocks. Coal prices rose from 1904 to 1908. This led to people trading. Thus, the third stock exchange was started by stockbrokers in Calcutta, who started the first two. Demand for industrial goods kept rising during the Inter-war years because the British were fighting in the World Wars at the same time. Existing businesses that made steel and cotton textiles, woolen textiles, tea, and engineering goods grew, and new businesses were set up. Another stock exchange opened in Madras in 1920.

The years **1935 to 1965** can be thought of as the time when the existing stock exchanges in India started to grow. At this time, planning for industrial development was very important because it helped the country grow its industrial and commercial base. At Hyderabad in 1943, and in Delhi in 1947, two more stock exchanges were set up to trade stocks. As soon as Mexico became a country in 1846, it had seven stock exchanges in the country's major cities. Between 1946 and 1990, 12 more stock exchanges were set up to trade the shares of 4843 more companies that were already on the stock market.

Twenty-three of the country's stock exchanges are regional ones that are only for a certain part of the country. The National Stock Exchange (NSE), the Over-the-Counter Exchange of India Limited (OTCEI), and the Interconnected Stock Exchange of India Limited (ISE) are three more that were set up in the reform era. They all have the job of setting up a national trading network. The ISE is run by 15 regional stock exchanges in India. It has been set up in Mumbai, which is the capital of the country. The ISE gives a member-broker of one of these stock exchanges access to the national market, which would be in addition to the local market that is already available. A system called the Screen-Based Trading System (SBTS) has been used by the NSE, OCTEI, ISE, and most other stock exchanges in the country. It allows investors from all over the country to trade in a transparent, fair, and automated way. At the end of March 1999, the stock market had 9,877 companies that were on it. The total value of those companies was 5,30,772. Indian stocks had 9,644 primary-listed companies as of the end of March 2002. It was worth Rs. 6,36,861 crores by March 2002. In India, there are a lot of different places where you can buy and sell stocks.

1. The Bombay Stock Exchange
2. The Ahmedabad Stock Exchange Association
3. Bangalore Stock Exchange
4. The Calcutta Stock Exchange Association
5. Cochin Stock Exchange

4.2.2 Role and Functions

Stock exchanges play a big role in the consolidation of the national economy, and they also help the industrial sector grow the most. India is a country that is still growing. In these countries, these exchanges are very important. They help move the money and keep things safe at the same time. These moves help to raise the level of capital formation. Let's now talk about how stock exchanges play a role in the Indian Capital Market, as well.

1. Mobilization of Savings**:** For both institutional investors and people who want to invest, the capital markets are one of the best places to do so. To make sure that investors are safe when they trade in the capital markets, there are rules and regulations in place. This also helps small savers and individual investors have more faith in the market. In this way, stock exchanges help to bring in a lot of money from a lot of people in the capital market.
2. Promoting Capital Formation:The mobilization of funds from the savers by the capital markets is channelized to various industries which are involved in the production and manufacturing of various goods and services which is beneficial for the economy. This enhances the capital formation and development of national assets. This channelization of savings into appropriate avenues of investment is one of the primary roles of the stock exchanges.
3. Liquidity of Investment**:**As an investor, it is very important to think about how easy it is to get your money out of your investment. This is made possible by the stock exchanges. Investors can sell their stocks and other capital market assets at any time during the trading hours and days. So, stock exchanges make sure that investments can be sold at any time. Following the dematerialization of securities, online trading on the

stock exchanges has changed the way people trade. It makes it easier for investors to buy, sell, and move their money.

4. Investment Safety**:**One of the most important things that the stock exchange does is make sure that investors' money is safe. Stock trading has been done entirely online since the act of dematerialization took place. The Securities and Exchange Board of India (SEBI) keeps an eye on how the exchanges work and finds new ways to cheat the system all the time. Measures are taken at times to make sure that investments are safe and that the same doesn't happen again. The people in charge of the exchanges do their best to stop people from speculating and to make sure that investors don't lose money.
5. Wide Marketability to Securities**:**Physical security certificates were used to trade on stock exchanges in the early days. This is how it worked: All trades were done at the office of the stock exchange and only there. Investors who live in other parts of the country don't know how the prices on the exchanges are going to change. Afterward, investors can keep an eye on prices and make the most of capital market price changes. The modern stock exchanges, which are backed by information technology, have made securities available to a lot of people.
6. Funds for Development Purpose: As we have already discussed, stock exchanges help in the mobilization and channelizing of funds from savers to various industries. Many times, these industries are the onesthat are involved in government development projects including infra companies, railways, telecommunications, etc. Stock exchanges help in the constant evaluation of government securities.
7. Barometer of National Economy: The stock exchanges are the barometer of a nation's economy. The economy of a country is economically symbolized by the most significant stock exchange of that country. These stock exchanges help in representing the progress and situation of a nation's economy at national and international levels. For instance, the Bombay Stock Exchange or BSE is often considered by overseas investors to have an idea about the economic condition of our country.

In sum and substance Stock exchange plays a pivotal role in nations' economies. We can say stock exchange is the lifeblood of the Indian economy it not only provides a trading platform for borrowers and lenders to exchange their surplus resources and provides ready marketability of shares. Following are some of the most important functions that are performed by the stock exchange:

1. Role of an Economic Barometer: When the stock market is going up and down, it is a good indicator of how the economy is going. You can see how much each share has changed over time. It is right to say that it is the pulse of the economy, which shows the state of the economy.
2. Valuation of Securities: The stock market helps people figure out how much money they need to buy or sell a certain type of thing. Companies that make money and plan are more

likely to have their securities valued higher. Valuing securities helps creditors, investors, and the government do their jobs better.

3. Contributor to National Growth: A stock exchange is a place where people can buy and sell stocks from different businesses. This process of trading involves a lot of disinvestment and reinvestment, which allows for more money to be made and for the economy to grow.
4. Transactional Safety: Transactions are safe because the securities that are traded on the stock exchange are listed, and the securities are only listed after the company's position has been checked, which makes sure that the transactions are safe. All the companies that are on this list must follow the rules and regulations that the governing body has set up.
5. Making the public aware of equity investment: Information about investing in equity markets can be found on the stock exchange. They also roll out new issues of securities to get people to invest in them.
6. Offers scope for speculation:To make sure there is enough demand and supply for securities and money, the stock exchange allows healthy speculation about the securities that are traded.
7. Facilitates liquidity:The most important thing the stock exchange does is make sure there is a place for people to buy and sell stocks and other things. This gives investors the confidence that their existing investments can be turned into cash, or in other words, the stock market gives investors the ability to turn their investments into cash.
8. Better Capital Allocation: If a company makes money, its shares will be traded a lot. This means that these companies can get new money from the equity market. To make the most money, the stock market helps investors put their money where they can make the most money.
9. Encourages investment and savings:The stock market is a good place to invest in different types of securities that pay out more money. Investing in the stock market is a better way to make money than investing in gold and silver.

Check Your Progress

1. Briefly explain the development of secondary market in India.
2. What do you understand by screen-based trading?
3. Why is stock market known as the Economic barometer?

4.3 Trading Mechanism in Stock exchanges

4.3.1 Traditional Floor Trading

The investor places an order for a certain number of shares of a company with his or her broker or sub-broker at the stock market. The broker sends the order to the floor clerk, who then tries to find someone who wants to sell those shares. A lot of bids are made. After the buyer agrees to the price that the seller has set, the deal is done. This method is also called "open outcry," because traders make their bids by yelling them out.

It is used on financial trading floors to communicate buy and sell information in an open outcry trading environment by making hand gestures. The system was used in the Bombay Stock Exchange before there were electronic trading platforms like the NYSE. It is common for traders to flash the signals quickly across a room when they want to make a sale or buy something. Signals that show palms facing out and hands away from the body are a sign that the trader wants to sell. When traders turn their palms in and hold their hands up, they are signaling that they want to buy. The number of fingers shows how many there are. People gesture with one hand the numbers one through five. People gesture with two hands the numbers six through ten (index finger out sideways is six, two fingers are seven, etc.) There are blocks of ten on the forehead, and blocks of hundreds and thousands can also be shown.

In other words, the signals can be used to show months, specific trades, option combinations, or other market information. The rules of each exchange can be very different, but the purpose of the gestures is the same, so the rules don't matter. People who trade stocks electronically can do so much faster and easier than people who trade stocks in person. Online stock market trading is when you place buy and sell orders for stocks in real-time. When the trading system can match bids and a confirmation is sent, the transaction is over.

On regional stock exchanges a few years ago, the open outcry system was very common. Now, there are online screen-based electronic trading systems that make it easier for people to trade. Right from the start, the NSE and OTCEI used screens to trade. Trades are now done through a computer terminal in the brokers' office, where trades are done on the floor have moved to. There was a system called "open outcry" in the past. The electronic trading system is better than that. It ensures that everyone can see the whole market at the same time. Increases the speed at which price-sensitive information can be added to the prices of things that are already on the market, which makes it easier to find the best prices. Operations are also more efficient because there is less time, money, risk of error, and fraud. There is also no longer a chain of brokers and jobbers, which means low transaction costs. This system has allowed a lot of people from all over the country to trade with each other in complete secrecy at the same time, which has made the market wider and more open. People across the country have been able to trade on the same platform because of this. SEBI has given the go-ahead for trading terminals to be set up outside India, as well as for trading on the web. People who want to trade in Indian stocks from any part of the world can now use the Internet to send orders. It costs less to trade on the internet than to use a trading terminal. In India, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) let people trade cash electronically. People in the market can buy and sell shares.

4.3.2. Modern Electronic Trading System

Floor trading is being replaced by a new system of trading known as screen-based trading in the new electronic stock exchanges, which have a fully automated computerized mode of trading. The trading ring is replaced by a computer screen in this new system, and participants can trade with each other over a computer network. Trading terminals can be installed by member brokers anywhere in the country. A large number of participants, all of whom are geographically separated from one another, can trade at high speeds from their respective locations at the same time. There are two types of screen-based trading systems:

1. Quote driven system
2. Order driven system

Under the **quote-driven system**, the market maker, who is a dealer in a particular security, inputs two-way quotes into the system under the quote-driven system, namely his bid price (buying price) and offer price (selling price). Following that, market participants place orders based on the bid-offer quotes. The system then matches these automatically based on certain rules.

Under the order-driven system, the brokers are in charge of placing the clients' buy and sell orders. After that, they're fed into the machine. The system matches buy and sell orders based on predefined rules.

Stop to Consider

Some differences between Floor Trading andElectronic Trading

Floor Trading	Electronic Trading
In-floor trading trade used to happen through a broker through an open outcry system	In electronic trading, trade takes place with the help of computers and trade terminals.
The brokerage is usually high	The brokerage is usually low, and it is beneficial for retail investors
In-floor trading settlement takes place usually within 14 working days generally it is T+14	In electronic trading, settlement takes place usually within two working days generally it is T+2

Types of Orders

The most common types of orders are market orders, limit orders, and stop-loss orders.

Market Order:A market order is an immediate purchase or sale of a security. This type of order ensures that the order will be fulfilled, but it does not guarantee the price of fulfillment. A market order will typically execute at or near the current bid (sell order) or ask (buy order) price. Investors should keep in mind, however, that the lasttraded price is not always the price at which a market order will be filled.

Limit Order: A limit order is a purchase or sale of a security at a set price or better. A buy limit order can only be filled if the price is below the limit, and a sell limit order can only be filled if the price is above the limit. An investor, for example, wants to buy shares of ABC stock for no more than Rs. 10. This amount could be specified in a limit order, which will only be executed if the price of ABC stock is Rs. 10 or less.

Stop Order:A stop order A stop-loss order, also known as a loss order, is an order to buy or sell a stock once its price reaches a specified price, known as the stop price. A stop order becomes a market order when the stop price is reached.

A buy stop order is placed at a price that is higher than the current market price. A buy-stop order is typically used by investors to limit a loss or protect a profit on a stock they have sold short. A sell stop order is placed at a price that is lower than the current market price. A sell stop order is typically used by investors to limit a loss or protect a profit on a stock they own.

4.4 Settlement System in Secondary Market

The final stage of the transaction is trade settlement, which is a two-way process. The trade is said to be settled once the buyer receives the securities and the seller receives payment for them. While the transaction date is when the official deal takes place, the settlement date is when the final ownership is transferred. The transaction date is always the same and is denoted by the letter 'T.' The final settlement does not have to take place on the same day as the initial agreement. T+2 is the standard settlement day.

When securities were held in physical form, it took five days to settle a trade after the transaction was completed. After receiving the securities, which came in the form of certificates and were delivered by mail, investors paid with checks. The delay resulted in price differences, posed risks, and cost a lot of money. Market regulators decided to set a deadline for transactions to be completed to reduce transaction delays. The settlement date used to be T+5 due to paperwork, but it has now been reduced to T+2 following computerization.

Types of settlements in the stock market:

Trade settlements in the stock market have been broadly categorized into two:

1. Spot settlement – This is when the settlement is done immediately following the rolling settlement principle of T+2.

2. Forward settlement – This happens when you agree to settle the trade at a future date which could be T+5 or T+7.

Stop to Consider

Some differences between Spot settlement andFloor Settlement

Spot Settlement	Floor Settlement
A spot rate, or spot price, represents a contracted price for the purchase or sale of a commodity, security, or currency for immediate delivery and payment on the spot date.	A forward contract involves an agreement of terms on the current date with the delivery and payment at a specified future date.
Settled immediately or within 2 to 3 working days usually T+2	Settled at future date usually T+5 or T+7

Rolling Settlement

A rolling settlement is one in which the settlement is made on each of the trade's subsequent days. Trades are settled in T+2 days in a rolling settlement, which means deals are settled by the second working day. Saturday and Sunday, as well as bank and exchange holidays, are not included. As a result, if a trade is made on Wednesday, it will be settled by Friday. Similarly, if you buy a stock on Friday, your broker deducts the total cost of your investment from your account the same day, but you don't get the shares until Tuesday. The day you become the shareholder of record is also known as the settlement day.For dividend-seeking investors, the settlement day is critical. If the buyer wants to receive a dividend from the company, he must close the trade for a profit before the record date.

Check Your Progress

1. What do you understand by quote driven system?
2. What do you understand by order driven system?
3. What is a Market Order?
4. What is a Limit Order?
5. What is a Stop- Loss Order?
6. Briefly Explain the Difference between Spot Settlement and forward Settlement

4.5 Key Terms

- **Secondary Market**: Secondary market is the market in which securities already issued by subsequently traded among investors. In the primary market, securities can be purchased only at the time of issue but in the secondary market, securities can be purchased throughout the year.
- **Rolling Settlement:**A rolling settlement is a process of settling security trades on successive dates based on the original trade date, such that trades executed today will settle one business day later than trades executed yesterday.
- **Stock Exchange:**The stock market refers to a collection of exchanges and other venues where shares of publicly traded companies can be bought, sold, and issued. Such financial transactions are carried out through institutionalized formal exchanges (physical or electronic) or over-the-counter (OTC) marketplaces that are governed by a set of rules.

4.6 Summary

We talked about the secondary market in this unit. The secondary market is where securities are traded after they have been first offered to the public in the primary market and/or listed on the Stock Exchange. The secondary market is where most of the trading takes place. The equity and debt markets make up the secondary market. The secondary market provides an efficient platform for trading securities for the average investor. Secondary equity markets serve as a monitoring and control conduit for the company's management, facilitating value-enhancing control activities, enabling the implementation of incentive-based management contracts, and aggregating information (via price discovery) that guides management decision-making.

SELF ASKING QUESTIONS

i) Write brief note on a recent public issue of a company. The note may include the size of the issue, type of security offered, price, and justification of premium, registrar, banker to issue, underwriter, etc.

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ii) Write out two sources of stock market information other than a newspaper.

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4.7 ANSWER TO "CHECK YOUR PROGRESS"

Short Questions

1. State the meaning of secondary market?
2. What do you understand by Rolling Settlement
3. Write are the different types of orders in the secondary market
4. What are the different types of settlement systems in the stock exchange?

Long Questions

1. Describe the origin growth and development of the stock exchange in India.
2. Discuss the role and functions of the stock exchange in India.
3. Explain the trading and settlement system in stock exchanges.
4. Explain the screen-based trading system in the stock exchange.

4.8 References and Suggested Readings

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BLOCK III: Unit-5

Security Depositories and its Benefits- NSDL and CDSL

Unit Structure:

1.11 Introduction

In common parlance, a depository can be understood as a place or an arrangement where people can store certain stuff or some important materials. In line with this, the financial system also has the concept of “depository” which serves the basic function of centralized storage and trading of securities. When it comes to any type of asset or property, the ownership can be claimed only through the production of papers, documents; or the certificates to be specific. In simplest sense, depositories can be understood as the institutional arrangement with the help of which documents related to holding and transfer of securities can be stored in a centralized location which can further assist in their trading. The concept of depository has emerged from the loopholes associated with the conventional trading system which required investors to keep the documents in paper form, creating difficulties in handling huge volumes of papers. This not only created difficulties, but also led to increase in costs and inefficiencies. This chapter summarizes the concept of depository along with it benefits, functions and the current Indian scenario of depositories.

1.12 Objectives

After thoroughly understanding this chapter, you will be able to

- understand the **meaning and concept of depository**,

- know how the **depository system** works,
- find out the **functions of depository**,
- assess the current scenario of **Indian depository system**.

1.13 Meaning and Concept of Depository:

Growth of technology and innovation has blurred the boundaries of financial market by expanding its reach to the global investors. This has changed the financial system in both positive and negative ways. Pointing at the positive ones, there is growth of different financial intermediaries across nations providing diversified financial services, increased efficiencies due to competition, etc. can be discussed; whereas the negative ones may include lots of paper work resulting from increased volume of trade and so on. Increased participation of different investors also increased the problems associated with huge volume of trade and paperwork. Owning and transferring of different securities and trading in them require lot of paper work which needs to be stored and kept properly. Prior to the advent of depository system, the work was entirely paper based. This previous system had its own inherent loopholes such as: delay in transfer of shares, possibility of forgery on various documents, possibility of theft of share certificates, loss of share certificates due to different other reasons, existence of fake certificates, etc. Presence of these issues was indeed the constraint in making the security market investor friendly.

Hence, depository may be understood as an institutional arrangement which holds securities in "dematerialized" form, wherein trading is done among different securities like shares, debentures, mutual funds, etc. These depositories can also be understood in terms of the facilities that they provide; holding of securities and assisting in further trading.

1.14 Depository system:

Depositories, which act as the storehouse of ownership record of securities, also aims at eliminating the paperwork associated with trading in securities. The depository system represents the institutional framework and includes different participants at different stages/points which help the entire system to function smoothly. The depository system functions through certain constituents as mentioned below:

- Depository
- Depository participants
- Companies/Registrars
- Investors

  As explained above, the depository acts like a securities bank, wherein the certificates and documents related to title of ownership for different securities are kept in dematerialized form. The prime cause of its emergence can be pointed as the existence of huge volume of paper work which also causes difficulties in safe-keeping of the same. This cause has led to maintaining the paper or documents in dematerialized form, commonly known as “demat” form. The depositories provide the process of dematerializing and rematerializing at the time of surrender and withdrawal of securities. As holding securities in physical form had its own disadvantages, depositories enable the investors to hold securities in electronic form. A depository needs to be registered as a depository with SEBI and has to be promoted as a corporate body under Companies Act, 1956. After getting the certificate of commencement of business from SEBI, it can start operating. However, it needs to develop automatic data processing systems in order to prohibit unauthorized access. They also need to establish link between the depository participant, issuer and issuer’s agent. Currently, there are two depositories in India: NSDL and CDSL.

Depository participant acts as the representative of an investor in the depository system. As per the guidelines prescribed by SEBI, if any financial institution or bank or custodian or stock broker meet such guidelines, it can become a depository participant. In simple words, a Depository participant establishes a link between the depository and the beneficial owner. It is also the first point of contact with the investor. Moreover, a company cannot serve a dematerialization request directly from the investors and the investors have to avail the service through approaching the depository participant.

The “company” represents the issuer of the securities which needs to get registered. In other words, it is a company, which is listed with the depository and the securities of which can be traded under demat form.

The investor, who is also known as the beneficial owner, avails the services of the depository participants. These investors get the rights and benefits which imply they will receive bonus, dividends, right to vote, etc. on the shares held by the depository on their behalf. However, the investors are also liable for the unpaid amount on shares held by the depository on their behalf. For availing such services, the investors need to pay charges to the depository participants. In simple, the beneficial owners are like the clients of the depository system who need to follow certain prescribed rules while opening demat account and trading in securities.

Stop to consider

Depository can be understood as a financial institution which acts as a custodian of security certificates. Due to the inherent limitations of traditional paper-based trading system, investors and other parties to trading could not get the maximum benefit. As a result of this, the concept of depositories emerged. The system of depository is a combination of certain elements or constituents: depository participants, investor, issuing company and the depository itself.

Check your progress

- What is meant by Depository?
- What is depository system?
- What are the constituents of depository system?

1.15 Functions of Depositories:

Having understood the meaning and concept of depository and depository system, it is necessary to know how the depository or the system of depository functions. The depository system operates and functions through depository accounts which are somewhat similar to opening of bank accounts. Opening depository account is the basic step to be followed by every investor who is willing to dematerialize holdings.

Dematerialization and rematerialization are two significant processes followed in depository system. Demateralisation is often shortened as "demat", and is a process, by which the share certificates of the investors are taken back by the company through depository participants, are verified and if all the formalities are completed well, demat process is confirmed whereby, equivalent number of shares are credited to the investor's account as electronic holdings. There are also guidelines by SEBI regarding number of days within which dematerialization has t be completed. Moreover, this process cannot be initiated without the request made by the investor through a request form known as Dematerialisation Request Form (DRF).

Again, the process of rematerialisation is concerned with converting the electronic holdings into paper certificates. Just like the process of dematerialization which is carried through depository participants, this process is also carried out in a similar way within a stipulated period of time. Therefore, in the depository system, an investor can dematerialize his/her holdings into electronic form and again, can convert the same into physical securities whenever needed after following the necessary procedure. When the investor requests for rematerialisation, the depository participant intimates the request through the system and confirms the process to the registrar. Subsequently, the registrar and the depository update the accounts and other details, following which the share certificates are dispatched to the concerned investor.

Prior to 1996, the Companies Act required the securities (shares or debentures) to have a distinct number which acted as an identification mark. However, by amending the above mentioned provision, the securities were made fungible. This means the dematerialized securities do not have any distinctive numbers and 100 shares of a security are same as any other 100 shares of that particular security. This function of depository has promoted interchangeability to a significant extent. However, each security held in dematerialized form is given a distinct ISIN (International Securities Identification Number).

The financial market, especially the capital market has become more disciplined and systematic with the emergence of depository system. This is so due to the inherent benefits associated with the system itself. On many aspects like: time saving in communication, reduction of fraudulent transactions, loss of physical security certificates, theft and forgery, etc. depository system has got its own benefits. As mentioned earlier, the security certificate which signifies the ownership of a particular security, if lost, can cause severe risk and financial loss to the investors. This is eliminated with the help of depository. Furthermore, a depository system provides benefits to all the constituents of the capital market: the investors, the issuers, the intermediaries and the country as a whole.

1.16 Current Indian Scenario of depositories:

The Depositories Act, 1996 prescribes different provisions and rules which act as guidelines for the depositories operating in India. Some such provisions include: all securities held by a depository should be in fungible form, the depository should be registered owner of the securities for the purpose of effecting transfer of ownership on behalf of the investor or beneficial owner, furnishing information to beneficial owner and issuers whenever necessary, etc. The year 1996 has been a significant year in the history of financial market in India. During the period, physical trading in securities was prevalent and the Government of India introduced the Depository Bill in Lok Sabha in 1996 to bring scrip-less trading in securities with a view to avoid bad delivery, theft, forgery, etc. India has currently the two depositories: NSDL and CDSL. The following section briefly explains about the two

1.16.1 NSDL: National Securities Depositories Ltd has been promoted by Industrial Development Bank of India, Unit Trust of India and National Stock Exchange and it has emerged as the first depository to be registered in India. It is one of the largest depositories in the world and was established in the year 1996. The enactment of Depositories Act in August, 1996 paved the way for establishment of NSDL. In its system, securities are held in depository accounts, which is somewhat similar to keeping funds in bank accounts. Transferring the ownership of securities is done through account transfers, which keeps away the risk and difficulties associated with traditional paper-based system of trading in securities. NSDL also offers bundle of services to different parties like: investors, stock brokers, custodians, issuing companies, etc. through its nationwide network of depository partners. Apart from this, it also provides stock lending and borrowing facilities to the investors subject to the rules and regulations applicable. Moreover, there is also facility through which the investor can receive his/her corporate benefits through NSDL. Here, the registrar is responsible for disbursement of cash benefits from dividends, interest etc., whereas the depository will distribute the securities entitlement on the basis of the information received from the registrar. NSDL operates through depository participants to perform the functions like: getting withdrawal and surrender of securities from and to the depository, maintaining investors' holdings in electronic form, conducting settlement of securities traded on and off the stock market, etc. As on 2022, NSDL has a total of 276 DPs, has Demat custody value (Lakh Crore) 290.72 and 2,60,69,206 active investors account.

1.16.2 CDSL: Central Depository Services Ltd was established in the year 1999 with the objective of providing convenient, dependable and secured depository services. Similar to NSDL, CDSL is a crucial part of the capital market and it provides services to different participants like: stock exchanges, depository participants, issuers, investors, etc. CDSL received its certificate of commencement of business from SEBI on February 8, 1999. It enables dematerialization and rematerialisation of securities so as to meet the objectives of providing the stakeholders quality service. At present there are 584 DPs and 6,07,62,732 investors account with CDSL.

Stop to consider

Depositories primarily perform the function of dematerialization and rematerialisation. Apart from these, it also makes the securities fungible and provides different necessary services to the beneficial owners and companies so as to make trading more efficient.

Check your progress

- What is meant by dematerialization of securities?
- Mention some of the functions performed by depository system.
- What are the two depositories operating in India?

Self Asking Question

Why do you think depositories have assumed importance in the Indian financial system?

1.17 summing up

- The concept of depository has emerged from the loopholes associated with the conventional trading system which required investors to keep the documents in paper form, creating difficulties in handling huge volumes of papers.
- Depository may be understood as an institutional arrangement which holds securities in "dematerialized" form, wherein trading is done among different securities like shares, debentures, mutual funds, etc.
- The depository system functions through certain constituents as mentioned below:
  Depository

Depository participants
Companies/Registrars
Investors

- Dematerialisation' is a process where by physical existence of security certificates is made extinct and converted into electronic holdings.
- Rematerialisation is a process of converting electronic holdings of investor back into share certificates in paper form.
- In India, currently there are two depositories: NSDL and CDSL.

1.18 References

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1.19 model questions

Q. What is a depository?
Q. What are the benefits of depository?
Q. What is depository system? How does it work?
Q. What do you mean by Dematerialisation of securities?
Q. What are the advantages associated with dematerialization of securities?
Q. What is rematerialisation of securities?
Q. Mention some of the legal provisions necessary to be followed by the depositories in India.

1.20 answer to check your progress

Q. What is meant by Depository?

Answer: Depository may be understood as an institutional arrangement which holds securities in "dematerialized" form, wherein trading is done among different securities like shares, debentures, mutual funds, etc.

Q. What is depository system?

Answer: Depository system implies the entire system of institutional framework with the help of which the depository works and trading in securities is conducted.

Q. What are the constituents of depository system?

Answer: The constituents of depository system are: depository, depository participants, issuing company, investors.

Q. What is meant by dematerialization of securities?

Answer: Dematerialisation' is a process where by physical existence of security certificates is made extinct and converted into electronic holdings.

Q. Mention some of the functions performed by depository system.

Answer: Some of the functions performed by depository system are: dematerialization of securities, rematerialisation of securities, serving as a link between issuer and investors, makes transfer of securities more efficient by reducing paper work, etc.

Q. What are the two depositories operating in India?

Answer: NSDL and CDSL.

BLOCK IV : Unit-1
Meaning and Function of Money

Unit Structure:

1.1 INTRODUCTION:

Initially money came into use for removing inconveniences of barter system, because money has separated the act of purchase from sales. As a result of using money as a common medium of exchange, it has been playing a vital role in economy, production, marketing, industry, and trade and business right from individual level to international level that is why without the knowledge of money neither the individual businessman nor industry or organization can take their financial, marketing and economic decisions. On the other hand in modern the time banking places a significant role in the economic development of all countries of the world. By the help of organize banking system the savings of general public as well as business can be mobilize and channelize into productive purpose. Hence banking is known as life blood of business. The modern banks perform multifarious activities and service for business industries and individual. Keeping in view these importances of both money and bank, the present unit aims at discussing some important issues related to money and banking sector.

1.2 OBJECTIVES:

This unit is an attempt to analysis some important issues relating to money and banking sector. After going through this unit you will be able to:

- define money
- describe characteristic of money
- discuss the different types of money
- explain various functions of money

- elucidate money supply
- Importance of money in modern society
- define commercial banks
- describe the evolution and growth of bank in India
- identify the characteristics of bank
- explain functions of modern commercial banks
- organizational and management of commercial banks

1.3 MEANING AND DEFINITION OF MONEY:

Anything which is generally acceptable in payment for goods, services and debts are known as money. Money is anything that serves as a medium of exchange. A medium of exchange is anything that is widely accepted as a means of payment. A medium of exchange is anything that is widely accepted as a means of payment. In Romania under Communist Party rule in the 1980s, for example, kent, cigarette served as a medium of exchange; the fact that they could be exchanged for other goods and services made them money.

Money, ultimately, is defined by people and what they do. When people use something as a medium of exchange, it becomes money. If people were to begin accepting basketballs as payment for most goods and services, basketballs would be money.

Different economist have defined money is different ways.

According to Walker, "Money can be defined as anything that is generally acceptable as a medium of exchange and at the same time acts a measure and store of value."

According to Thomas, "Money is a commodity chosen by common consent to be a measure of value and a means of value and a means of exchange between all the others commodities."

According to Kent, "Money is anything which is commonly used and generally accepted as a medium of exchange or as a standard of value."

STOP TO CONSIDER

Approaches to Definition of Money

There are four approaches to the definition of money viz.

i) Traditional approach: According to this approach money is regarded only as a medium of exchange.

ii) Monetarist approach: This approach was given by Milton Friedman and other quantity theorists or monetarists. According to this approach money is a temporary abode of purchasing power; money can act as a temporary abode of purchasing power, if it is kept in form of cash, demand deposits or any other assets which is close to currency.

iii) Liquidity approach: This approach was given by Gurley and Radcliffe committee. As per this approach money include currency, demand deposits, time deposits, saving bank deposits, shares and bonds.

iv) Central bank approach: According to this approach money includes currency, bank credit, time deposits, credit from non-banking financial institutions and credit from unorganized agencies.

1.4 CHARACTERISTICS OF MONEY:

The following are the prime characteristic of money-

(i) General Acceptability: A commodity is known as money if it is generally acceptable as a medium of exchange. Thus to be money a commodity must have universal acceptability.

(ii)Divisibility: Divisibility is an important characteristic of money. Money must be easily divisible into small parts and thus it facilitates small transactions.

(iii) Limited Supply: Another important characteristic of money is that its supply is limited. Any material which is freely available cannot be termed as money.

(iv) Portability: Money must be portable one so that it can be transferred easily from one place to another at a lot. Portability of paper money is very high.

(v) Durability: Money must be highly durable so that it should not perish away soon.

(vi) Cognizability: A good money must have the quality of cognizability, i.e, it must be easily recognized.

(vii) Homogenity: Various units of money must be homogeneous in quality. There should not be any difference between the various units of money coins and paper money are always homogeneous.

Check Your Progress 1.1

A. Say True or False:

i) Money supply is limited

ii) Money may not have the quality of cognizability.

iii) Various units of money must be homogenous in quality.

1.5 TYPES OF MONEY:

Different types of money are discussed below:

1. Legal Tender Money: The money which is legally tendered by certain authority is known as legal tender money. As it is tendered legally thus it cannot be refused by anybody. Legal tender money may be two types- unlimited legal tender money and limited legal tender money. The type of money which is legal tender for unlimited amount is known as unlimited legal tender money e.g Rupee in India and the dollar of U.S.A. Again those type of money which legal tender only upto a certain limited amount is known as limited legal tender.

2. Standard Money: Standard Money is a kind of unlimited legal tender money whose face value is equal to its intrinsic or content value.

3. Bank Money: Bank Money includes all deposit and credit created by banks including overdrafts. This bank money can be easily used for making payments through cheques as these deposits are chequable, Deposit money is really a kind of guarantee given by banks to offer cash money. This type of money is different from money proper and is created in the account book of banks. In modern times bank money has become the most important form of money. Bank money is a very convenient form of money for making large payments.

4. Token Money: Token money is a type of money whose face value is greater than its content value. As token money is legally tendered and as it is convenient to use thus people, in general, accept the token for their daily transactions.

5. Commodity Money: Commodity money includes all those commodities which were generally accepted by the people as money. In the primary stage of monetary economy haman being started to use some commodities as money. Commodity money was a full-bodied economy. The commodities which were commonly used as commodity money include cows, precious stone and metals like gold, silver, copper etc.

6. Paper Money: Paper money is a kind of legal tender money which is made of paper. Most of the countries of the world are now using paper money.

7. Money of Account: Money of account acts as unit of account. In every country there must be unit of account for keeping accounts and also for making all transactions. Normally the money of account and legal tender money is same. The Rupee in India and Dollar in USA are taken as both legal tender money and money of account.

STOP TO CONSIDER

Near Money

Near money refers to all those assets which posses many of the characteristic of money, have high degree of liquidity and can inexpensively be converted into money of course near money cannot be directly use for making transactions. This money must first be converted into money proper before spending. Different types of near money are bill of exchange, bonds, equity shares, Time deposits and Savings deposits with commercial banks and other banks, bankers' acceptances etc.

1.6 FUNCTIONS OF MONEY:

Money performs five important functions which are described below:

(i) Money as Medium of Exchange: The most important function of money is to serve as a medium of exchange. As a medium of exchange, money removes all the difficulties of barter. There is no necessity for a double coincidence of wants in a money economy. The man with the cow, who wants to purchase a horse, need not hunt for a horse seller, who wants a cow. He can sell his cow in the market for money and then purchase a horse with the money thus obtained. Money units are of all denominations and it is easy to make fractional purchases, which is not possible under most cases of barter.

(ii) Money as a standard measure of value: When money serves as a medium of exchange, it incidentally measures the values of things for which it is exchanged. One inconvenience of value in terms of which other values could be expressed and added and accounts kept. Money serves as a unit of account. In a money economy, it is easy to compare different from one another. The values are in proportion to their respective prices. Expression of values in prices enables us to add them and habe a definite idea of person's or a community's wealth.

(iii) Money as a standard of deferred payment: Money also serves as a standard of payments made after lapse of time. Lending and borrowing, therefore, must take place in terms of a commodity which will, reasonable speaking, keep its value stable over time. Most commodities deteriorate with the passage of time. But if the money material is properly selected and managed, its value can be kept stable than that of other articles. By serving as standard measures of payment over time, money makes borrowing and lending much less risky. Thus, it helps in stimulating all kinds of economic activity which depends on borrowed money or credit.

(iv) Money as a store of value: Money serves as a store of value or, more correctly, it enables a person to keep a portion of his assets liquid. Liquid assets are those which can be used for any purpose at any time one likes. Most person in the modern world have to keep currency notes in their pockets or at home, or they may keep current accounts with the banks withdraw able by cheque.

(v) Money as a means of transferring value: there is also another function which money performs. One can sell one's immovable and movable belongings at one place and with the money so acquired he can buy them elsewhere. Value will thus be transferred. Such things have happened on a very large scale in India after the partition of the country.

Check Your Progress 1.2

A. Fill up the blanks:

i) Money serves as a unit of ________.

ii) Money as a ________measure of payment makes borrowing and lending much less risky.

iii) __________Days assets are those which can be used for any purpose at any time one likes.

iv) Money units are of all _____________ which makes easy to do fractional purchases.

1.7 MONEY SUPPLY:

Money is used as a common medium of payment and accepted for settlement of business transaction. On the other hand money supply implies total stock of money held by the public in spendable form. Here public means individuals as well as business organization in the economy excluding central govt., the central bank and the commercial banks. In other words money supply has to two concepts, one is stock concept and another is flow concept. According to stock concept money supply is viewed at a point of time. So money supply as per stock concept at a particular movement of time is the stock of money help by the public at that movement of time. It implies that the total currency notes, coins and demand deposits with the bank held by the public. On the other hand according to flow concept money is viewed over a period of time. According to flow concept of money over a period of time, the average number of times a unit of money passing from one hand to another. So the flow of money supply over the period of time can be known by multiplying a given stock of money held by the public by the velocity of circulation of money, which can be expressed according to *fisher's* equation as given below-

PT=MV

Where M refers to the stock of money held by the public and V refers to the velocity of circulation of money.

STOP TO CONSIDER

Till 1967-68, the Reserve Bank of India (RBI) used to adopt only the narrow measure of money supply (M) defined as the sum of currency and demand deposits, both held by the public. From 1967-68 it started publishing additionally broader measure of money supply, called aggregate monetary resources (AMR). It was defined emphirically as money narrowly defined plus the time deposits of banks held by the public. From April, 1977, the RBI has adopted four alternative definitions of money supply, labeled as M_1, M_2, M_3 and M_4.

M or M_1=C + DD + OD

M_2 = M_1 + savings deposits with post office savings banks.

AMR or M3 = M1 + net time deposits of banks.

M_4 = M_3 + total deposits with the Post Office Savings Organisation (excluding National Saving Certificates.)

In the above definitions, C =currency held by public,

DD = net demand deposits of banks,

OD = 'other deposits' of the RBI which include demand deposits of quasi-government institutions (like the IDBI), foreign central banks and governments, the IMF and the World Bank etc.

Source: Paul, R.R.(2001). *Money, Banking and International Trade (3rd ed).* New Delhi: Kalyani Publishers

1.8 COMPONENTS OF MONEY SUPPLY:

In time of determining the amount of supply of currency as well as coins, it is to be mentioned that the monetary authority is to follow the general requirement of economy. on the other hand there are many factors by which the currency component of the money supply, i.e, coins and notes, are influenced . These influencing factors are discussed under the following points as follows:

1. **Volume of Transactions:** According to changing of physical volume of trade as well as transaction of economy, the supply of currency is varied. In case of the issue of currency is more than its requirement, it leads to creation of inflationary pressures. Otherwise in case of money supply is less than its requirements, it creates deflationary trends.

2. **Nature of Trade:** Both the nature of wholesale trade and retail trade, determine the proportion of currency of different denomination. In case of wholesale trade, the notes of higher denomination are required, on the other hand in case of the retail trade; larger proportion of notes and coins of lower denominations is required.

3. **Method of Payment:** The method of payment is another influencing factor which determines the currency component of the supply of money. In case of more cash transactions, greater proportion of currency to money supply is required. On the other hand in case of more transactions through cheques, less currency is required.

4. **The Price level:** Another factor supply of money is Price level. In case of higher the price level, larger the amount of currency is needed. On the other hand in case of lower the price level, smaller the amount of currency is required for carrying out the given amount of transactions.

5. **Banking habits:** If the public has confidence in the bank money and has banking habits, the currency requirements will be less. But, if the people have less banking habits, the transactions will be conducted with currency and more currency is required.

1.9 IMPORTANCE OF MONEY:

There is hardly any walk of life in which money is not significant. The following points highlight the importance of money in modern society.

1. Advantage to the consumer: Consumer's behavior is based on prices of commodities which are expressed in terms of money.
2. Advantage to the producer: Producers' decision regarding what to produce, how to produce and how much to produce is a function of the prices of goods and services.
3. Medium of Exchange: Money facilitates trade as a medium of exchange.
4. Eliminate Barter system: Money eliminates the drawbacks of the barter system.
5. Productive: Money makes capital more productive. Money can be used anywhere to earn more.
6. Importance of money in distribution: All factors of production are paid in terms of money.
7. Importance of money in public finance: Government receives income and spends income in the form of money.
8. Money is the measure of social welfare: Increase in money income with the people shows rise in social welfare.
9. Money is the barometer of economic progress: Economic progress takes place if capital accumulation leads to industrialization. Savings and investments are required for capital accumulation. Savings and investment are possible only with the help of money.

Check Your Progress 1.3

A. Fill up the blanks:

i) Consumers behavior is based on ___________ of commodity which are expressed in terms of money.

ii) Money makes________ more productive.

iii) Increased in money income with people shows rise in social _________.

1.10 DEFINE BANK

In simple language bank can be defined as an establishment which makes to individuals and organizations such advances of money or other means of payment as may be required by them and safely made to which individuals and organization entrust money when not required by them for use. According to

Oxford English Dictionary, bank is defined as an establishment for custody of money received from or on behalf of its customers. It's essential to pay their drafts on it. Its profits arise from the use of money unemployed by them. The meaning of the bank can be understood more clearly from its definition as given below-

a) According to Banking Regulation Act 1949, Under section 5 (1)(c), banking company means any company which transacts the business of banking in India.

b) According to Sir John Paget, who is known as the father of banking, defines banker in his book "Law of Banking" as "that no person or body corporate or otherwise can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheque and (iv) collect cheques crossed and uncrossed for his customers."

c) According to Indian Companies Act, 1956, "Bank is every company accepting deposits of money subject to withdrawn by cheque, drafts or others".

Out of the above definitions the bank can be defined basically into three senses such as-

(i) As a noun, bank is called an establishment, an institution, a manufacture, a firm, a corporation body corporate etc.

(ii) As a verb, bank or banking is defined as dealing in money, instrument of credit creation, means of accepting or lending money etc.

(iii) As an individual bank or banker can be defined as a person as a company, as a body corporate etc.

There are two distinctive features of a banking institution. These are:

(i) Acceptance of chequable demand deposits (ii) Lending them to others, That is why, Post Office saving banks, some financial institutions like IFCI, UTI, LIC, ICICI, IDBI, Co-operative Land Development Banks along with Indigenous banker and money lenders are not regards as banks. Because, they lend money to other, but these do not accept chequable demand deposits and receive any depost from public regularity. In this connection, the court case of samyukta Samajan VS Goli Kalyani held that "the firm lending money out its own capital was not a bank." because, banking is not their main function. SO, another court case "Staffort Vs Henry" held that "carrying on banking business as a part of any business would not entitle a man to be called a banker.

STOP TO CONSIDER

Use of the term "Bank"

Regarding the use of the term bank, it is gratifying to mention that "the unauthorized use of the word "bank" is prohibited in Argentia, Belgium, Canada, Denmark, Germany and Italy and in Sweden, private banking firms are prohibited from using the word "bank" as part of their name. In Zurich any person could use the word "bank" as a part of his name until a federal law was introduce in 8th November 1934"

1.12 CHARACTERISTICS OF BANK

Findlay Shirras mentioned in his book "Indian Finance and Banking" that a bank is a person, firm or company having a place of business where credits are opened by deposit or collection of money or currency or where money is advanced or loaned." From this definition, a bank can distinguished from other financial institution. On the basis of above concept below we discuss the nature of bank:

1. Businessman: By nature bank is a businessman. As a businessman bank only deals in money and credit. The main purpose of dealing in credit by bank is to earn profit. "Strictly speaking, the term banker should apply to the credit merchant only when he uses the credit and funds of others. He is otherwise more a capitalist than a banker, if he uses only his own credit and fund."

2. Accept, deposits and lending or investing the deposit: According of deposits is one of the primary functions of a bank. Of course, "The purpose of accepting of deposits is not to lend or invest, the business will not be called banking business."

3. Deposits from public: Bank accepts deposits from all public, who agree to pay for the purpose of deposit in this book. Of course, the person must be considered as eligible one for depositing money in the bank. That is why, sometimes, bank may not to receive the deposit of a person, if he is undesirable one, such as a thief, robber etc.

4. Intermediary: Another important nature of bank is that it acts as an intermediary between two parties. One is saver of money and other is borrower of money.

5. Time and mode of withdrawal of deposit: The bank is to refund the deposited money to the depositor on his demand made by the letter or order or draft or cheque or any other procedure as prescribed in their agreement.

6. Continuity: Bank must perform its function that is (i) take deposit account (ii) take current accounts (iii) issue and pay cheque and (iv) collect cheques etc. continuously. That is why, Sir John Paget said that the bank must do its functions in a regular and recognized manner.

7. Financial Institution: Bank is a financial institution which performs the function of accepting deposits from public and facilitating then loan and advances; withdrawal and transfer of money by credit instruments on otherwise. As a financial institution banks act as representatives of their customers or the one hand and on the other hand, they play very important role in creating and implementing government plans and policies as an instrument too.

8. Use of bank money: Another nature of bank is that it operates mostly with cash and bank money such cheques, drafts etc.

9. Service provider to customer: A bank provides a number of services to its customers. Banks make direct payment on behalf of its customers and also receive money on behalf of customers.

10. Play a vital role in business: The banks play a vital role in modern business.

Check Your Progress 1.4

Q.1 Define Bank as an intermediary?

Q.2 What is the difference of bank from money lenders and indigenous bankers?

Q.3 Write three functions performed by the bank as a financial institution.

Q.4 Briefly describe bank as a businessman?

1.13 FUNCTIONS OF MODERN COMMERCIAL BANKS:

The function of modern bank can be understood from statement given by Prof. R.S.Sayers that 'Ordinary banking business consists of changing cash for bank deposits and bank deposits for cash: transferring bank deposits from one person or corporation to another, giving bank deposits in exchange for bills of exchange, government bonds, the second promises of businessman to repay and so forth."

From the above discussion the functions of bank can be classified as shown below:

A. Main or Primary Function

B. Secondary or Subsidiary Function

C. Modern Function

A. Main or Primary Function: "Banking in the traditional form is concerned with acceptance of deposits of money from the customers, the lending of the surplus of deposited money to suitable customers who wish to borrow, and transmission of funds. These are still the primary functions of banking. Banks have slowly activity."

These are:

(i) Acceptance of Deposits

(ii) Advancing of Loans

(iii) Use of cheque system and

(iv) Issue paper currency (only by the central bank)

(i) Acceptance of Deposits: Acceptance of deposit is an important primary function of a bank. The main purpose of accepting deposit is to mobilize savings from the people of the society.

(ii)Advancing of loans: The bank keep a certain amount of accepting deposit as cash reserve, thereafter, remaining amount of deposit is paid as loan to the needy person. Of course, the bank always satisfies itself about it credit worthiness before giving advances.

(iii) Use of cheque system: It is an important and unique function of bank. Bank introduces various kinds of cheques to settle debt of the modern business transactions. Cheque is a most convenient, inexpensive and developed credit instrument in modern time.

(iv)Issue of paper money: it is an important and monopoly function done by only the central bank. Printing and issuing of paper money is one of the most important functions of a modern Central bank.

(B) Secondary or subsidiary function: In addition to above primary function, under section 6 of the Indian Banking Regulation Act 1949, a bank is allowed to perform some other functions. These functions are known as secondary functions are to attract new customers and to earn extra income. These secondary functions can be classified into two categories.

These are:

(i) Agency services

(ii) General utility service

(i) Agency services: The relationship between the banker and customer is like a principal and agent. The main purpose of doing some agency service by a bank to provide necessary facilities to customers. Bank collects cheques, dividends, bills or promissory notes on behalf of his customers. Banks also acts as trustee, attorney, executor, correspondent or a representative.

(a) Remittances of fund: Remittance funds are another function done by the modern bank. There are many branch offices of bank throughout the country. By virtue of which branches, bank provides the facilities or remittance of funds from one to another place on behalf of different customers. These funds are remitted through bank drafts, mail transfers or telegraphic transfers. Bank takes a minimum service charge from the customer, which is much cheaper than the cost of postal money order or other systems.

(b) Makes payment: Bank also makes various payments to its customers for bills, cheques, bill of exchange, hundies, coupons, drafts, promissory notes, interest, dividend, rents, and subscriptions. Insurance premium, bill of lading, railway receipt, warrants etc.

(c) Purchasing and selling of securities and other: Another important agency function of bank is purchasing and selling of foreign exchange including foreign banks notes, securities and investments of all kinds, such as shares, debentures, stock, bonds and obligations.

(d) Acting as trustee executor: Bank can preserve the "Wills" of his customers and can execute the same after the expiry of the customers. Most of the commercial banks have an executor and trustee department, some may have affiliated companies to deal with this branch of their business. They aim at providing a complete range of trustee, executor or advisory service for small charges. The business of banks acting as trustees, executors, administrator etc. has continuously expanded with considerable usefulness to their customers.

2. General utility, agent and representative: in addition to above, banks also perform some functions as correspondent, agent and representatives. For the purpose, the bank may obtain passports, travellers' tickets and secure air as well as sea passages on behalf of its customers. The bank performs the utility services in order to render some important service to the people of the society which are discussed below:

(i) Safe deposit lockers: It is a unique facility. Under the facility, bank provides one or more locker boxes to the customers on hire or payment of a charge. There are two keys to open the locker box. One is with bank and another is with customer. The locker box can be opened if the two keys are used, the customers can keep their valuable documents and to her goods with the locker.

(ii) Safe custody of valuable articles: Now, the modern commercial bank also provides safe custody facilities to customers. Under this facility, the customer can hand over some valuable articles such a negotiable instruments, securities, jewellery, documents of title, wills, deed-boxes etc. The customer may hand over these valuable articles either openly or in a sealed cover or box. When a customer avails of this service by keeping valuables, then such valuable are not subject to the general lien of the bank and the bank is placed in the position of a bailee. If the customer gives the particulars about the articles they are recorded in the safe custody register.if no particular is given by the customer, then the description of sealed cover on box is recorded in a register. A receipt is issued by the bank and customer's signature is taken on the counterfoil or the duplicate copy.

(iii) Issue of travellers' cheque and letter of credits etc.: A travellers' cheques is a printed cheque of a particular denomination. Travellers or other persons can carry travellers cheques instead of money. The advantage of traveler cheque is that it is convenient and has limited risk than the cash. A bank may issue travelers cheque at the request of the customer after cheque, the customer is to sign on this cheque, which is to be counter signed by the banker. When the payment is made, then the customer is to sign in the presence of the person who accepts the traveller's cheque. The signature is tally with the signature, which has been already affixed in the time issue.

(iv) Supply information and advice on financial matters to customers: The bank also provides necessary to the customers. There are various data and information with the bank such as economic, market, price, supply, demand, credit etc. related to industry, trade, and commerce. Some banks also publish these data and information help the customers in taking their different financial and monetary decisions.

(v) Underwriting of capital issue and loans: Banks act as underwriter of capital issue and loans of Government bodies and companies. The general public can purchase the debenture, share of private companies, if these are unwritten by banks. General public has good faith on banks. So, if general public get the signature of banks in these debenture and shares, then they will a free to purchase these securities.

(vi) Foreign exchange business: The Reserve Bank of India provides licenses to different banks for dealing in foreign exchange business. Commercial banks provide short-term finance to exporter at the pre-shipment and post-shipment stages. Moreover, these banks provide long term finances to the exporters and importers.

(vii) Credit creation: Credit creation is an important function of modern bank. There are two ways of credit creation. These are (a) by issuing notes, (b) by giving loans. "The process of creation of bank deposit is essentially an exchange of claims. The customer is allowed to draw cheques beyond the amount previously standing to his credit in the bank's books up to the limit set in the overdraft arrangement. This overdraft facility is equivalent to a bank deposit representing part of supply of money with which individuals can buy goods and services.

(viii) Acting as a referee: Some time bank performs activity as a referee as to the responsibility and financial standing of its customers. By this service, bank enables the customers to obtain reliable and speedy information about the general standing of people with whom they have to do the business transaction. When a seller intends to sell his goods to an unknown buyer he may do so only after knowing the financing standing of the buyers.

3. Modern Function: At present banks are able to provide some new services by virtue of introducing computerized equipments in the day to day activities of banks. The following modern functions are discussed below:

(i) SWIFT message: At present, remittances of funds can be done by the method of SWIFT message. The full meaning of SWIFT is *Society for Worldwide Inter Bank Financial Tele-communication*. The Transfer of funds from one country to another can be affected by SWIFT message.

(ii) ATM: Automated Teller Machine works like a computer. In order to provide ATM service, each customer is given an ATM card. The ATM card holder can withdraw and deposit cash at any time-day and night. After inserting the ATM card into the terminal, he is to enter his identification code. Thereafter the machine will perform the deposit, withdraw or any other instruction as per given by the card holder.

(iii) Issue of Credit Card: A credit card is an instrument which provides instantaneous credit facilities to its holders to avail of a variety of goods and services at merchant outlets. Of course, credit cards are issued by the banks to persons with income above certain minimum level. These cards are accepted only by specified business establishment or member establishment.

(iv) Cheque card: In case of cheque payment, disadvantage from the payee's point of view is that there is no guarantee that the funds will be available to meet the cheque. So the cheque might be returned unpaid. In order to overcome this problem, the cheque card was developed. A cheque card is a document issued by a bank guaranteeing to a payee that any cheque up to a certain amount will be honoured at any branch of the issuing bank or any other bank having mutual arrangement.

(v) Gift cheque: One of the new devices adopted by some banks to attract customers is the issue of gift cheques. This gift cheque is artistically designed in attractive folders and covers. The purchaser of a gift cheque need not be an account holder with that bank or any other bank to avail of this service. This gift cheque is collectable at par at all offices of the issuing bank in India.

(vi) Merchant banking: Merchant banking is one of the important business now being undertaken by banks. Which banks perform wither through their subsidiaries or departmentally. Merchant banking involves giving advisory service and assistance to entrepreneurs setting up new industrial units and for expanding and diversifying production to existing industrial units.

(vii) Debit card: Bank also provides debit card to the account holder. The main purpose of issuing debit card is to transfer money electronically from one bank account to another when making a purchase. Of course, no overdraft facility is given to debit card.

(viii) Electronic Funds Transfer Systems (EFTS): This is electronic process of transferring fund. By this process salary, dividend etc. are transferred from the account of one person to the account of another person. This is a very safe and convenience process of transferring and handling money.

(ix) Mobile Banking Services: Mobile Banking service can be defined as "Anywhere Banking". Under this service, customers now do not need access to a computer terminal to access their banks, they could do so on the go when they are waiting for their loans to the work place, why they are travelling on, when are waiting for their orders to come through ina restaurant by using their mobile handset, developing one of the following four channels:

(a) IVR (Interactive Voice Response): This service operates through pre-specified numbers that banks advertise to their customers. Customers make a call at IVR number and are usually greeted by a store electronic message followed by a menu of different options.

(b) SMS (Short Messaging Service): This service uses the popular text-messaging standard to enable mobile application based banking. The way this works is that the customer requests for information by sending an SMS containing a service command to a pre-specified number. The bank responds with a reply SMS containing the specific information.

(c) WAP (Wireless Access Protocol): WAP uses a concept similar to that used in internal banking. Banks maintain WAP sites which customer's access using a WAP compatible browser on their mobile phones.WAP sites offer familiar form based interface an dcould also implement security quite effectively. Once customer log into their banks' WAP site through their WAP/GPRS enabled mobile phone, all you need to do is enter your customer ID and net banking IPIN.

(x) Internet banking: Internet banking is system of online banking from home or anywhere. Internet banking provides. "Anywhere", "anytime" banking access to one's account as well as to the public information updated by the bank on its website. Majority commercial banks have introduced internet banking facilities, which banks are fully computerized their operations. As the staff of the banks accesses the account of a customer online, the customer can also access his account online through internet. Internet banks perform hold onto customers' money and lend the same out to others respectively. Internet banking manages loans an helps the customers.

1.15 SUMMING UP:

1. Meaning of money**:**

   Anything which is generally acceptable in payment for goods, services and debts are known as money. Money is anything that serves as a medium of exchange.

2. Characteristic of money; different characteristics of money are i) General acceptability ii) divisibility iii) limited supply iv) Portability v) durability vi) Cognazability and vii) homogeneity
3. Types of money; different types of money are- i) legal tender money ii) standard money, iii) bank money, iv) token money, v) Commodity money, vi) Paper money and vii) Money of accounts
4. Money performs five important functions, such as- i) Medium of Exchange, ii) Standard measure of value, iii) standard of deferred payment, iv) Money as a store of value, v) means of transferring value
5. Money supply implies total stock of money held by the public in spendable form.
6. Money supply has to two concepts, one is stock concept and another is flow concept.
7. The currency component of the money supply, i.e, coins and notes, is influenced by a number of factors, such as i) Volume of transactions, ii) Nature of Trade, iii) Method of payment, iv) Price level, v) Banking habits
8. The importance of money in modern society are as: i) Advantage to the consumer, ii) Advantage to the producer, iii) Medium of Exchang, iv) Elimination of barter system, v) Productive
9. Bank can be defined as an establishment which makes to individuals and organizations such Advances of money or other means of payment as may be required by them and safely made to which individuals and organization entrust money when not required by them for use.
10. The nature of bank is: i) Businessman, ii) Accept, deposits and lending or investing the deposit, iii) Deposits from public, iv) Intermediary, v) Time and mode of withdrawal of deposit

1.16 References and Suggested reading:

1. Mithani, D.M.(2010). *"Money, Banking, International Trade and Public Finance"*; New Delhi Himalaya Publishing House.

2. Hajela,T.M.(2009). *"Money, Banking and Public Finance"*; ANE Books New Delhi.

3. Jhingan, M.L.(2014), *"Money, Banking and International Trade and Public Finance"*; New Delhi Vrinda Publications Pvt. Ltd..

1.17 Model Questions:

1. What do you understand by term Money?
2. Give a definition of Money?
3. Explain the various characteristic of money?
4. Discuss different types of money?
5. "Money is that Money does"-in light of this statement describe the various function of money?
6. What is money supply?
7. What are the various components of money supply?
8. What are the importances of money?
9. Define Bank?
10. Explain the evolution and growth of bank in India?
11. What are the characteristic of bank?
12. Describe the primary functions of bank?
13. Discuss the secondary functions of bank?
14. What are the emerging/modern functions of bank?

1.18 Answer to Check Your Progress

1.1 Answers- A. (i) True
(ii) False
(iii) True

1.2 Answers- A. (i) Accounts
(ii) Standard
(iii) Liquid
(iv) Denominations

1.3 Answers- A (i) Prices
(ii) Capital
(iii) Welfare

1.4 Answers- A (i) Bank acts as an intermediary between two parties, one is saver of money and other is borrower of money
(ii)Money-lender and indigenous bankers do their business on their own resources and fund. They never can accept deposits from general public.
(iii) A financial institution act as representatives of their customers, they play very important role in creating and implementing government plans and policies as an instrument too.
(iv) As a businessman bank only deals in money and credit. The main purpose of dealing in credit by bank is to earn profit.

BLOCK IV : Unit-2
Credit Creation

Unit Structure:

1.1 **Introduction:** Creation of credit is unique and important function of commercial banks supporting this capacity of creating credit many scholars define banks as a manufacturer of credit. Such as, according to Horace White "Bank is a manufacturer of credit and machine for facilitating exchanges. Likewise, according to Kenneth Mackenzie "The business of banking may be defined as dealing in money and instrument of credit" Crowther, mentions about three ancestors of modern commercial bank. These are the merchant, the money-lender and the Goldsmith. According to him Goldsmiths received deposits and created credit like a commercial bank today. In the words of withers banks can create credit by opening a deposit every time they advance a loan; payment is made through cheques by the customers. These payments are adjusted through clearing. The deposit of this amount remains outstanding with the bank. Therefore, every loan creates a deposit. There are also some equally well-known economists such as Edwin Cannan Walter and Leaf who do not agree with the view. According to them banks cannot create money out of thin air. They can lend only what they have in cash. So, they cannot and do not create money.

Considering these facts this chapter aims at discussing some important aspects of credit creation.

1.2 Objectives: This unit is an attempt to analysis some important issues relating to credit creation. After going through this unit you will be able to:

- Define credit creation
- Describe role of commercial banks in credit creation
- Explain various methods of credit creation
- Elucidated techniques and mechanism of credit creation

- Identity various advantages of credit creation
- Describe various limitation of credit creation

1.3 **Meaning and concept of Credit Creation**:

Credit implies a promise of future payment in lieu of present payment. Before discuss the meaning creation of credit, we should have a clear concept on deposit of bank, because, the process of creating is based on deposit system of bank. In this connection, it is to be mentioned that there are two ways of arising deposits.

These are:

(i) **Primary or passive deposit:** In case of depositing money by a customer in the bank the amount of deposited money is credited in the customer account and debited in the bank account. The customers can withdraw the money from this account whenever they need. So, it is an obligation of bank to repay according to demand of customers. This deposit is called primary deposit.

(ii) **Derivative or active deposits:** bank opens a deposit account in the name of customers, who want to borrow money. The amount of deposit will be equivalent to the amount of borrowed money. The bank gives credit as some amount of money in the deposit account of the customer.

STOP TO CONSIDER

There are some differences between banks and financial institutions. Because bank can accept chequeable demand deposits and lend this deposits to others as a main medium of exchange. Post office saving banks cannot be treated as bank, because they cannot lend money. On the other hands, different financial institution, such as UTI, IFCI, IDBI, along with moneylender, which lend money but do not accept deposits, by virtue of this unique ability of expanding multiple deposits and to lend money the bank can enjoy the facility of creating credit.

1.4 Role of commercial banks in credit creation:

Various roles of commercial banks in connection to credit creation are described below:

1**. Earning Profit:** Credit creation is done by commercial banks through depositing money. The main purpose of credit creation is to increase profit.

2. **Advance loans:** In order to earn profit through credit creation another role is played by the commercial bank which is called Advance loans.
3. **Accepting deposits:** On the other hand for granting loans and advance by the process of credit creation bank is to play its role by the depositing money.
4. **Opening accounts:** Another very important role of commercial bank in credit creation is opening accounts because when bank advances a loan it does not pay the amount in cash. In lieu of advancing in terms of money banks open a current account in the name of customer and allow him to withdraw required amount by cheque. It is the basic way of creating credit by commercial banks.
5. Credit multiplier coefficient: In handling the process of credit creation bank is to play another role that can be done by the following formula-

Total Credit Creation= Original Deposit x Credit Multiplier Coefficient

Credit multiplier coefficient = 1/r

Where, r= Cash reserve requirement also called as Cash reserve ratio (CRR).

$$\text{Credit multiplier co-efficient} = \frac{1}{100}\ \% = \frac{1}{10/100} = 10$$

Total credit created = 10,000 x 10 = 1,00,000

If CRR changes to 5%

$$\text{Credit multiplier coefficient} = \frac{1}{5}\% = \frac{1}{5/100} = 20$$

Total credit creation = 10,000 x 20 =2,00,000

STOP TO CONSIDER

Credit creation depends upon the ratio of cash reserves to deposits. The credit or the deposit multiplier is: $k = \frac{1}{r}$; where k is the credit multiplier and r is the cash-reserve ratio. Thus, credit multiplier is the reciprocal of cash reserve ratio. If cash-reserve ratio is 20% then $K= \frac{1}{r} = \frac{1}{.2} = 5$

The higher the cash-reserve ratio, the lower will be the credit multiplier; the lower the cash reserve ratio, the higher will be the credit multiplier.

1.5 Methods or ways of credit creation:

There are various methods or ways of creation of credit of a bank which are discussed below;

i. **Loan and Advances**: Through granting loan and advances overdraft and cash credit banks provide credit to their customers. After sanctioned the loan, and show the some loan as deposits money in the name of customer account. Thereafter, bank allows the customers to draw the money by cheque either entire amount at one time or shall amount from time to time. This way, by creating more and more loan and advance, overdraft and cash credit, bank create credit.

ii. **Discounting of Bills:** Generally discount is allowed by the bank against various bill of exchange for 90 days or less of their customer. In case of discounting of bill, bank credit the amount of bill in the customers' account and customers are allowed to withdraw the same through cheques. Likewise credit is created by bank through discounting of bills of exchange.

iii. **Purchase of securities or investment**: A deposit account is opened in the name of seller's account of the securities by the bank in time of purchasing of Govt. and private securities or debentures. So, bank can invest a part of their fund in various securities.

iv. **Money at Call and Short Notice**: Generally bank provides money at call and money at short notice to the speculators and stock brokers for very short notice generally from 24 hours to 2 to 3 days. In the time of giving this advance; the amount of money is credited in the account in the account of speculators or stock brokers. After that bank issue cheque to them and the person who accept the cheque can deposit the amount to cheque again into their accounts. This is the way that banks provide money at call and short notice.

STOP TO CONSIDER

Multiple credit creation by banking system

In the real world, there are many banks in existence comprising multiple banking systems. Whereas a single bank cannot lend beyond the amount of excess reserves, the banking system as a whole can do what a single bank cannot do. The banking system can grant loans many times the excess reserves of cash created for it. When an individual bank creates derivative deposits, it loses cash to other banks; the loss of deposit of one bank is the gain of deposit by some other bank. This transfer of cash within the banking system creates, in turn, primary deposits and increases the possibility for a further creation of derivative deposits by the banks receiving cash. This process of the banking system to increase credit many times more than the initial excess reserves is called multiple credit creation.

1.5 Techniques and mechanism of credit creation:

"When we say that a banker is lending money, he is actually lending money in the form of deposit credit with a right to be borrower to draw cheques against it. For instance take the case of a loan, granted to a customer. Instead of paying always the whole loan at once, the banker is actually placing the sum to the credit of the borrowers. Thus, the borrower acquires a claim against the bank, just as a sum of money deposited by him with the banker creates a claim against the bank."[1]

Below we explain the technique of creation of credit by the help of an illustration:

We assume that there are many banks in a locality and all the banks maintain 20% reserve against their deposit liabilities. Suppose one bank has deposit of Rs. 10,000. Out of this amount 20% that is 2,000/- will be reserved and remaining (10,000-2,000) = Rs. 8,000/- will be used for granting loan. In time of discounting the loan, the bank will issue a cheque of Rs.8,000/- to the borrower again will issue the cheque to the company, wherefrom he will purchase a machine. Thereafter, the company will deposit the cheque in another bank. After getting this deposit the second bank will again reserve 20% of this deposit that is 1,600 and remaining amount that is (8,000-1,600) = Rs 6,400 will be granted as loan. As a result of continuing this process the deposit becomes loan or investment and again the loan will create new deposits. This is called "process of multiple creation of credit" by commercial bank. Below we give the illustration in detail.

Number of Bank	**Amount of Deposit**	**20% reserve**	**Amount of loan**
1st Bank	10,000.00	2,000.00	8,000.00
2nd Bank	8,000.00	1,600.00	6,400.00
3rd Bank	6,400.00	1,280.00	5,120.00
4th Bank	5,120.00	1,024.00	4,096.00
5th Bank	4,096.00	819.00	3,276.80
6th Bank	3,276.00	655.36	2,621.44
7th Bank	2,621.44	524.29	2,097.15
8th Bank	2,097.00	419.43	1,677.68
9th Bank	1,677.68	335.54	1,342.14
10th Bank	1,342.14	268.43	1,073.71
Total amount for 10 Banks	44,631.21	8,926.25	35,704.92
Additional amount	5,368.79	1,073.75	4,295.08
Grand Total of 10 Bank	50,000.00	10,000.00	40,000.00

The formula for credit creation is given below:

Here, K= deposit multiplier

r = Ratio of Cash Reserve to deposit

1. Shekhar, K.C. and Shekhar, L. "*Banking Theory and Practice".P.18*

In case of 20% Cash Ratio as mentioned in the above illustration, the deposit multiplier will be

$$K=\frac{1}{r}=\frac{1}{.2}=5$$

Hence, out of above illustration it can be understood that the credit creation depends upon the ratio of cash reserve to deposit.

STOP TO CONSIDER
The process of credit creation can be analyzed in two ways: (a) credit creation by a single bank; and (b) credit creation by the banking system as a whole. In the single bank system, only one bank operates and all the cash deposits and cheques are to be made with this bank alone.

1.6 Advantages of credit creation: The advantages of credit creation are explained under the following points:

1. Easy to deposit: For the purpose of credit creation bank can deposit money easily from customers.

2. Easy to borrow: Moreover by credit creation banks can provide huge amount of loan and advance to the corporate sector.

3. Continuity: Credit creation is done by the bank through the process of borrowing and lending. That is why being borrowing and lending is a continuous function, the bank can also continue the credit creation process.

4. Less Risk: Behind the credit creation there is no serious risk to be borne by the bank. Because based on depositors deposit amount of money bank can create credit creation. On the other hand accepting deposit is inherent function of a bank.

5. Easy to Handle: In fact credit creation process is easy to handle because it can be executed through telephone, mail and internet.

1.7 **Limitation of credit creation:** out of the above discussion, it can be understood that Banks have unlimited power to create credit. Of course, there are some other restrictions of banks regarding the creation of credit, which can be explained as below:

1. **Adequate cash reserve:** Before, creating credit the banks have to reserve an adequate amount of cash. The main purpose of providing this cash reserve is to meet the demand of customers on their deposited money. The success of banks mostly depends upon the capacity to meet this demand of depositors. Otherwise, the banks will fail to obtain the confidence of their reserve to serve their customers' demand.

2. **Amount of Cash:** The capacity of credit creation mostly depends on the amount of cash possessed by the commercial banks. According to Crowther, the banks cash is the

lever with which the whole gigantic system is manipulated. "Generally banks get cash through primary deposit. If banks can get larger amount of cash, then they can increase more fund and the more fund will create more credit. But, there is a limited power of bank to get cash in its hand through primary deposit. So credit creation power of bank is limited.

3. **Quantity of money is circulation:** In a country only the central bank has a power to issue currency notes. If the central bank increases the quantity of money by issuing more and more currency, thereby the commercial banks can improve their cash position and they can create more credit. But, the decrease of issuing currency by the central bank can decline the capacity of expanding deposit as well as capacity of credit creation by commercial banks.

4. **Availability of securities:** Due to availability of securities in the market, the banks can enjoy a limited power of creating credit. Bank never can create anything out of thin air. Generally banks acquire shares, debentures, bonds etc. mobile wealth in the forum of I.O.U., which also act as money. It is gratifying to mention that the banks can create credit in the time of producing these mobile securities by the borrowers.

5. **Attitude of people:** The banks always depend on the attitude of people of deposit cash money. If people want to deposit more money in the banks, thereby banks can improve the position of creating credit. On the other hand, if the people want to hold more cash because of uncertainty of economic or other condition, then they would withdraw a major part of the deposits. Hence, the banks will fail to deposit more cash and unable to create more credit.

6. **Position of the business activities:** The ups and down position of business activities also impact on the power of banks to multiply credit. In time of recession of trade cycle, the business activities decline and banks have to adopt more caution measures. Therefore, banks hold more reserve balance. That is why in time of recession banks can create a limited amount of credit.

7. **Policy of the Central Bank:** The policy of the Reserve Bank of India can effect on the capacity of creating credit. The Reserve Bank of India directs to keep a certain percentage of cash against the deposit of every commercial bank. If the Reserve Bank directs to keep higher percentage of cash against the deposit money then the commercial bank can create smaller amount of credit and vice-versa.

8. **Other banks:** The capacity of creating credit mostly depends on the behavior of other banks. If other banks are not agree to grant loans as per banking system, there by a particular bank cannot increase its credit.

9. **Use of cheques:** The use of cheque also highly effect on the creation of credit. Because if the use of cheques become popular amongst public, then the commercial bank can issue a sizable number of cheques and against which the banks can keep more amount of cash to create more credit.

10. **Leakages:** If, there is any leakage is respect of credit creation of banking system, then no bank can increase the credit. It is assumed that the loan extended by the bank will be returned through new deposit. But, practically, some people do not return the entire amount of their loan. So, the power of creating credit is limited to that extent upto which the amount of cash is withdrawn.

Check Your Progress 1.1

1. Fill Up the blanks

    i. Banks have unlimited power to create ______.

    ii. Generally banks get cash through ________deposit.

    iii. If the central bank increases the quantity of ______supply then the commercial banks can increase more credit creation.

    iv. Banks can create credit in the time of producing mobile _________by the borrowers.

    v. In time of _________banks can create a limited amount of

1.15 SUMMING UP:

1. Creation of credit is unique and important function of commercial banks supporting this capacity of creating credit many scholars define banks as a manufacturer of credit
2. Credit implies a promise of future payment in lieu of present payment.
3. The various roles of commercial banks in connection to credit creation are (i)Earning Profit, (ii) Advance loans, (iii) Accepting deposits, (iv) Opening accounts, (v) Credit multiplier coefficient
4. There are various methods or ways of creation of credit of a bank, such as (i) loans and Advances, (ii) Discounting of bills, (iii) Purchase of securities or investment, (iv) Money at cal and short notice.
5. Instead of paying always the whole loan at once, the banker is actually placing the sum to the credit of the borrowers. Thus, the borrower acquires a claim against the bank, just as a sum of money deposited by him with the banker creates a claim against the bank.

6. The advantages of credit creation such as (i) Easy to deposit, (ii) Easy to borrow, (iii) Continuity, (iv) Less Risk, (v) Easy to Handle

7. There are some other restrictions of banks regarding the creation of credit, they are (i) Adequate cash reserve, (ii) Amount of cash, (iii) Quantitiy of money is circulation, (iv) Availability of securities, (v) Attitude of people, (vi) Position of the business activities, (vii) Policy of the Central Bank, (viii) Use of cheques, (ix) Leakages

1.16 References and Suggested reading:

1. Mithani, D.M.(2010). *“Money, Banking, International Trade and Public Finance”*: New Delhi Himalaya Publishing House.

2. Hajela,T.M.(2009). *“Money, Banking and Public Finance”*: ANE Books New Delhi.

3. Jhingan, M.L.(2014), *“Money, Banking and International Trade and Public Finance”*: New Delhi Vrinda Publications Pvt. Ltd..

1.17 Model Questions:

1. What do you understand by credit creation?
2. Explain the role of Commercial Banks in credit creation?
3. Describe the various method of credit creation?
4. Write with example the mechanism of credit creation?
5. What are the advantages of credit creation?
6. Discuss the limitations of credit creation?

1.18 Answer to Check Your Progress

1.1 Answers- (i) **Credit**
(ii) **Primary**
(iii) **Money**
(iv) **Securities**
(v) Recession

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BLOCK IV : Unit-3

Types of Banks and Banking System, Structure of Commercial Banks in India

Unit Structure:

3.0 INTRODUCTION

Banks are the financial institutions which plays a very important role in the economic development of the country. Banks may be defined as an institution engaged in accepting deposits of money from the public and lending to the needy borrowers. According to Sec 5 (1) (b) of the Banking Regulation Act, 1949, "Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques draft, order or otherwise." Over the period of time, various banks have been developed to cater to the requirements of the economy. In this Unit, you will learn about the various Types of Bank, the prevailing Banking System and the structure of Commercial Bank in India.

3.1 OBJECTIVES

After studying this unit, you should be able to:

- Explain the types of banks;
- Understand various type of Banking system and its features; and
- Describe the structure of Commercial Banks in India.

3.2 TYPES OF BANKS

A bank is a financial institution which act as an intermediary between the lender and the borrower. It accept deposits of money from the public and creates credit by making advances out of the funds received as deposits. In other words, it mobilises savings and channelise them to investments. In addition to its primary functions, it also provides services such as transfer of funds, remittance, issue of drafts, locker facilities, dealing with foreign exchange, online banking, mobile banking, debit card, credit card, etc. Each type of banks provide a specialised and particular type of banking activity. Banks in India can be classified into the following types-

3.2.1. Central Bank

The central bank occupies a central position in the banking system and acts as the highest financial authority in a country. It is an apex institution which is generally set up by the government of a country to undertake central banking functions. It is an autonomous institution entrusted with the powers of control, supervision of the monetary and banking system of the country. Its primary responsibility is to maintain stability of the national currency and money supply. Besides issuing currency notes, it controls the credit, custodian of foreign exchange reserves, clearing house and also acts as the bankers' bank and banker to the Government. It also ensures that banks and other financial institution do not behave recklessly or fraudulently. In India, Reserve Bank of India function as the central bank, which was set up in 1935.

3.2.2. Commercial Bank

Commercial banks performs all kinds of ordinary banking business such as accepting deposits, advancing loans, credit creation, agency and general utility functions. It operates on a commercial basis and profit making is their main objective. It occupies a very important place in the banking structure of a country and cater to the needs of short and medium term financial requirements of the economy. Commercial banks may be public sector banks, private sector banks and foreign banks.

Some of the commercial banks in India are:

i. State Bank of India,
ii. Canara Bank,
iii. Allahabad Bank,
iv. United Bank of India,
v. Punjab National Bank,
vi. Union Bank ofIndia,
vii. Bank of India,
viii. HDFC Bank,
ix. ICICI Bank,
x. Axis Bank, etc.

The structure of Commercial Bank is discussed in brief at 3.4

3.2.3. Co-operative Banks.

A Co-operative Bank is a voluntary association of members which operates on the principles of cooperation, self-help and mutual help. Co-operative banks are set up under the Cooperative Societies Act. This bank is also engaged in the ordinary banking business of accepting deposits and advancing loans. However, its main goal is to promote social welfare by providing concessional loans to its members and needy borrowers. Generally, this bank works on no-profit no-loss mechanism and do not pursue to the idea of profit maximisation. This banks primarily focus on granting short term loans to agricultural and other allied activities and serves as one of the important source of rural credit.Their business in the urban areas have increased in recent years due to the increase in the numbers of Primary Cooperative Banks.They are also regulated by Reserve Bank of India and governed by Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1965.

They are organised in Three- tier structure-

i. Tier 1 (State Level) - State cooperative Banks (SCBs)

State cooperative banks are the apex institutions in the Three-tier cooperative credit structure operating in the state level.

ii. Tier 2 (District Level) - Central /District Cooperative Banks (CCBs)

Central cooperative Banks are placed in the middle of the Three –tier cooperative credit structure. These banks operate in the district level and are located in the district headquarters or prominent towns.

iii. **Tier 3 (Village Level) - Primary Agriculture Credit Societies (PACS)**

Primary Agriculture Credit Societies forms the base in the Three-tier cooperative credit structure operating in a village level. These institutions directly deals with the people and provides banking services. It depends on the central cooperative banks and state cooperative banks for its funding requirements.

3.2.4. Development Banks.

Development banks are specialised type of financial institutions which are engaged in providing both fund as well as non-fund based services. They provide medium term as well as long term funds and acts as a catalytic agents in promoting balanced development of the country. These banks mainly focuses in the promotion and development of industry, agriculture and other key sectors in the economy. In other words, they are engaged in the activities for economic development in general and industrial development in particular.

In India, Industrial Finance Corporation of India (IFCI) was the first institution established as the development bank in 1948. Thereafter more development banks have been established both at central level and at the state level. Some of them are as follows.

i. Industrial Development Bank of India (IDBI)
ii. National Bank for Agriculture and Rural Development (NABARD)
iii. Small Industries Development Bank of India (SIDBI)
iv. State Industrial Development Corporations (SIDCs)
v. State Finance Corporation (SFCs)
vi. North Eastern Development Finance Corporation (NEDFi),
vii. Industrial Investment Bank of India (IIB) etc.

3.2.5. Regional Rural Bank (RRBs)

Regional Rural Bank was first setup in 1975 on the recommendation of M. Narasimham committee. The objective was to provide credit and other facilities to small and marginal farmers, agricultural labourers and artisans. These banks are generally based in the rural areas with the aim of taking the banking services into the doorstep of rural poor. The capital of Regional Rural Bank are shared between the Government of India (50%), concerned State Government (15%) and the sponsoring nationalised bank (35%). These banks are scheduled banks and governed by Regional Rural Bank Act, 1976.

However, as per the recommendations of Bhandari Committee (1994-95) and Basu Committee (1995-96) the government made two policy changes-

i. Concessional loans of RRBs has been abolished and RRBs started charging commercial interest rates from its customers
ii. The target clients of rural masses and weaker sections were set free and RRBs started giving loans to all customers.

There are two Regional Rural Banks operating in Assam- Assam GraminVikash Bank headquartered at Guwahati and LangpiDehangi Rural Bank headquartered at Diphu.

3.2.6. Investment Banks

An investment bank is a financial institution that assist individuals, corporations and government in raising capital by underwriting and/ or acting as the client's agent in the issuance of securities. These banks also assist corporations involved in mergers and acquisition and provide certain ancillary services such as market making, trading of derivatives, fixed income securities, foreign exchange, commodities and equities. Investment Bank aims at earning income through charging fees and commissions.

Some of the Investment banks in India are: ICICI Securities Ltd, IDBI Capital Market service Ltd, SBI Capital Markets Ltd, etc.

3.2.7. Exchange Banks

Exchange Banks are the banks which facilitates the foreign exchange transactions. They are specialised in financing the foreign trade and have branches in the foreign countries and other important trade centres.

Exchange bank plays an important role in the growth of a foreign trade of a country. They are primarily engaged in converting the foreign currency into domestic currency, and domestic currency into foreign currency. They finance the foreign trade by discounting, accepting and collecting foreign bill of exchange. They also provide other services such as opening letters of credit, issue of foreign currency draft, traveller's cheque, collecting and supplying information about foreign customers, etc.

Apart from financing the foreign trade, they are also engaged in facilitating the internal trade of the country by advancing loans to traders and discount their bill of exchange.

The Exchange bank also performs ordinary commercial banking functions like accepting deposits, advancing loans, agency services, remittance facility, locker facility, etc.

3.2.8. Export Import Bank of India

The Export and Import Bank is an institution engaged in promotion and development of foreign trade in a country. The Export – Import bank of India (EXIM Bank) was established in 1982. Most of the countries have their own Export and Import bank. The main function of this bank is to provide financial and other required assistance to the exporter and importer of a country. Moreover, this institution also act as the Apex institution in regard to export and import by coordinating other institution engaged in export and import for providing all the necessary services for the growth of international trade.

3.2.9. Payment Banks

Payment bank are newly developed form of banking in India. They are differentiated bank (niche banks) which cater to the needs of certain demographic segments of the population.

The objective of payment bank is to boost the financial inclusion by providing -

- Small savings account

- Payments/ remittance services to migrant labour workforce, low income households, small business, other unorganised sectors and other users.

Thesebanks can carry out most of banking operations but cannot advance loans or issue credit cards. They also provide services such as Internet banking, mobile banking, ATM, debit card.

They are registered under Companies Act, 2013 but are governed by host of legislations such as Banking Regulations Act, 1949; RBI Act, 1934; Foreign Exchange Management Act, 1999; Payment and settlement system act, 2007 and the like.

Currently 6 payment bank are operating in India. They are -

i. Airtel Payment Bank
ii. India Post Payment Bank
iii. Paytm Payment Bank
iv. Jio Payment Bank
v. Fino Payment Bank
vi. NSDL Payment Bank

Check your Progress

1. When was the Reserve Bank of India set up?
2. What is a Co-operative Bank?
3. Mention the 6 Payment Banks.

3.3 BANKING SYSTEM

The banking system refers to the procedure or manner of undertaking banking business by a bank. The banking system of a bank is determined on the basis of business pattern, volume of operation and the area of operation.

The most common system of banking are-

i. Branch banking.
ii. Unit banking
iii. Group banking
iv. Chain banking
v. Retail banking
vi. Universal banking
vii. Wholesale banking

Let us discuss all the above types of banking system briefly.

3.3.1 Branch banking system

Branch banking is a system of banking where the bank provides banking services through a wide network of branch offices. Under this system of banking, the banks may have branches within and outside the country. This system has made the banking more convenient by removing the geographical barriers. In India, since the introduction of organised banking institutions, branch banking system is being followed.

Features of branch banking are:-

a) There is separation of ownership and management of the banks. Ownership lies with the shareholders and the management lies with the single Board of Directors.
b) Under this system, the bank has a head officethrough which it controls the operation of all the branch offices.
c) The customers of the bank can avail banking services from any of the branch offices.
d) There is a manager for each branches, responsible for managing the affairs of the branches.
e) In the preparation of financial statements, the assets and liabilities of the Head office and the branches are aggregated.

3.3.2 Unit banking system

Unit banking is a system of banking where an independent isolated bank undertakes banking business/ functions in a particular area to cater the financial needs of particular region. They are confined to particular areas and does not have any branches. They are also called localised bank. These banks maintain and control the entire banking operations on their own. Under this system of banking, the banks usually focus on development of local area and better community services. They provide collection and remittance facilities to its customers by taking the help of other banks.

Following are the features of unit bank:-

a) Legal entity: The bank has a separate legal entity.
b) Unit office: It has only one office. It does not have branches.
c) Particular area: It operates in a particular area, where it is established.
d) Ownership: The ownership may be sole proprietorship, partnership or Joint Stock Company.
e) Scale of operations: It operates in small scale and have small capital. Therefore they are not capable of providing huge loans.

3.3.3 Group Banking system

Group banking is a system of banking where two or more banks come together as a group to provide banking services.These individual banks act as a subsidiary of the holding or parent company. The holding company may be a banking or non-banking institutions.The main purpose of this type of banking is to unify the management of banks and to achieve economies of large-scale operation.

Following are the features of Group Banking system:-

a) The individual banks are controlled by the holding company.
b) Each individual banks have their own separate identity
c) The individual or the participating banks have their own Board of Directors which is responsible to the holding company.
d) The Board of Directors of individual banks are responsible to the depositors for the proper management of the banks.

3.3.4Chain Banking System

Chain Banking is a system of banking when a small group of individuals control two or more banks which are independently chartered. In this system a number of separately incorporated banks are controlled through holding majority of shares in each bank or inter-locking of directorship.

Each bank retains its own separate entity and carries out its operations without the interference of any central organisation. The purpose of chain banking is to maximise profit and goodwill in the market. The banks which entered into chain banking within a community, had less scope of competition from other banks operating in the same area.

Features of Chain banking are:-

a) It offers services to the investors in the form of consistent return and complete control.
b) There is optimum utilization of resources to maximise profit.
c) Due to centralised and unified control it provides quick decision-making.

3.3.5 Retail banking System

Retail banking is a system of banking which is concerned about the current requirements of the individual customers. It provides financial services to the individual consumers rather than the corporate clients. It is also known as consumer banking or personal banking.In other words, all the services that an individual can avail from a bank falls under the retail banking. For example multiple deposit accounts, credit cards, debit cards, A.T.M, online banking, etc.

Features of Retail banking are:-

a) Retail banks deals with individual customers rather than the corporate clients.
b) Retail banks deals in large number of customers and large volume of transactions having low transaction value.
c) It provides services to wide range of consumers thereby mitigating the risk of non-performing assets.
d) Retail banks provide the services of various deposit accounts, various loans, debit card, credit card, internet banking, mobile banking, etc.
e) With the emergence of internet banking, Retail banks have the luxury of multiple distribution channels.

3.3.6 Universal banking system

Universal banking is a banking system which offers a set of services under one roof. It carries on the comprehensive financial services comprising of investment banking and commercial banking. In other words, these banks may also be called financial superstore. The services offered are accepting deposits, sale of different financial products, merchant banking, selling of insurance policies, underwriting, book runners, asset under management services, stock broking, money transfer services (RTGS&NEFT), and any other services related to banking.

Features of Universal banking are:-

a) In universal banking system all types of customers are served, such as individuals, corporates, government, etc.
b) In universal banking all types of funds for short, medium and long term are provided.
c) Universal bank provides all types of services such as accepting deposits, advancing loans, credit creation, agency and general utility functions, asset management, merchant banking, bill discounting, fund transfer, etc.

3.3.7 Wholesale banking system

Wholesale banking can be described as banking system where the target customers are the large clients, such as banking institutions, non-banking institutions, Government agencies, large corporations, real estate developers. These banking system is opposite to the retail banking system which focuses on individual consumers. Some of the services offered in wholesale banking system are large trade transactions, consultancy, underwriting, working capital financing, mergers and acquisitions.

Following are the features of Wholesale banking system:-

a) Wholesale banking deals with corporate clients rather than individual consumers.
b) It deals with high value transactions with limited number of clients.
c) It provides the services of underwriting, working capital finance, mergers and acquisitions, etc.
d) It has low operational cost but deals in very high risky assets.

Check Your Progress

4. What is Unit Banking?
5. Define Wholesale Banking.

3.4 STRUCTURE OF COMMERCIAL BANK IN INDIA

The Commercial bank in India can be broadly classified as follows:

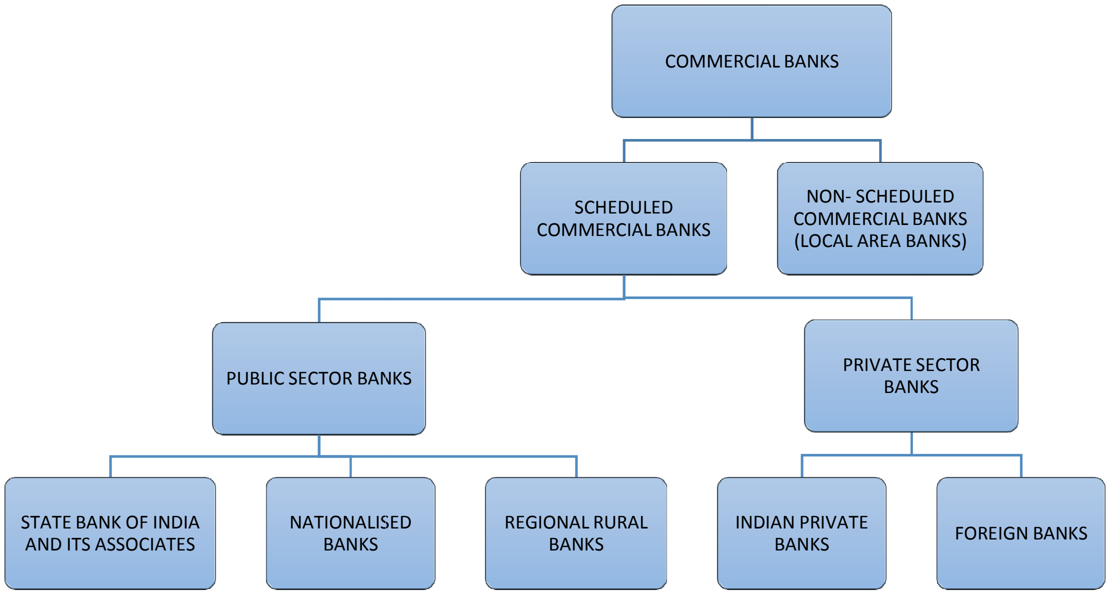


Fig: Structure of Commercial Banks in India

3.4.1. Scheduled Banks: A scheduled bank refers to those banks which are included in the Second Schedule of the Reserve Bank of India Act 1934. The banks that satisfy the criteria under clause 42(6) (a) of this Act. To qualify as a scheduled bank, a bank must satisfy the condition that the paid-up capital and the collected funds of the bank must not be less than Rs.5 lakh. Schedule banks are eligible for loans from Reserve Bank of India at bank rate and are given membership to clearing house.

Scheduled banks are classified into:-

i. Public sector banks
ii. Private sector banks

Let us discuss both the types of public sector banks in details.

3.4.1.1 Public sector banks- Public sector banks are those banks in which the government holds more than 50% ownership. In India, public sector banks are owned and controlled by the government either directly or indirectly through the Reserve bank of India. These banks are also known as 'National banks'.

Public sector banks are further classified into-

3.4.1.1.1 State bank of India and its Associate banks- The state bank of India is the largest public sector bank in India. The State Bank of India earlier had seven subsidiaries. State Bank of Indore was merged with SBI on 26 August, 2010 and State Bank of Saurashtra was merged with SBI on 13 August 2008, leaving only five associate banks. The five associate banks were:

i. State Bank of Hyderabad.

ii. State Bank of Mysore.
iii. State Bank of Patiala.
iv. State Bank of Travancore
v. State Bank of Bikaner and Jaipur.

On 1st October 2017, all these five banks have been merged with SBI, making it the biggest bank in India. At present there are no associate banks of SBI.

3.4.1.1.2. Nationalised Banks- Nationalization of bank means taking over of a bank owned by the private sector into public ownership of a national government by purchasing more than 50% of stake. The main objective of nationalization of the bank was to help achieve balanced regional sectoral and sectional development of the economy by way of making the banking service available to all the section of people and throughout the country, be it rural, urban or semi-urban areas.

- In July 1969, the Government of India nationalised 14 large banks. In April 1980, 6 more banks were nationalised increasing the number of nationalised banks to 20.
- State Bank of India has been merged with State Bank of Saurashtra in 2008, State Bank of Indore in 2009, State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala, State Bank of Travancore and The BharatiyaMahila Bank in 2017.
- Bank of Baroda has been amalgamated with Dena Bank and Vijaya Bank in 2018.
- Punjab National Bank has been merged with Oriental Bank of Commerce and United Bank of India in 2020.
- In 2020, Syndicate Bank was merged with Canara Bank and Union Bank of India was merged with Andhra Bank and Corporation Bank.
- Allahabad Bank was merged with Indian Bank in 2020.

At present there are 12 nationalised banks operating in India after the mergers of Government banks.

3.4.1.1.3. Regional Rural Banks- The Regional Rural Bank was established in October 1975 and added to the Public Sector Banks. Initially five RRBs were set up, two in Uttar Pradesh and one each in Haryana, Rajasthan and West Bengal. At present there are 43 Regional Rural Banks functioning in the country. These banks have been set up with the objective of providing credit and other facilities for agriculture and other productive activities in rural areas. These banks are public sector banks as 50% of their capital is provided by Central government, 15% by the state government concerned and the remaining 35% by the sponsoring public sector commercial banks.

3.4.1.2 Private Sector Banks- Private Sector banks are those banks in which the majority of the stake is held by shareholders of the bank and not by the government. They perform all the commercial banking functions. This segment comprises of:

3.4.1.2.1 Indian private banks: The first private bank in India was IndusInd bank. It is one of the fastest growing private sector banks in India.

The First financial institute in India to receive an "in principle approval" from RBI was the Housing Development Finance Corporation Limited (HDFC), as part of RBI's Liberalisation of the Indian banking Industry. Thus, HDFC bank limited was incorporated as a private bank in January 1995 with its registered office in Mumbai. Some of the private banks operating in India are-

i. HDFC Bank ltd.
ii. ICICI Bank Ltd.
iii. IDBI Bank Ltd.
iv. IndusInd Bank Ltd.
v. Kotak Mahindra Ltd.
vi. Axis Bank Ltd.
vii. Yes Bank Ltd. Etc.

3.4.1.2.2 Foreign Banks- Foreign banks are those banks which are registered or incorporated outside India. They have an office or branches in India. In other words, it can be said that foreign banks are foreign in origin but have a place of business in India. These bank performs almost the same range of functions as being performed by Indian banks. However, they are mostly active players in export and import trade and foreign exchange transactions. Some of the foreign banks are-

i. HSBC Ltd.,
ii. Citibank,
iii. Standard Chartered Bank,
iv. United Overseas Bank Ltd, etc.

3.4.2. Non Schedule Banks- The banks which are not listed in the second schedule of the Reserve Bank of India are called Non-Scheduled banks. These banks are defined in clause (c) of sec 5 of the Banking Regulation Act, 1949 (10 of 1949). The requirements of statutory cash reserve is also applicable to these banks. However, unlike scheduled banks they are not required to keep the reserves with the Reserve bank of India. These banks are deprived from the privileges available to the scheduled banks.

The presence of non-scheduled banks has declined over the years. It has become almost nil now. However, RBI considers the four Local Area Banks as the non-scheduled commercial banks

i. The Costal Area Bank Ltd., Vijayawada.
ii. Capital Local Area Bank Ltd., Phagwara, Navsari.
iii. Krishna BhimaSamrudhi Local Area Bank Ltd., Mehabub Nagar.
iv. Subhadra Local Area Bank Ltd., Kolhapur.

Check Your Progress

6. List two Private Banks.
7. Name the Regional Rural Banks available in Assam.
8. Which is the First financial institute in India to receive an "in principle approval" from RBI?

3.5 SUMMING UP

- A Bank accept deposits of money from the public and creates credit by making advances out of the funds received as deposits.
- Central Bank is an apex institution which is generally set up by the government of a country to undertake central banking functions. It is anautonomous institution entrusted with the powers of control, supervision of the monetary and banking system of the country.
- Commercial banks performs all kinds of ordinary banking business such as accepting deposits, advancing loans, credit creation, agency and general utility functions. It may be public sector banks, private sector banks and the foreign banks.
- A co-operative Bank is a voluntary association of members which operates on the principle of cooperation, self-help and mutual help. Co-operative banks are set up under the Cooperative Societies Act. They are also regulated by Reserve Bank of India and governed by Banking Regulation Act, 1949 and Banking Laws (Co-operative Societies) Act, 1965.
- Development banks are specialised type of financial institutions which are engaged in providing both fund as well as non-fund based services. They provide medium term as well as long term funds and acts as catalytic agents in promoting balanced development of the country. Industrial Finance Corporation of India (IFCI) was the first institution established as the development bank in 1948.
- The capital of Regional Rural Bank are shared between the Government of India (50 %), concerned State Government (15%) and the sponsoring nationalised bank (35%). These banks are scheduled banks and governed by Regional Rural Bank Act, 1976.
- An investment bank is a financial institution that assist individuals, corporations and government in raising capital by underwriting and/ or acting as the client's agent in the issuance of securities. Investment Bank aims at earning income through charging fees and commissions.
- Exchange Banks are the banks which facilitates the foreign exchange transactions. They are specialised in financing the foreign trade and have branches in the foreign countries and other important trade centres. Apart from financing the foreign trade, they are also engaged in facilitating the internal trade of the country by advancing loans to traders and discount their bill of exchange.
- The Export – Import bank of India (EXIM Bank) was established in 1982. The main function of this bank is to provide financial and other required assistance to the exporter and importer of a country.
- Payment bank are newly developed form of banking in India. They are differentiated bank (niche banks) which cater to the needs of certain demographic segments of the population. These banks can carry out most of banking operations but cannot advance loans or issue credit cards. The also provide services such as Internet banking, mobile banking, ATM, debit card.

- Branch banking is a system of banking where the bank provides banking services through a wide network of branch offices. This system has made the banking more convenient by removing the geographical barriers.
- Unit banking is a system of banking where an independent isolated bank undertakes banking business/ functions in a particular area to cater the financial needs of particular region.
- Group banking is a system of banking where two or more banks come together as a group to provide banking services. These individual banks act as a subsidiary of the holding or parent company. The holding company may be a banking or non-banking institutions.
- Chain Banking is a system of banking when small group of individuals control two or more banks which are independently chartered. In this system a number of separately incorporated banks are controlled through holding majority of shares in each bank or inter-locking of directorship.
- Retail banking is a system of banking which is concerned about the current requirements of the individual customers. It provides financial services to the individual consumers rather than the corporate clients
- Universal banking is a banking system which offers a set of services under one roof. It carries on the comprehensive financial services comprising of investment banking and commercial banking.
- Wholesale banking can be described as banking system where the target customers are the large clients, such as banking institutions, non-banking institutions, Government agencies, large corporations, real estate developers.
- A scheduled bank refers to those banks which are included in the Second Schedule of the Reserve Bank of India Act 1934.
- Public sector banks are those banks in which the government holds more than 50% ownership.
- Nationalization of bank means taking over of a bank owned by the private sector into public ownership of a national government by purchasing more than 50% of stake.
- Regional Rural banks are public sector banks as 50% of their capital is provided by Central government, 15% by the State government concerned and the remaining 35% by the sponsoring public sector commercial banks.
- Foreign banks are those banks which are registered or incorporated outside India. They have an office or branches in India.
- Those banks which are not listed in the second schedule of the Reserve Bank of India are called Non-Scheduled banks.

3.6 Key Terms

- Bank - According to Sec 5 (1) (b) of the Banking Regulation Act, 1949, "Banking means accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques, draft, and order or otherwise."

- Deposits – A deposit is a financial term that means money held at a bank. A deposit is a transaction involving a transfer of money to another party for safekeeping.
- Commercial Bank – A financial institution which provides the services of accepting deposits and giving loans for investment with the aim of earning profit.
- Loans – A sum of money that is borrowed and is expected to be paid back with interest.

3.7 Answer to 'Check Your Progress'

1. The Reserve Bank of India was set up in 1935.
2. A co-operative Bank is a voluntary association of members which operates on the principle of cooperation, self-help and mutual help. Co-operative banks are set up under the Cooperative Societies Act.
3. The 6 payment bank operating in India are –Airtel Payment Bank, India Post Payment Bank, Paytm Payment Bank, Jio Payment Bank, Fino Payment Bank and NSDL Payment Bank.
4. Unit banking is a system of banking where an independent isolated bank undertakes banking business/ functions in a particular area to cater the financial needs of particular region.
5. Wholesale banking can be defined as a banking system where the target customers are the large clients, such as banking institutions, non-banking institutions, Government agencies, large corporations, real estate developers.
6. The two Private Banks are- HDFC Bank Ltd and ICICI Bank Ltd.
7. The two Regional Rural Banks operating in Assam are Assam GraminVikash Bank and LangpiDehangi Rural Bank.
8. The First financial institute in India to receive an "in principle approval" from RBI was the Housing Development Finance Corporation Limited (HDFC).

3.8 Questions and Exercises

Short- Answer Questions:

1. What are Regional Rural Banks?
2. Explain in brief about Development Banks.
3. Give the features of Branch Banking System.
4. Why is Payment Bank important in the present era?
5. Write in short about the State Bank of India and its associates along with the latest mergers?

Long – Answer Questions:

1. Explain in detail the types of Banks in India.
2. Elucidate the Banking System in India.
3. Discuss the Structure of Commercial Banks in India.

3.9 References and Suggested Readings:

1. Muraleedharan D. 2014, *Modern Banking Theory and Practise*. PHI Learning Private Limited, Delhi.
2. Gupta Shashi K, Sharma R.K, and Gupta Neeti, 2014, *Financial Institutions and Markets.* Kalyani Publishers, Delhi.
3. Nag Rajdeep 2014, *Modern Banking Practises.* Aditya Book Distributor, Guwahati.

BLOCK IV : Unit-4

Recent Developments in Banking Operations: E-Banking, Core Banking Services, Electronic Fund Transfer, RTGS and NEFT

Unit Structure:

4.1 INTRODUCTION

Banking systems and financial institutions are an integral part of an economy. Seamless functioning of these sectors is important for an economy to grow. Due to the advent of digital technology, banking and financial services have undergone a massive shift in their mode of operations. New trends are gaining momentum at a fast pace as the customers find it convenient and also flexible at the same time. The emergence of financial technology has resulted in the introduction of several technological advancements in the industry. Internet banking and mobile banking are just some examples that mark this shift. This unit will introduce you to the latest trends that are revolutionising the Indian banking and financial sector.

4.2 UNIT OBJECTIVES

After going through this unit, you will be able to:

- Understand the recent developments in banking operations, viz,
- E-Banking
- Core Banking Services
- Electronic Fund Transfer
- Real Time Gross Settlement and
- National Electronic Funds Transfer

4.3 E-BANKING

E-banking is a blanket term used to indicate a process through which a customer is allowed to carry out, personal or commercial banking transactions using electronic and telecommunication network. It is a product offered by banks which facilitates online banking, with the help of which the customer can have access to the bank account in just one click. Through e-banking, a client can acquire his record and manage numerous exchanges utilising his cell phone or personal computer.

Electronic banking has many names like web-based banking, e-banking, virtual banking, or web banking, and online banking. It is just the utilisation of telecommunications networks and electronic networks for conveying different financial services and products. It covers facilities such as – fund transfer, checking account statements, utility bill payments, opening of bank account, locating nearest ATM, obtain information on financial products and services, applying for loans, etc. using a personal computer, smartphone, laptop or personal digital assistant.

4.3.1 E-BANKING SERVICES

E-banking refers to a banking arrangement, with which the customer can perform various transactions over the internet, which is end-to-end encrypted, i.e. it is completely safe and secure. It promotes paperless/cashless transactions and comes with a number of rights, responsibilities and fees as well. The range of services covered under E-banking are:

Internet Banking

A banking facility provided to the customers through which the customers are able to perform a number of monetary and non-monetary transactions, using the internet, through the bank's website or application.

Here are some of the best features of internet banking:

- Provides access to financial as well as non-financial banking services
- Facility to check bank balance any time

- Make bill payments and fund transfer to other accounts
- Keep a check on mortgages, loans, savings a/c linked to the bank account
- Safe and secure mode of banking
- Protected with unique ID and password
- Customers can apply for the issuance of a chequebook
- Buy general insurance
- Set-up or cancel automatic recurring payments and standing orders
- Keep a check on investments linked to the bank account

Mobile Banking

Almost all the banks have designed their mobile applications with which one can perform transactions at their fingertips. For this, four things are required – a smartphone, internet, mobile application, and mobile banking service enabled in the bank account.

Automated Teller Machines (ATM)

Automated Teller Machine, popularly known as ATM is one of the most common and initial service, provided under e-banking. It is not just a machine with which one can withdraw cash as and when required, but it also allows a customer to check their account status, transfer fund, deposit fund, changes mobile number, change Debit Card PIN, i.e. Personal Identification Number.

Debit Card

Debit cards are used in our day to day life so as to perform end number of transactions. Debit cards are linked to the customer's bank account and so the customer only needs to swipe the card, in order to make payment at Point of Sale (POS) outlets, online shopping, ATM withdrawal. In this way, the amount is deducted from the customer's account directly.

Credit Card

Just like a debit card, a credit card is also a payment card which the banks issue to the customers on their request, after checking their credit score and history. It enables the cardholder to borrow funds upto the pre-approved limit and make payment. The limit is granted by the banks which issue the card. The cardholder promises to repay the amount within a stipulated time, with some charges, for the use of credit card.

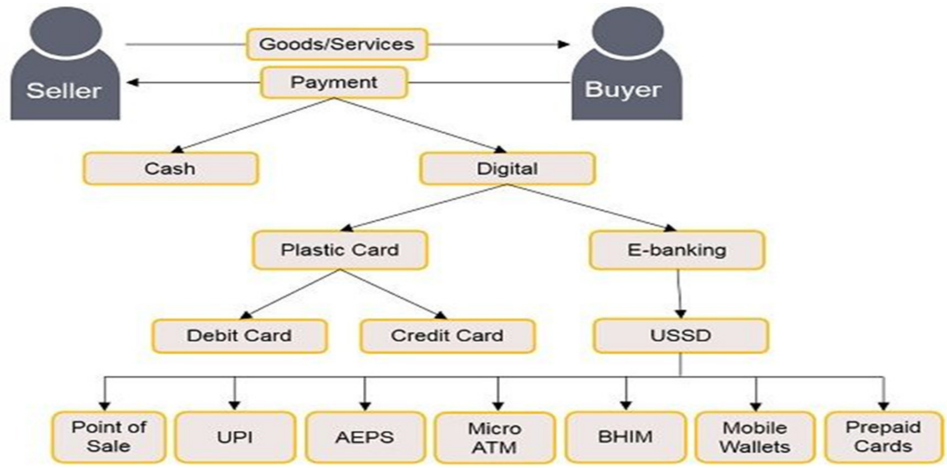
Electronic Fund Transfer (EFT)

When money is transferred electronically from one bank to another, it is called as electronic fund transfer. It covers direct debit, direct deposits, wire transfers, NEFT, RTGS, IMPS, etc.

Point of Sale (POS)

Points of sale system refers to the point, in terms of date, time and place (retail outlet) where the customer makes a payment, using a plastic card, for the purchase made or services received.

Let us understand E-Banking better



Are electronic banking and internet banking the same?

No, electronic banking and internet banking are often confused with each other. However, these are two different services launched by the bank. Electronic banking is a broad term or category which includes various forms of banking services and transactions performed through electronic means such as internet banking, mobile banking, telebanking, ATMs, debit cards, and credit cards. Internet banking is one of the latest additions to electronic banking. Thereby, internet banking is a part of electronic banking.

4.3.2 SIGNIFICANCE OF E-BANKING

A. Importance to customers

Convenience of initiating financial transactions:E-banking is largely preferred because of the convenience that it provides while fund transfer and bill payments. Registered users can use almost all the banking services without having to visit the bank and standing in queues. Financial transactions such as paying bills and transferring funds between accounts can easily be performed anytime as per the convenience of the user.

Proper Track of Transactions: Acknowledgement slips are provided by the bank after transactions which have a high possibility of getting misplaced. However, with internet banking, it becomes very easy to track the history of all the transactions initiated by the user. Transactions and fund transfers made online are organised in the 'Transaction History' section along with other details such as payee's name, bank account number, the amount paid, the date and time of payment, and remarks.

Quick and Secure:E-banking users can transfer funds between accounts instantly, especially if the two accounts are held at the same bank. Funds can be transferred via NEFT, RTGS or IMPS as per the user's convenience. One can also make bill payments, EMI payments, loan and tax payments easily. Moreover, the transactions, as well as the account, are secured with a password and unique User-ID.

Non-financial Transactions: Besides fund transfer, internet banking allows the users to avail non-financial services such as balance check, account statement check, application for issuance of cheque book, etc.

Lower cost per exchange: Since the customer doesn't need to visit the branch for each exchange, it saves him both time and cash.

No topographical hindrances: In conventional financial frameworks, geological distances could hamper specific financial exchanges. Nonetheless, with e-banking, geological obstructions are diminished.

B. Importance to Businesses

Better efficiency: Electronic banking further develops usefulness. It permits the computerisation of ordinary, regularly scheduled payments and provides further banking activities to upgrade the efficiency of the business.

Lower costs: Usually, costs in financial relationships and connections depend on the assets used. Assuming that a specific business needs more help with deposits, wire transfers, and so on, at that point, the bank charges its higher expenses. With internet banking, these costs are limited.

Lesser errors: Electronic banking diminishes mistakes in normal financial exchanges. Awful penmanship, mixed-up data or information, and so on can cause mistakes that can be exorbitant.

Diminished misrepresentation: Electronic banking gives an advanced impression to all representatives who reserve the privilege to alter banking exercises. In this manner, the business has better perceivability into its exchanges, making it hard for any fraudsters from committing crimes.

Account reviews: Business proprietors and assigned staff individuals can get to the records rapidly utilising a web-based financial interface. This permits them to audit the record action and, furthermore, guarantee the smooth working of the account.

C. Importance to banks:

Lesser exchange costs: Electronic exchanges are the least expensive methods of exchange.

Lesser desk work: Advanced records decrease desk work, paperwork, and make the cycle simpler to deal with. Likewise, it is ecological.

Decreased fixed expenses: A lesser requirement for branches which converts into a lower fixed expense.

More steadfast clients: Since e-banking administrations or services are convenient to the clients, banks experience higher reliability from their clients.

A decreased edge for human blunder: Since the data is handed-off electronically, there is no space for human mistakes or errors.

4.3.3 ADVANTAGES OF E-BANKING

E-banking has changed the banking system completely developing a convenient banking system. Some of the reasons for adopting e-banking may be highlighted as under.

i. Faster Transactions

E-banking provides the facility of instant transfer of funds to its customers. It saves the time of customers as funds get transferred very fast from one account to another. People don't need to wait in queue to transfer their funds or pay off their bills; they can easily do it through their device. It saves the time of customers as they can easily access their account with the help of their device.

ii. Lowers Transaction Cost

E-Banking reduces the cost involved in doing financial transactions. Electronic transactions are termed as the cheapest medium of doing transactions. It reduces the manpower requirements as workload is reduced.It has also reduced the paperwork in organisations as all transactions are recorded digitally.

iii. Provides 24×7 Service

This is the most important feature of e-banking. E-Banking provides customers with all-time access facility to their accounts. Customers can easily access their account anytime and from anywhere with no limitations. It provides convenience to the customers as they can perform transactions as per their wish.

iv. Reduces the chances of error

E-banking has reduced the chance of human error. It has reduced the role of the human in the whole transaction process. E-banking system works fully automated over the internet. All transactions are recorded and stored digitally. So, the chances of human error are minimised.

v. Develops Loyalty in Customers

E-banking helps the banks to develop large number of loyal customers. Through E-banking service banks are able to serve their customers well. They are able to provide fast & better service to customers.Customers are able to get a user-friendly interface from the banking website. They are able to avail services any time even from their home comfort. This develops a sense of loyalty among customers when they are happy with the services of their banks.

vi. Removes geographical barriers

E-Banking has removed all distance barriers for performing transactions. It has removed all distance barriers that customers used to face in the traditional method of performing transactions. It provides the facility of instant transfer of funds both nationally and internationally. All systems are connected to each other online which facilitate easy transfer of funds.

vii. Provides better productivity

E-banking plays an efficient role in increasing the productivity of the businesses. The whole financial transaction system is supported by automated software systems. These systems are specially designed for doing transactions of funds.It thus reduces the time required for doing transactions and also reduces the workload of business organisations. It increases the overall productivity of the businesses.

viii. Reduce frauds in transactions

Another important feature of e-banking is that it helps in continuously monitoring of accounts. A customer can easily track each and every transaction of their accounts. They can easily track if any fraud is done by anyone in financial transactions.It provides a complete digital footprint of all those who can modify a customer's banking activities and commit fraud.

A quick glance…

It enables digital payments, which encourages transparency.

It allows 24/7 access to the bank account.

It also sends notifications and alerts to get updated with the banking transactions and changes in the rules.

It lowers transaction cost for the banks.

It is convenient and easy for customers, as they are not required to visit the bank branch every time.

In a nutshell, any type of banking transaction performed through electronic mode comes under E-banking.

4.3.4 DISADVANTAGES OF E-BANKING

E-banking has various advantages which improves the banking system but there are disadvantages of using it too. These are as follows:

i. Security issues

Internet banking is completely insecure as there are many problems related to the website and data can be hacked by the hackers. It can lead to financial loss to the users. The financial information can also be stolen that can also create financial loss.

ii. Lack of direct contact between customer and banking officer

E- banking requires effective customer service for handling issues faced by the user. But lack of customer support creates disappointment among the customers. There are some online payments which may not be reflected in the system due to technical issues. It also creates insecurity among the customers. Thus, the lack of support from customer service executive is a barrier in online banking.

iii.Transaction problem

During online banking there are various issues faced by the user such as transferred payment is not reflected, payment failed, and other issues due to technical support.

iv. Long procedure to access e-banking

In order to avail internet banking facilities a procedure needs to be followed which sometimes requires quite a lot of formalities as well as time. A form to avail the service needs to be filled in and sent for approval. Once approved, the customer can access security password to log in. The App then needs to be downloaded and all credentials needs to be filled for logging in successfully.

v.Training and development

The banks need to conduct training and development program for employees for providing quality online services which enhance the customer experience. It requires huge investment to train them for providing effective services.

**** CHECK YOUR PROGRESS**

1. Define E-banking. State any two features of e-banking.

2. Mention any two merits and demerits of adopting e-banking by the modern commercial banks.

4.4 CORE BANKING SERVICES

Core Banking is an umbrella term that refers to the services rendered by a range of networked bank branches. It is a back-end system through which banking transactions related to deposit, loans, and credit can be processed daily across different bank branches, and updates are recorded and reflected immediately. Core banking is a business carried out by the bank with its retail and small business customers.

It assists customers to handle the transfer of funds in a quick turnaround time. Moreover, the updates related to the customer accounts are automatically posted. This is to empower the present and potential customers to achieve more freedom, as to their account transactions.

The word 'core' in the core banking system, expands to a Centralized Online Real-time Environment, which implies that applications are accessed by bank branches from centralized data centers. Hence, whenever a deposit is made, it is updated instantly on the bank's servers, and the customers are allowed to withdraw money from any branch or ATM throughout the world.

4.4.1 NEED FOR CORE BANKING SERVICES

Use of Information Technology is vital for the growth, and long term survival of any industry, and the same applies to the banking industry as well. Banks can benefit by using such technologies in terms of reduction in operation costs etc. The need for core banking is significant because it can satisfy the needs of the market and customers. Core banking is needed as it can improve and simplify the process of banking and provide convenience to customers and banks.The rural areas are unexposed to such technologies, and they are unable to access banking facilities due to various reasons. Core banking can help in expanding the banking facilities to the remote and rural areas of this country.

The requirement for computerized banks in India was felt in the early 1980s. Various national committees were formed by the government to modernize the banking system in India.

In the late 1980s, the then deputy governor of Reserve Bank of India (RBI) Dr C Rangrajan implemented the concept of core banking in India. It formed a platform for facilities like telebanking, off-site ATM's and customer terminal.

In the 1990s, core banking was transformed when private sector banks and foreign banks started having access to the Indian banking industry. The progress continued due to globalization, liberalization and the introduction of TRAI(Telecom Regulatory Authority of India).

Implementation of the core banking system in India was a landmark moment for the Indian banking industry. It has transformed the way business of money is handled and the functioning of banks. Core banking could be just a beginning, paperless and branchless banking system could be the future of Indian Banking industry.

4.4.2 OBJECTIVES OF CORE BANKING SERVICES

The key objective of adopting core banking technology is to improve the customer experience. It ensures customer convenience and allows "anytime and anywhere" banking.

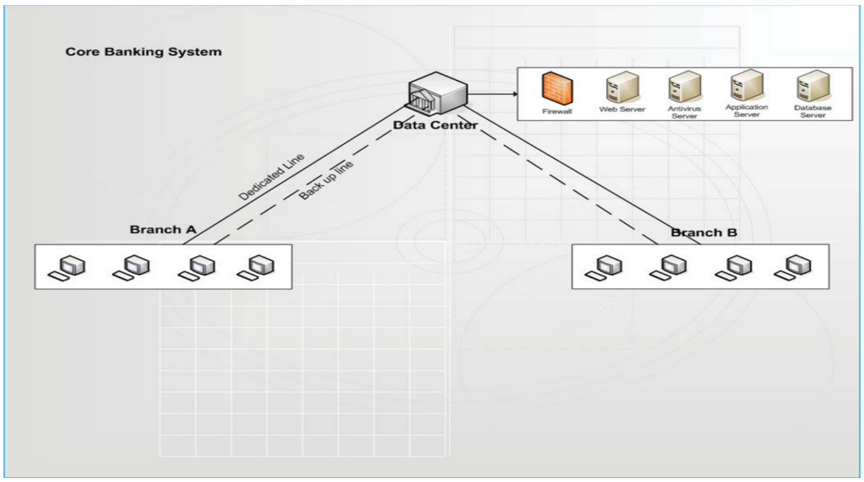
Simultaneously, it has drastically changed the way the banks function. Previously, basic bank functions like maintaining records of the account holders, deposits, transactions, maintaining ledger records, customer information, loan accounts, and others were performed manually. With the introduction of IT technology, various applications have been developed to automate these processes. Now, recording the transactions, calculation, assimilating customer information and maintaining a huge database is possible through software that enables automatic recording in the digital backend database. And the same software is installed throughout the systems of the many branches of the banks, creating a core banking network of the bank.

Another core objective of this new technology is to make informed decisions with the help of facts and figures. The various processes of the core banking system enable banks to store the data in proper format. All the data and reports can be quickly accessed through an authentication system and allow the customers and employees to make informed decisions.

Additionally, it helps in generating and providing the statutory and regulatory reports to the regulators of the government. Furthermore, core banking software provides the opportunity for customization.

In simple words, core banking is a bank automation process that aims to provide impeccable means of book-keeping, enhanced customer services and ease the decision-making process. When all of these fundamental goals are achieved, it eventually leads to increased efficiency, customer satisfaction, and profitability.

ILLUSTRATION



4.4.3 ITS FEATURES

Some of the key features of the Core Banking Services are as follows:

i. Opening new accounts in the bank
ii. Processing and recording money deposits and cash withdrawal
iii. Calculating loan interest
iv. Processing loans
v. Cheque clearance
vi. Payment clearance
vii. Managing customer information
viii. Calculating and managing interest rate
ix. Maintaining customer relationship
x. Assists in developing new banking products
xi. Banking analytics
xii. Banking products like mobile banking, internet banking, ATMs and more.

4.4.4 ADVANTAGES OF CORE BANKING SYSTEM

With a better understanding of the working principle and features of the core banking platform, the key benefits of theCore Banking System can be highlighted as under:

i. Enhanced productivity

Core banking platforms increase operational efficiency by reducing the time it takes to connect with multiple branches. As a result, banks can process transactions faster, regardless of the client's physical location.

ii. Improved security

Core banking systems use advanced encryption modules to protect the infrastructure from hackers and malware. On the client's side, bio-verification and two-factor authentication also provide additional layers of security to the platform. These features help banks maintain KYC standards and comply with other banking regulations.

iii. 24/7 access to banking services

In this era of contactless payments, access to round-the-clock bank services is vital. Users can conduct financial operations anywhere and anytime since the core banking platform never goes offline. Customers can also contact customer support for assistance at any time.

iv. Lower operational costs

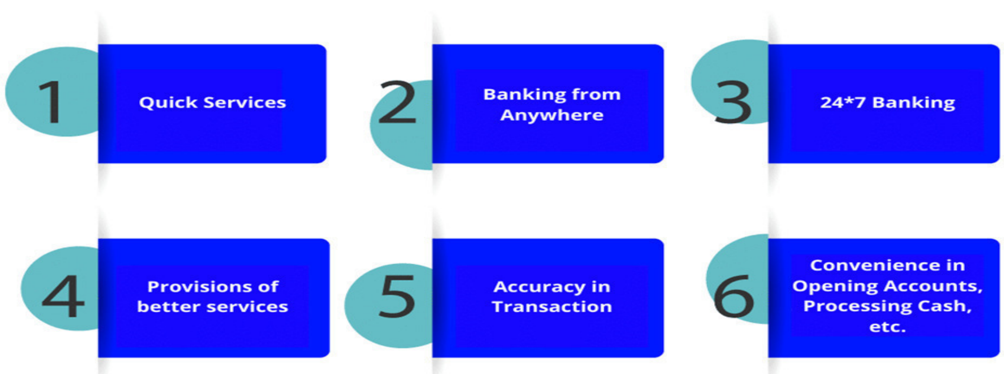
Banks can rely on their core platforms to reduce operational costs since these systems require fewer human resources to function. Besides, the powered infrastructure increases the completion rate of operations and reduces the chances of errors in documentation.

v. Multiple currencies

The customers can trade in multiple currencies instantly without needing to change large amounts at a currency exchange.

In a nut shell it can be seen that customers are benefitted in multiple ways – round-the-clock banking, quicker services anywhere, anytime, convenience of banking processes through a single datacenter, rural/remote area penetration and so on.

Banks benefit in no lesser way. Among the primary boons are process standardization, customer retention, improved documents management and considerable eradication of errors, and better safety & compliance process.



4.4.5 LIMITATIONS OF CORE BANKING SYSTEM

Despite the benefits of core banking system, it still has certain flaws like:

i. Technical downtimes can disrupt regular banking operations, thereby frustrating customers.
ii. Using a core banking system can introduce a single point of failure that affects all branches simultaneously in the case of a cyber-attack.
iii. Modern core banking systems can be expensive to buy and maintain, especially for small and medium-sized banks.
iv. Legacy core banking software can leave the entire infrastructure vulnerable to system failure. The modernization effort will also cost a lot of money.

4.4.6 HOW DOES CORE BANKING WORK

A core banking system comprises back-end servers that handle standard operations like interest calculation, passbook maintenance, and withdrawal.

For example, when a customer withdraws money from a branch or an ATM, the application sends a request to the centralized data centre, which then processes the request and authenticates the operation.

The data centre contains the database, an application server, a web server, and a firewall to protect the system from malware attacks. Banks can host their data centre locally or on the cloud.

To have a successful Core Banking system, the following criteria needs to be fulfilled:

i. Centralized Dashboard

Bankers need a single-view dashboard to visualize the system in real time. Also, bankers and customers should have access to the same dashboard view which will help diagnose and solve issues faster.

ii. Onboarding (with KYC features)

Before using the dashboard, the customer must sign in to their account with a unique username and password. With KYC features, banks can verify identities of prospective customers when they register. The onboarding process should also be simple enough for users to complete without stress.

iii. Two-factor authentication

The system needs to offer two-factor verification to boost security and protect customers' sensitive data.

iv. Push notifications

When building a core banking solution for mobile, push notifications should be installed to deliver timely account updates to customers.

v. Loan management

The core banking solution must allow customers to monitor their loans and schedule payments according to the specified plan.

vi. Interest calculators

For loan and mortgage payments, users need access to real-time calculators to help them make informed decisions.

vii. Live chat

A live chat feature must be on the platform to help users contact support agents when they need assistance. Automated chatbots can also provide templated answers to frequently asked questions.

vii. Transaction management

Customers can customize their popular payments and P2P transfers to ensure that their contact lists remain updated. They can also use multi-currency exchanges to trade on their preferred currencies.

Core banking in India has tremendously evolved in the past few years, and it is still evolving. Therefore, one can expect better and improved features in the future. Almost all private sector banks and public sector banks in India have adopted the core banking system. Still, some are left to adopt, but RBI is hopeful of 100% implementation of this system all over India.

****CHECK YOUR PROGRESS**

1. Why do you think Core Banking Services evolved?

2. Mention any three features of Core Banking Service.

3. How does CBS work?

4.5 ELECTRONIC FUNDS TRANSFER

An electronic funds transfer is a widely used method for moving funds from one account to another using a computer network. Electronic funds transfers replace paper-based transfers and human intermediaries, but provide the customer with the convenience of doing their own banking.

In simple words, an electronic funds transfer (EFT) is the electronic transfer of money over an online network.

Electronic funds transfers can be performed between the same bank or a different one, and can be accomplished with several different types of payment systems. An EFT can be initiated by a person or by an institution like a business and often doesn't require much more than a bank account in good standing.

Every time a banking customer uses her credit or debit card, whether at a physical point-of-sale or online, she’s engaging in an electronic funds transfer. Any preauthorized charges, such as direct deposits or utility bills, also utilize an EFT.The most popular form of electronic funds transfer is a direct deposit, in which an employee of a company preauthorizes his/her employer to pay the salary directly into his/her bank account.

Numerous other electronic funds transfers exist, including the following:

- ATMs.
- Online peer-to-peer payment apps like PayPal and Venmo.
- Pay-by-phone systems.
- Wire transfers.
- Online or mobile banking.
- Electronic checks.

4.5.1 UNDERSTANDING ELECTRONIC FUNDS TRANSFER (EFT)

Every transaction has a starting point. The starting point happens anytime a money transfer is initiated through an electronic system with an electronic funds transfer. These systems include ATMs, computers, telephones, remote banking programs, or magnetic tape (the black data stripe on the back of credit and debit cards).

Making an electronic funds transfer is fairly straightforward. The process allows the person sending money to initiate a transfer from an originating account.

EFTs work via electronic signals that the sender generates when initiating sending money to the receiver. Instantly the networks and the servers or payment terminals receive the signals to initiate and continue with the payment. The receiver and the sender can be many parties like employers to their employees, vendors to customers, retailers, etc.

EFT is possible by initiating a digital cheque — usually between vendors and retailers during the purchase, direct deposit and phone payments — for utility payments, ATMs and card payments or internet transactions via proper authorization.

Electronic funds transfers are secured by a personal identification number (PIN) or the login information that unlocks the customer’s online banking service. ETFs are encrypted across 128-bit signals, ensuring security. As such, they are secure and swift, and cost effective for businesses.

It requires very little effort to set up, usually requiring a bank account and proper documents to allow transfers at the time of set-up only. During the transfer, there is no necessity of providing documents or physical presence to initiate the transaction.

Highlights of Electronic Funds Transfer (EFT)

- *Usually, a very small fee is charged to process the payment across a window, and in large amounts during transfer.*
- *To make an EFT payment, all you need is your bank information and the receiver’s bank information.*
- *You cannot stop an ETF payment after you’ve initiated it by clicking continue after entering your bank details.*

4.5.2 TYPES OF ELECTRONIC FUNDS TRANSFER

Electronic funds transfer can be considered a blanket term that describes all digital money transactions. To help you better understand, here are some common types of EFT services you may encounter.

1. Direct Deposit

This allows a user to authorize specific deposits into their bank account, including paychecks, social security checks, or other benefits. One can also preauthorize automatic withdrawals directly from your bank account for recurring expenses such as auto insurance, mortgage payments, and utility bills.

2. ATM

An ATM (Automated Teller Machine) is an electronic terminal that allows access to a bank almost anywhere at any time. A person can use them for withdrawing cash, making deposits, or transferring funds between accounts. The process generally involves inserting an ATM card and entering the security PIN.

3. Personal Computer Banking

Being able to handle banking tasks straight from the comfort of your home is a reality due to online banking. By using one's personal computer and a secure internet connection, a person can make transfers between accounts or even pay bills electronically. There are also apps that extend this service to smartphones.

4. Pay-by-Phone Systems

Making an electronic funds transfer by phone (telephone banking) involves calling the customer's financial institution and providing instructions to either pay specific bills or transfer money between accounts. Typically, the customer must have an agreement with their bank or credit union to make these transfers.

5.Debit or Credit Card Transactions

Whether using a debit or credit card, both works similarly by allowing a person the ability to make purchases or make payments. Card transactions can occur in person, online, or via phone. The most significant difference between the two is that debit card purchases quickly remove money from the account. Hence, it's crucial to make sure the money in the account is sufficient to cover your payment before using a debit card.

6. Electronic Cheque Conversion

This is a process that converts paper cheques into electronic payments. It works because a digital cheque gets generated after being authorized by the person making the payment or purchase. This can be done in a store or after a company receives the cheque by mail.

7. Peer-to-Peer Payment Apps

Sending money to someone you know is easier than ever since the introduction of peer-to-peer (P2P) payment apps such as PayPal, Venmo etc. These apps allow the sender to transfer money to another person by entering the recipient's email address or phone number. Most of these transactions occur in real-time. However, in most cases, P2P payments do not offer the same protections as debit and credit cards. The sender may be solely held responsible for losses if the incorrect email or number is entered and money is mistakenly sent to the wrong person.

4.5.3 ADVANTAGES AND DISADVANTAGES OF ELECTRONIC FUNDS TRANFER (EFT)

A. ADVANTAGES

i. Cost-effective: For businesses, EFTs are a cost-effective way to save money on printing paper cheques and postage. EFTs not only eliminate the risk of human counting errors and fraudulent bills, but they also eliminate the risk of cheques being lost or intercepted in the mail.

ii. Safe and convenient: For consumers, no matter which method is chosen, transferring funds typically requires minimal effort. In addition, it eliminates the need for visiting bank branches in person, which increases the consumer-convenience factor.

B. DISADVANTAGES

i. Debit cards are susceptible to fraud: If a debit or ATM card is lost or stolen, the person could lose money if he doesn't report the loss quickly enough.

ii. Isn't always immediate: Depending on the business and type of recurring transaction, it could take a few days or a few weeks to cancel recurring payments or direct deposits. Plus, fees could be involved, especially if one requests for a stop payment.

iii. Electronic Funds Transfer Fees: When using an ATM, it's important to note that some financial institutions and ATM owners may charge fees. These fees may be more likely if a person doesn't have an account with the ATM owner or transactions occur at remote locations.

KEY TAKEAWAYS

- An electronic funds transfer is the digital way of moving money from one bank to another.
- Anyone with a bank account can initiate an electronic funds transfer.
- Using an electronic funds transfer can be quicker, more secure, and more convenient than sending or receiving paper checks.
- The Electronic Funds Transfer Act (EFTA) has protections in place for consumers.

****CHECK YOUR PROGRESS**

1. Discuss briefly the various methods of Electronic Funds Transfer.

4.6 REAL TIME GROSS SETTLEMENT (RTGS)

With the digitalisation of banking transactions, many new receiving and sending money methods have come into place. One such way of transaction in money is RTGS, which stands for Real-Time Gross Settlement. It is a system in which money can be transferred from one bank account to the other instantly.

The term real-time gross settlement (RTGS) refers to a funds transfer system that allows for the instantaneous transfer of money and/or securities.It is a process used for the transfer of funds instantly from one bank to another bank. It involves high-value transactions. It is the continuous process of settling payments on an individual order basis without netting debits with credits across the books of a central bank. Once completed, real-time gross settlement payments are final and irrevocable. In most countries, the systems are managed and run by their central banks.

To simplify it, Real-Time Gross Settlement or RTGS means transaction takes place in "real-time", that is, the transaction or settlement takes place immediately as per the requestor's instructions without any delay. And "Gross Settlement" means that the transactions are settled on a one-to-one basis and not on a deduction of one amount from another or netting-off basis.

The meaning of RTGS in banking is a real-time fund transfer system for the customers to initiate money transfers from anywhere using online banking services. The customer can also transfer funds using the offline mode where they are required to deposit the money in the bank branch that provides RTGS services and submit a form requesting fund transfer through the RTGS system.

4.5.1 IMPORTANCE OF REAL-TIME GROSS SETTLEMENT (RTGS)

The Real-Time Gross Settlement system (RTGS) is an important element in today's banking system in which maximum transactions are performed online. In the fast-moving business environment where time is a major constraint and security of money or funds is a major concern, RTGS provides a fast and secure measure for high-value money transactions.

The RTGS transactions are safe and secure. The high-value transactions are settled in real-time on a one-to-one basis. Also, the RTGS system is legally backed and is controlled by the Reserve Bank of India. Thus, the risk is reduced as compared to other modes of transfer.

There are no geographical limitations in transferring funds within India. The customers can access internet banking on their mobile devices and laptops from anywhere and utilise this service to transfer money to other bank accounts in any country's location.

The service of RTGS can be availed on a 24*7 basis. Thus, the funds can be transferred through online mode using the Real Time Gross Settlement Service even on the weekends and bank holidays. Therefore, the customers can initiate transactions anytime. Moreover, There is no delay in processing RTGS requests, and the funds can be transferred speedily.

There is no upper limit for the amount that can be transferred using this system. Any amount above Rs 2,00,000 can be transferred using RTGS. However, some banks can impose restrictions on the maximum amount transferred using the RTGS service through Net Banking.

4.5.2 MODES TO USE RTGS SYSTEM

The customers can transfer the funds from one bank account to another via the RTGS system in the following two ways:

1. Online mode- The customers can use the RTGS service at their comfort in online mode using their mobile and Internet banking.

2. Offline mode- The customers can also transfer the funds using RTGS through offline mode. For this, they need to visit the bank branch that provides the RTGS service and deposit the funds to be transferred in cash and fill up an RTGS request form for RTGS payment.

4.5.3 PROCESS OF REAL TIME GROSS SETTLEMENT (RTGS)

A. Limits for transfer

The amount to be transferred using the RTGS system shall not be less than Rs 2 Lakh. An amount less than this limit cannot be transferred using the RTGS system.However, any other mode like net banking, national electronic Funds transfer or NEFT etc., can be used.

The Real-Time Gross Settlement (RTGS) system is mainly used for high-value transactions. Therefore, there is no upper or maximum limit of the amount of money transferred utilising this system.

B. Information sought in the process

To transfer money via RTGS, a user needs to mention the following information:

1. Name of the beneficiary, the person to whose account the money is to be transferred.

2. The amount needed to be transferred.

3. Name of the bank of the receiver or beneficiary of the money.

4. The IFSC code of the bank name of the receiver or beneficiary.

5. The beneficiary's account number, the person in whose account the money will be transferred.

> ***A beneficiary is a person to whom the funds are to be transferred or, in simple terms, the receiver of the money. The fund's transfer under the RTGS system can occur only after 24 hours of adding a beneficiary. The maximum amount that can be transferred without adding a beneficiary is Rs 50,000.***

With the Indian government's endeavour to enable maximum financial transactions through online mode, money transfer has become faster, safer and more accessible. It is easy to track online transactions, and therefore, it has increased the transparency in the banking system. The Real-Time Gross Settlement (RTGS) is helpful for businesses. A fast-growing economy also needs a faster money transfer system. RTGS payments can be made using net banking and mobile banking without the use of cheques or drafts. Hence, RTGS is a safe system for transferring higher amounts.

KEY TAKEAWAYS

- Real-time gross settlement is the continuous process of settling interbank payments on an individual order basis across the books of a central bank.
- This system's process is opposed to netting debits with credits at the end of the day.
- Real-time gross settlement is generally employed for large-value interbank funds transfers.
- RTGS systems are increasingly used by central banks worldwide and can help minimize the risks related to high-value payment settlements among financial institutions.
- The remitting bank would receive a message from RBI, through the beneficiary bank, that the money has been credited to the beneficiary bank/customer account.
- Based on this, the remitting bank should advise the remitting customer that money has been credited to the receiving bank's beneficiary account.
- In case of non-credit or delay in credit to the beneficiary account, the customer can contact his or her bank. If the issue is not resolved satisfactorily, a complaint can be lodged with the RBI, giving the Unique Transaction Reference (UTR) number, which is a 22-character code used to uniquely identify a transaction in the RTGS system.

4.6 NATIONAL ELECTRONIC FUNDS TRANSFER (NEFT)

NEFT stands for National Electronic Funds Transfer. Started in November 2005, NEFT is an electronic funds transfer system set up and managed by the Reserve Bank of India. NEFT allows the online transfer of funds from one NEFT-enabled bank account to another.

4.6.1 FEATURES OF NEFT

The National Electronic Funds Transfer system is one of the various methods of online money transfer. It is regulated by the RBI and hence, works as per the guidelines laid down by RBI. Some of the unique features of NEFT can be summed up as under:

i. NEFT isa one-to-one payment facility.
ii. NEFT transactions can be processed only between the banks that offer NEFT-enabled services.
iii. Transactions made through NEFT do not take place in real-time; implying that it takes a few days for NEFT transactions to complete.

iv. Earlier,any NEFT transaction could be processed only between 8:00 AM and 6:30 PM from Monday to Friday and 8:00 AM to 12:00 PM on Saturdays. However, from 2020, NEFT transactions can be performed 24*7.
v. To transfer funds through NEFT, one must add beneficiaries on the internet banking portal of the required bank.
vi. There are no limits on the amount of NEFT transactions.
vii. There is a fee applicable on all NEFT transactions; the amount varies from Rs. 2.5 to Rs. 25, depending on the amount being transferred.
viii. As per RBI guidelines, the payments made via NEFT are processed and settled in batches of half-hour

4.6.2 OPERATION OF NEFT

Under NEFT, individuals, corporate and firms can be able to transfer funds electronically from any bank branch to any individual, corporate or firm having an account with any other branch of a bank in India participating in the Scheme. Here are the processes you should know about the NEFT system.

Step 1: First, an individual or corporate or firm who wants to originate a transfer of funds through NEFT, will have to fill an application form giving details of the beneficiary and the amount to be remitted.

For example, details like name of the beneficiary, name of the bank branch where the beneficiary has an account, IFSC of the beneficiary bank branch, account type and the account number have to be filled in. The application form will be available at NEFT enabled originating bank branch.

The remitter will have to authorise their bank branch to debit their account and remit the specified amount to the beneficiary.Customers enjoying net banking facility offered by their bankers can also initiate the fund transfer request online. Some banks offer the NEFT facility even through the ATMs.

Step 2: In the next step, the originating bank branch will prepare and send a message to its pooling centre (also known as the NEFT Service Centre).

Step 3:The pooling centre will then forward the message to the NEFT Clearing Centre (operated by National Clearing Cell of RBI in Mumbai) to be included for the next available batch.

Step 4: The Clearing Centre will sort the fund transfer transactions destination bank-wise, prepare to account entries to receive funds from the originating banks (debit) and provide the funds to the destination banks (credit).

Thereafter, bank-wise remittance messages will be forwarded to the destination banks through their pooling centre (NEFT Service Centre).

Step 5: The destination banks will receive the inward remittance messages from the Clearing Centre and pass on the credit to the beneficiary customers' accounts.

4.6.3 ADVANTAGES OF NEFT

- NEFT makes the transfer of funds easy, convenient and feasible.
- All NEFT transactions take place online; hence, there is no involvement of a third party.
- Owing to the involvement of RBI, NEFT transactions are completely safe and secure.
- The receiver and sender of the funds gets notified instantly upon completion of the transaction.
- NEFT does not require cheques or demand drafts while transferring money; hence, it is economical.
- Any account holder, whether an individual, firm or corporate can carry out NEFT transactions. The only required condition is that the banks of both the parties must be NEFT-enabled.
- Apart from transferring money, a person can also use NEFT to pay one's loan installment, credit card dues, EMIs, etc.
-

4.6.4 DIFFERENCE BETWEEN NEFT AND RTGS

NEFT (NATIONAL ELECTRONIC FUNDS TRANSFER)	RTGS (REAL-TIME GROSS SETTLEMENT)
Through National Electronics Funds Transfer, transactions of any amount can be sent to the recipient's account without any maximum limit to the funds that can be sent in a day	Large amounts of funds can be used to transfer instantly with Real-Time Gross Settlement. The transaction speed is faster than any other form of online payment.
The National Electronic Funds Transfer method does not have a minimum transfer limit ceiling.	The minimum amount needed to be transferred has to be of Rs. 2 Lakhs and above for RTGS
The funds transferred through NEFT are processed in 12 batches between 8:00 AM to 6:30 PM on weekdays and between 8:00 AM and 1:00 PM on Saturdays. It is not available on Sundays and bank holidays.	The Reserve Bank of India (RBI) has allocated the following time-slots for Real-Time Gross Settlements settlements: • 9:00 AM – 4:30 PM on weekdays • 9:00 AM – 1:30 PM on Saturdays
The settlement of funds happens on a half-	The settlement of funds is instantaneous and

hourly basis	happens in real-time
The NEFT mode is used when the transactions are of smaller values.	RTGS is used in high-value transactions.
The National Electronic Funds Transfer system was introduced in November 2005 to replace the Special Electronic Fund Transfer (SEFT) system that was in use at the time.	The Real-Time Gross Settlement system was first implemented in India in March 2004 as a major technology-based electronic funds transfer system across the country.
When NEFT transactions fail or are not processed on time, destination banks are required to return the fund to the originating branch within two hours of completion of the batch in which the transaction was processed	In an event when transactions fail, the money is credited into the sender's account once the money is received back by the remitting bank. The funds are returned to the originating bank within one hour or before the end of the RTGS business day or whichever comes first

** *https://byjus.com/free-ias-prep/difference-between-neft-and-rtgs/*

****CHECK YOUR PROGRESS**

1. Mention any two advantages of NEFT and RTGS.

2. Differentiate between NEFT and RTGS. (Any three points of distinction)

BLOCK IV : Unit-5

Central Bank and its Functions – Reserve Bank of India

Unit Structure:

5.1 INTRODUCTION

This unit will introduce you to Central Bank and their functions, specifically the Central bank of our country, The Reserve bank of India.

Central bank is the heart of the entire banking system. It is the highest monetary institution in the country. Itis a financial institution given privileged control over the production and distribution of money and credit for a nation. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks.

5.2 UNIT OBJECTIVES

After going through this unit, you will be able to:

- Understand the importance of Central Banks
- Differentiate between Central Bank and Commercial Banks
- Know the functions of the Reserve Bank of India
- Study in depth the mechanism implemented by the Reserve Bank of India i9n controlling credit.

5.3 CENTRAL BANK

Central Banking is essential for the smooth and sound functioning of the economy. Just as a man cannot survive without its heart, so also it is almost impossible for a country to survive without a central bank.

A central bank is an independent authority that formulates monetary poliiesy, regulates the banks functioning within the country, provides financial services while including economic research. Its goal is to stabilize the nation's currency, keep unemployment low, and prevent inflation.

5.3.1 EVOLUTION

The story of central banking goes back at least to the seventeenth century, to the founding of the first institution recognized as a central bank, the Swedish Riks Bank. Established in 1668 as a joint stock bank, it was chartered to lend the government funds and to act as a clearing house for commerce.

A few decades later, the most famous central bank of the era, the Bank of England, was founded also as a joint stock company to purchase government debt. Other central banks were set up later in Europe for similar purposes, though some were established to deal with monetary disarray.

Early central banks issued private notes which served as currency, and they often had a monopoly over such note issue.While these early central banks helped fund the government's debt, they were also private entities that engaged in banking activities. Because they held the deposits of other banks, they came to serve as banks for bankers, facilitating transactions between banks or providing other banking services. These factors allowed them to become the lender of last resort in the face of a financial crisis.

At the turn of the twentieth century,some banks were set up primarily to consolidate the various instruments that people were using for currency and to provide financial stability. Many also were created to manage the gold standard.Central banks of this era also learned to act as lenders of last resort in times of financial stress—when events like wars, bad harvests, defaults by rail and roads happen leading to a crisis for liquidity.

The central banks were originally started as private joint stock banks which were managed by shareholders. The idea of state ownership of central banks gathered momentum after the First World War so much so that today central banks have become na important organ to the government.

Below are given names of a few distinguished central banks of countries along with their year of establishment.

YEAR OF ESTABLISHMENT	***NAME OF THE CENTRAL BANK***
1668	Riks Bank of Sweden
1694	Bank of England
1914	Federal Reserve Bank (USA)
1924	National Bank of Hungary, Bank of Poland
1934	Reserve Bank of New Zealand, Central Reserve Bank of Salvador
1935	Reserve Bank of India, Central Bank of Argentina, Bank of Canada
1948	State Bank of Pakistan, Union Bank of Burma, Central Bank of Philippines, National Bank of Cuba
1954	Bank of Israel

**** CHECK YOUR PROGRESS**

1. Which is the first Central Bank established?
2. When was the Reserve Bank of India established?
3. What is the objective behind the establishment of the Central Bank?

5.3.2 FUNCTIONS OF CENTRAL BANK

Central bank is regarded as an apex financial institution in the banking system. It is considered as an integral part of the economic and financial system of a nation. The central bank functions as an independent authority and is responsible for controlling, regulating and stabilising the monetary and banking structure of the country.

The functions of a central bank can be highlighted as under:

1. Currency regulator

2. Banker to the government

3. Lender of last resort

4. Custodian of cash reserves

5. Custodian of International currency

6. Clearing house for settlement

7. Controller of credit

8. Protecting depositors' interests

Lets discuss them in detail.

Currency regulator: Central banks possess the monopoly right to manufacture and issue notes in a country. All the central banks across the world are involved in issuing notes.

This is one of the most important functions of the central bank and due to this the central bank is also known as the bank of issue.

The central banks being authorised to function as the issuer of currencies resulted in uniformity in circulation and balanced supply of money within the country.

Banker to the government: The central bank accepts deposits and issues funds to the government. It is also involved in making and receiving payments for and on behalf of the government. They also offer short term loans to the government in times of emergencies or crises.

In addition to being the bank to the government, it acts as an advisor and agent of the government by providing advice to the government in areas of economic policy, capital market, money market and loans from the government.

Lender of last resort: The central bank acts as a lender of last resort by providing money to its member banks in times of shortage of cash. This is regarded as one of the most crucial functions of the central bank wherein it helps the member banks from financial crunches.

Custodian of cash reserves: It is a practice of the commercial banks of a country to keep a part of their cash balances in the form of deposits with the central bank. The commercial banks can draw that balance when the requirement for cash is high and pay back the same when there is less requirement of cash.

Custodian of International currency: An important function of the central bank is to maintain a minimum balance of foreign currency. The purpose of maintaining such a balance is to manage sudden or emergency requirements of foreign reserves and also to overcome any adverse deficits of balance of payments.

Clearing house for settlement: In a clearing house, the representatives of different banks meet and settle the inter-bank payments. The Central bank acts as a clearing house of the commercial banks and helps in settling of their mutual indebtedness.

Controller of credit: The central bank controls the credit creation by commercial banks which in turn increases inflation. It is done by engaging in open market operations or bringing about a change in the CRR to control the process of credit creation by commercial banks.

Protecting depositors' interests: Central bank also needs to keep an eye on the functioning of the commercial banks in order to protect the interests of depositors.

5.4 DIFFERENCE BETWEEN CENTRAL BANK AND COMMERCIAL BANK

CENTRAL BANK	COMMERCIAL BANK
The central bank is the apex institution in the monetary and banking system of the country.	The commercial bank is only a constituent unit of the banking system of the counry.
The main motive of the central bank is not to make profits but to promote general economic policy of the government.	A commercial bank on the other hand is a profit-making institution.
The central bank is closely related to the government as its banker, agent and advisor. It does not engage itself in ordinary banking business.	Commercial banks on the other hand acts as banker and advisor to the general public.
The Central bank is generally given the statutory power to check on the activities of the commercial banks.	The commercial banks are however not given the right to check the workings of the central bank nor other commercial banks.
Central bank helps in establishing financial institutions to strengthen the economy of the country.	Commercial banks help in setting up industries by underwriting their shares and debentures.
Central bank possesses the monopoly of note issue.	This right is not held by he commercial banks at present.
The Central bank act as the custodian of foreign reserves while also maintaining the stability in the exchange rates.	Though the commercial banks deal with foreign currencies, they are neither the custodian nor are they required to maintain the stability.
Every country has just one Central bank .	There are many commercial banks with hundreds of branches both within and outside a country.

*****CHECK YOUR PROGRESS***

1. Why is the Central Bank considered the lender of last resort?
2. Mention any two differences between Central Bank and Commercial Bank.

5.5 THE RESERVE BANK OF INDIA

The Reserve Bank of India is India's central bank. It is the apex monetary institution which supervises, regulates, controls and develops the monetary and financial system of the country. The Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. Initially it was constituted as a private shareholder's bank with a fully paid-up capital of Rs. 5 crores. Eventually, it was nationalised on January 1, 1949.

THE TIMELINE

Year	**Event**
1934	The British enacted the Reserve Bank of India Act
1935	Reserve Bank of India was established on 1st of April in Calcutta
1937	Reserve Bank of India was permanently moved to Mumbai
1949	Got nationalized after independence. The bank was held by private stakeholders before this.

In the year 2016, the original RBI Act of 1934 was amended and that provided the statutory basis for the implementation of the flexible inflation-targeting framework.

5.5.1 ORGANISATION AND MANAGEMENT

The Head Office of the Reserve bank of India is located in Mumbai.There are 31 Regional Offices of the Reserve Bank of India in the following places:

Srinagar. Jammu, Chandigarh, Shimla, Dehradun, New Delhi, Jaipur, Lucknow, Kanpur, Patna, Bhopal, Ahmedabad, Nagpur, Raipur, Kolkata, Belapur, Mumbai, Hyderabad, Ranchi, Bhubaneswar, Panaji, Bengaluru, Chennai, Kochi, Thiruvananthapuram, Gangtok, Guwahati, Imphal, Shillong, Aizawl and Agartala

The management of the bank is under the control of the Central Board of Directors consisting of 20 members.

i. The executive head of the bank is called the Governor who is assisted by four Deputy Governors. They are appointed by the Government of India for a period of five years.

ii. There are four local boards situated in Delhi, Kolkata, Chennai and Mumbai representing the four regional areas, namely, northern, eastern, southern and western respectively. These are basically advisory in nature and the government nominates one member from each board to the Central Board.

iii. There are ten directors from various fields nominated to the Central Board by the government along with one government official from the Ministry of Finance.

THE PREAMBLE

Another thing to know about RBI is its Preamble. It describes the basic functions of the Reserve Bank as:

"…to regulate the issue of Bank Notes and keeping of reserves to secure monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Organisationally, the Reserve Bank operates through various departments. They are:

1.Banking Department

This department handles various bank's service for the government as well as the other banks. There are 4 sub-divisions to this department namely, a. Public Debt Department, b. Public Accounts Department, c. Securities Department and d. Deposit Accounts Departmen. The Joint or Deputy Manager heads the branches of the banking department.

2.Issue Department:

The Issue department is concerned with the proper and efficient management of the note issue.

3. Currency Management Department

This department is responsible for forecasting the long-term requirements of the currency and subsequently allocating it to the various other branches. It takes into account the storage facilities, demand pattern, etc. The Chief Officer heads this department.

4. Government and Bank Accounts Department

The main task of this department is to handle and maintain the various bank's accounts in the banking and issuing departments. It compiles weekly statements and the balance and annual profit and loss account. The Chief Accountant heads this department.

5. Budgetary Control and Expenditure Department

Under this department, the bank's budget and various expenditures are monitored for the different units. This department is headed by the Financial Controller.

6. Department of Exchange Control

This department is responsible for maintaining the exchange rate and controlling the foreign exchange. They try to stabilize the exchange rate of the country.

7. Department for Industrial Credit

This department as the name suggests is related to the credit-related activities of the industries. Their primary task is to provide various credit guarantee schemes for the small-scale industries and looking after its administration. They work in tandem with the government of India, SFCs, and the Industrial Development Bank of India (IDBI). Their task is to collect data about the finances of the small-scale businesses and other related problems.

8. Banking Operations and Development Department

This department looks after the commercial banks in India. They control, supervise and develop these banks. Earlier, this department was also involved in works related to bank credit and lead bank scheme for the priority sectors.

9. Agriculture Credit Department

This department deals with the problems of agricultural credit and provides facilities of rural credit to state governments and state cooperatives. It also provides the required financial assistance to the state governments to improve their financial structure.With the formation of NABARD, all the agriculture credit-related activities are now shifted towards the new institution.

10. Non-banking Companies Department

The primary task of this department is to regulate the deposits related to non-banking financial companies. Further, it also controls and administers companies.

11. Credit and Rural Planning Department

This is one of the oldest departments in the RBI. This department is concerned with the issues like lead bank scheme, credit plans for the district, provision for the expert assistance, processing the credit line for short-term loans of the NABARD and putting forward the policies for Reserve Bank regarding rural India.

12. Economic Policy and Analysis Department

This department handles the economic reviews and research for banking and financial conditions of the country. It comprises majorly of 5 units, a. International Financial Unit, b. Internal Finance Unit, c. General Unit, d. Analysis of National Economic Parameters Unit and e. Prices, General and Production Unit.

They are in charge of preparing the annual report and the report on progress and trend of banking in India. Besides this, the department produces a report on finance and currency and the bulletins for RBI.

13. Computer Services and Statistical Analysis Department

This department as the name suggests collects, generates, processes and compiles the statistical data related to the financial and banking sectors from the operational point of view of the RBI.

14. Legal and Inspection Department

The inspection department carries out the inspections of the various departments and offices of the RBI. For the legal advice on various issues referred by the RBI, the legal department is responsible.

15. Department of Administration and Personnel

It looks after the general administration and personnel policy, such as recruitment, training, placements, promotions, transfers, discipline, appeals, service conditions, wage structure, etc.

16. Premises Department

It is mainly concerned with the construction of buildings for the Bank's offices, training institutions and staff quarters.

17. Management Services Department

It is basically concerned with organisational analysis, systems research and development, work procedure studies and codification, manpower planning, costing studies, etc.

18. Reserve Bank of India Service Board

Its functions involve conducting of examinations/interviews for the selection and promotion of staff in the Reserve Bank.

19. Central Records and Documentation Centre

It is meant for the preservation of non-current records of the Bank. It provides arrangement for the scientific preservation of records, retrieval service to the enquirer departments, tools of reference such as catalogues, indices, etc.

20. Secretary's Department

It attends to the secretarial work connected with the meetings of the Central Board and its committee and of the Administrators of the RBI Employee's Provident Fund and RBI Employees' Co-operative Guarantee Fund.

21. Training Establishments

The Reserve Bank has set-up three prominent training institutions for imparting training in different areas of banking.These are:
(i) the Banker's Training College, Mumbai
(ii) the College of Agricultural Banking, Pune
(iii) the Reserve Bank Staff College, Chennai

There are also Zonal Training Centres situated in Mumbai, Kolkata, Chennai and New Delhi for conducting induction, functional and short-term preparatory courses for the clerical staff.

The Central Board of the Reserve Bank of India consists of:
- Governor
- 4 Deputy Governors
- 2 Finance Ministry representatives
- 4 directors to represent local boards headquartered at Mumbai, Kolkata, Chennai, and New Delhi
- The executive head of RBI is Governor.
- The Governor is accompanied by 4 Deputy Governors.
- The First Governor of RBI was Sir Osborne Smith and the First Indian Governor of RBI was C D Deshmukh.
- The First woman Deputy Governor of RBI was K J Udeshi.
- The only Prime Minister who had been the Governor of RBI was Manmohan Singh.

The current governor of RBI (2021) is Shaktikanta Das.

Zonal Offices
- RBI has four zonal offices: New Delhi for North, Chennai for South, Kolkata for East, and Mumbai for West.
- The bank has three training colleges for its officers:
- Reserve Bank Staff College at Chennai, College of Agricultural Banking at Pune, Banker's Training College, Mumbai

*****CHECK YOUR PROGRESS***

1. Explain the functions of any two departments of the Reserve Bank.
2. Who is the first woman Deputy Governor of Reserve Bank.of India?
3. Who is the present governor of the Reserve Bank of India?

5.5.2 FUNCTIONS OF THE RESERVE BANK

The functions of the Reserve Bank of India may be divided under two categories:

A. Central Banking Functions and
B. Other Functions

A. Central Banking Functions

*1. Issue of Bank Notes:*The Reserve Bank of India has the monopoly of note issuein the country. It has the sole right to issue currency notes of all denominations except one-rupeenotes, The one-rupee notes are issued by the Ministry of Finance. However, the Reserve Bank being the only source of legal tender the one-rupee notes are circulated by it. The Reserve Bank has a separate Issue Department which is entrusted with the job of issuing currency notes.

The reason for concentration of note issue with Reserve Bank may be cited as under:

- Uniformity in note circulation to attain effective state supervision.
- Control over undue credit expansion by the commercial banks.
- To give distinctive prestige to the note issue.
- Maintain stability in the internal and external value of the currency.

Methods of Note Issue

Method 1: Simple Deposit System

Under this system, the monetary authority is required to keep 100% of the bullion (gold or silver) for every note issued. That is why it is also known as the Full Reserve System.

This system is safe and enjoys public confidence because there is full backing of the bullion for every note issued. There is no possibility of over issue of notes. There is also the saving of precious metals through debasement because metal coins

However, this system lacks in elasticity because the money supply cannot be increased without the full backing of bullion reserves. This may be harmful during war or emergency. Secondly, this system is especially unsuited for poor countries lacking insufficient quantities of gold or silver.

Thus, this system is some what impracticable in modern times. Perhaps this is the reason for its being not put into practice in any country of the world.

Method 2: Fixed Fiduciary System

This system was introduced in England in 1844, in India in 1860, followed by Japan and Norway.Under this system, a fixed amount of currencies are issued by the central bank against reserves of government securities. Such amount is issued on the fiduciary of the central bank and is called the fiduciary limit. The central bank is required to keep 100% gold reserves beyond the fiduciary limit. The fiduciary limit is raised from time to time with the expansion of trade and industry.

However, it is a rigid and inelastic system because in times of a financial emergency, notes cannot be issued without keeping cent per cent gold in reserves. Secondly, the system is inconvenient because in the event of a fall in gold reserves, the central bank has to withdraw notes from circulation with the result that the quantity of money is reduced in the country with its adverse effects on prices, trade and industry.

Method 3: Maximum Fiduciary System

Under this system, there is a maximum limit up to which the central bank is authorised to issue notes without any gold reserves. But there has to be full backing of gold reserves beyond this limit. The central bank is, however, authorised to raise or lower the maximum fiduciary limit and to fix the quantity of gold reserves.

This system is not rigid but is elastic. It is also economical because the gold reserves can be kept to the minimum to meet the requirements of trade and industry. This system has one major defect that there is the possibility of inflation through over issue when the maximum limit may be raised by the government.

This system was in operation in France, Japan, Russia, Norway, Finland and England.

Method 4: Proportional Reserve System

This system was in use in India between 1927 to 1956.

Under this system, a certain percentage of the total notes issued by the central bank has to be in gold reserves and the remaining in the form of government securities. This percentage varies between 25 to 40 per cent.

This system is simple and elastic. The money supply can be changed with changes in the percentage of gold reserves. It provides sufficient security because a certain percentage of note issue is supported by gold.

Still, this system has certain drawbacks. Firstly, it is uneconomical because large quantities of gold reserves have to be kept which cannot be issued for productive purposes. Secondly, if the gold reserves fall, the reduction in currency in circulation may be more than in proportion to the fall in reserves. This may lead to deflationary tendencies and vice versa.

Method 5: Minimum Reserve System

India adopted this system of note issue in 1956 after discarding the proportional reserve system. Under the minimum reserve system, the central bank is authorised to issue notes up to any extent but it must keep a statutory minimum reserve of gold and foreign securities. Accordingly, the Reserve Bank of India is required to keep a minimum reserve of Rs. 200 crores. Of this, Rs. 115 crores must be in gold and Rs. 85 crores in foreign securities.

This system is highly useful for developing countries because they can meet their financial requirements by printing more notes. They can also reduce the money supply to check inflation. It is, therefore, an elastic system. Further, it is very economical because only a small and fixed amount of gold is required to be kept in reserve.

Despite these merits, the minimum reserve system may prove to be a dangerous tool. It can print any number of notes, thereby creating inflationary pressure within the economy. A corrupt and inefficient government can bring disaster to the economy by excessive printing of notes and thus lose confidence of the people.

2. *Banker to the Government:* The Reserve Bank of India acts as a banker to the central and the state governments.

- It maintains and operates government deposits.
- It collects and makes payments on behalf of the government.
- It helps the government to manage public debts.
- It sells Treasury Bills on behalf of the government.
- It undertakes foreign exchange transactions on behalf of the government.
- It provides development finance to government to undertake five year plans
- It advises the government on matters related to investments, loan operations, planning, banking, economic development etc.

3. Banker's Bank:

As Banker to banks, the Reserve Bank provides similar banking functions to other banks just like the commercial banks provide to their customers.It provides short-term loans and advances to select banks, when necessary, to facilitate lending to specific sectors and for specific purposes.
Among other provisions, the Reserve Bank stipulates minimum balances to be maintained by banks in these accounts. It is the responsibility of each bank maintaining current account with the Reserve Bank to ensure that sufficient balance is available in the account to avoid defaults in payments and settlements.
The current accounts of individual banks are being opened by Banking Departments of the Regional Offices. These current accounts are maintained for participation in Centralised and Decentralised Payment Systems and are used for settling inter-bank obligations, such as clearing transactions or clearing money market transactions between two banks, buying and selling securities and foreign currencies.

4. Custodian of Exchange Reserve:

Exchange control was first imposed in India in September 1939 at the outbreak of World War II and has been continued since. Under it, control was imposed on both the receipts and payments of foreign exchange.
The RBI acts as the custodian of the country's foreign exchange reserves, manages exchange control and acts as the agent of the government in respect of India's membership of the International Monetary Fund.

The foreign exchange regulations requires that all foreign exchange receipts whether on account of export earnings, investment earnings, or capital receipts or private account or on government account, must be sold to the Reserve Bank of India (RBI) either directly or through authorized dealers (mostly major commercial banks). This resulted in centralisation of country's foreign exchange reserves with the RBI and facilitated planned utilization of these reserves.

The exchange control was so operated as to restrict the demand for foreign exchange within the limits of the available supplies of it. This became essential in the context of actual or potential shortage of foreign exchange, which had been an important constraint on India's efforts at planned economic development, most of the time.

5. Controller of Credit:

Reserve Bank of India formulates and implements the Monetary Policy of India to keep the economy on the growth path. Monetary Policy refers to the process employed by Reserve Bank to control availability and cost of currency, thus keeping inflationary & deflationary trends low and stable. RBI adopts various measures to regulate the flow of credit in the country. The measures adopted by RBI can broadly be categorized as Quantitative & Qualitative tools.

Quantitative measures of credit control are applicable to entire money and banking system without discrimination. They broadly refer to reserve ratios, bank rate policy etc. Reserve ratios are the share of net demand & time liabilities (NDTL) which banks have to keep aside to ensure that they have sufficient cash to cover customer withdrawals.
Qualitative measures of credit control are discriminatory in nature and are applied for specific purpose or to specific financial organization, bank or others which RBI thinks are violating the monetary policy norms.

B. OTHER FUNCTIONS

The Reserve Bank is authorised to transact the following ordinary banking business:

- Acceptance of money on deposits without interest from the Central and the State Government.

- The purchase, sale and rediscounting of bills of exchange and promissory notes arising out of bonafide transactions.
- The purchase, sale and rediscounting of bills for financing agricultural operations or marketing of crops etc.
- Making of loans and advances to states, local bodies, scheduled banks and state cooperative banks.
- Making of ways and means advances to Central and State Governments.
- The purchase and sale of securities of the Central and State Governments.
- The purchase and sale of gold bullion.
- All such functions as may be incidental or consequential upon the exercise of its powers or discharge of duties under the Reserve Bank of India Act.

Reserve Bank of India works as:

Monetary Authority:

- Implementation of monetary policies,
- Monitoring the monetary policies,
- Ensuring price stability in the country considering the economic growth of the country

Regulator and Administrator of the Financial System

It determines the comprehensive parameters of banking operations responsible for the functioning of the country's banking and financial system.

- License issuing,
- Liquidity of assets,
- Bank mergers,
- Branch expansion etc.

Managing Foreign Exchange

- RBI manages the FOREX of India.
- It is responsible for maintaining the value of the Rupee outside the country.
- It aids foreign trade payment.
- Issuer of currency

5.5.3 RESERVE BANK OF INDIA AS CONTROLLER OF CREDIT

Apart from meeting developmental and expansionary requirements of the economy, the Reserve Bank has also been assigned the task of controlling the inflationary pressure on the economy. It formulates and implements the monetary policy of India to keep the economy on growth path thus keeping inflationary & deflationary trends low and stable. The Reserve

Bank adopts various measures to regulate the flow of credit in the country. These can broadly be categorized as Quantitative measures and Qualitative measures.

QUANTITATIVE TOOLS

Quantitative measures of credit control are applicable to the entire money and banking system without discriminations. They broadly refer to reserve ratios, bank rate policy etc. Reserve ratios are the share of net demand & time liabilities (NDTL) which banks have to keep aside to ensure that they have sufficient cash to cover customer withdrawals.

a. *Bank Rate:*

The bank rate is the rate at which the Reserve Bank advances to the member banks against approved securities or rediscounts the eligible bills of exchange or other papers.It is the interest rate which the Reserve Bank charges from other banks when they borrow for long term requirements. Change in the Bank rate influences the entire interest rate structure including both long term and short-term interest rates.
A rise in the Bank rate leads to a rise in the other market interest rates which implies a costly monetary policy increasing the cost of borrowing, Similarly, a fall in the Bank rate results in a fall in the other market rates, which implies a cheap monetary policy with reduced cost of borrowing.
The Reserve Bank changes the Bank rate from time to time to meet the changing conditions of the economy. It now serves as a reference-rates for other rates in the financial markets. The current bank rate is 6.25%. the bank rate is not used to control money supply these days although it provides the basis of arriving at lending and deposit rates.

b. Cash Reserve Ratio (CRR):

Cash Reserve Ratio is most commonly used by Reserve Bank as a quantitative tool of credit control. The ratio specifies the minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank.
The Reserve Bank can change the cash reserve requirement of the bank in order to affect their credit creation capacity.
An increase in the cash reserve ratio reduces the excess reserve of the bank. Therefore, the banks are unable to inject more money in the market in the form of lending loans. This in turn reduces the flow of money in the market. Similarly, a decrease in the cash reserve ratioincreases the excess reserve of the banks which again enables them to provide more and more credit to the public and the market at large.

The Reserve Bank is empowered to vary the cash reserve ratio between 3 percent and 15 percent.The present cash reserve ratio prevailing in the country is 4 percent (as in 2019-20). Earlier, the cash reserve ratio in India averaged 5.67 percent from 1999 until 2016, reaching an all-time high of 10.50 percent in March of 1999 and a record low of 4 percent in February 2013.

Example:
Let us suppose, a bank has a total reserve of Rs. 100 crores. With the prevailing CRR at 10%, the bank is required to keep Rs. 10 crores as reserve and the remaining 90 crores can be lent out by the bank to earn interest from it. Now, we assume that the economy is showing inflationary trends and the Reserve Bank wants to control this situation by adjusting the CRR. If the Reserve Bank increases the CRR to 20% then bank will be left only with Rs. 80 crores for operations. Now it will be very difficult for bank to maintain profitability with such small capital. Bank will be left with no choice but to raise interest rate which will make borrowing costly. This will in turn reduce the overall demand and hence price will come down eventually.

c.S*tatutory Liquidity Ratio (SLR):*

The main goal of the Reserve Bank is to make sure that prices are always stable in the nation without heavy fluctuations. Its primary responsibility is to create and operate a monetary policy which helps in administering the flow and supply of money for the purpose of attaining good growth in the economy. This is in one way done by monitoring and managing various interest rates.
Statutory Liquidity Ratio (SLR) refers to the minimum reserve requirement that needs to be maintained by commercial banks in the nation. The word 'statutory' indicates that it is mandatorily and legally required. The Reserve Bank states that every commercial bank in India has to keep a certain amount of time deposits as well as demand deposits as liquid assets in its independent and own vault.In the case of statutory liquidity ratio, these assets can be gold, cash, securities that are approved by the Indian government, etc. Apart from these assets, securities that are sanctioned under market stabilisation schemes (MSS) as well as market borrowing programmes, and treasury bills are included in the statutory liquidity ratio.
The current SLR announced by the Reserve Bank is 19% of net demand and time liabilities (NDTL) as announced in 2020.

d. Open Market Operation (OMO):

Open Market Operation is the activity of buying and selling of government securities in open market to control the supply of money in the banking system.Through this technique, the Reserve Bank seeks to influence the excess reserve position of the banks by purchasing and selling government securities and other such papers.
When the Reserve Bank purchases securities from the banks, it increases their cash reserve position, and hence their credit creation capacity. On the other hand, when the Reserve Bank

sells securities to the banks, it reduces their cash reserve and hence their credit creating capacity. Thus, the Reserve Bank indirectly controls the money supply and influences short-term interest rates. This operation has also been used as a tool to assist the government in raising borrowings.
In India, after the economic reforms of 1991, the Open Market Operation has gained more importance than the Cash Reserve Ratio in adjusting liquidity.When there is excess supply of money, the Reserve Bank sells government securities thereby taking away excess liquidity. Similarly, when economy needs more liquidity, the bank buys government securities and infuses more money supply into the economy.

e. Repo Rate:

When banks need to borrow short term money from the Reserve Bank, the banks have to pledge government securities as collateral. This kind of deal happens through a repurchase agreement and at the Repo rate.
Say for example, if a bank wants to borrow Rs. 100 crores, it has to provide government securities at least worth Rs. 100 crores and agree to repurchase them at Rs. 106.50 crore at the end of borrowing period. The bank has paid Rs. 6.50 crore as interest. This is the reason it is called repo rate.

To curb inflation, the Reserve Bank increases repo rate which makes borrowing costly for banks. The banks pass this increased cost to their customers which make borrowing costly in the whole economy. Fewer people apply for loan and aggregate demand gets reduced. This results in inflation coming down. The opposite is done to fight deflation.

The present repo rate is 5.75% with effect from June 6, 2019.

f. Reverse Repo Rate:

Reverse Repo rate is just the opposite of Repo rate. If a bank has surplus money, they can park this excess liquidity with the Reserve Bank and the ReserveBank will pay interest on it. This interest rate is called Reverse Repo rate.At present, the Reverse Repo rate is 5.75% with effect from May 2019.

g. Marginal Standing Facility (MSF):

This scheme was introduced in May, 2011 and all the scheduled commercial banks can participate in this scheme. Banks can borrow up to 2.5% of their respective Net Demand and Time Liabilities. RBI receives application under this facility for a minimum amount of Rs. 1 crore and in multiples of Rs. 1 crore thereafter. The important difference with repo rate is that unlike Repo where the collateral offered as security against the loan should not be from the Stautotry Liquidity Reserve, the banks in this case can pledge government securities from SLR quota (up to 1%). The current MSF rate is 6.25%.

QUALITATIVE TOOLS

Qualitative or Selective Credit Control measures are tools undertaken bt the Reserve Bank to divert the flow of credit from speculative and unproductive activities to productive and urgent activities.
The Banking Regulation Act, 1949, empowers the Reserve Bank to issue directives to the banks regarding their advances. The following selective control measures to check inflationary pressure.

h. Margin Requirement:

While accepting the securities for the loan the banks first asses the market value of the securities and then considering the amount of loan required the bank would require the margin to be paid by the borrower which on most occasions is the difference between the market value of the securities and the amount of loan required.

The Reserve Bank can vary this percentage of margin requirement from time to time to regulate the flow of credit on certain securities.A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security. This method is effectively used to counter inflationary and deflationary conditions in an economy.

This method ensures use of available funds only for productive and useful purposes and also discourages speculative activities. It helps to control inflation by diverting the funds available to produce only goods which helps to bring down the price level.

i. Credit Rationing:

According to this method the commercial banks are instructed to encourage borrowing for certain purposes and discourage certain other types of borrowing.

The Reserve Bank may extend or curtail the consumers’ loans for certain items during a particular time. For example, during inflationary period, the Reserve Bank may curtail the commercial banks from consumer durable loans.As a result, the demand for these luxury items will come down bringing down their price and indirectly helping to control general price level.

The Reserve Bank may also alter the initial money to be deposited by the borrower and through that encourage or discourage borrowing.

Changing the maturity period of the loan is one more method of consumer credit regulation. Suppose the Reserve Bank wants to encourage the consumer credit, then it may allow maximum repayment period say 60 months. On the other hand, if it wants to discourage the consumer credit, it may fix the maximum repayment period as only 36 months.

Changing the rate of interest on consumer credit is one more usual method to regulate. Increase in rate of interest will discourage borrowing while reducing the interest will encourage borrowing.

j. Control through Directives:

Under this method periodical directions, instructions, information, guidelines and warning are issued by the Reserve Bank to the commercial banks to make them follow the credit policies of the former.Every central bank is empowered to issue such directive by virtue of the statutory powers conferred on it and usually the central bank implements this policy by offering incentives like liberal refinancing facility to banks which follow the directives.The directives issued serves the following purposes:

- It controls the lending policies of the commercial banks.
- To determine the maximum amount that could be lent for certain purposes.
- It channelises the available credit to more productive and urgent uses from less urgent and less productive purposes.

k.Moral Suasion:

Moral suasion refers to the persuasive approach of the Reserve Bank towards the commercial banks in making them follow and implement their policies. The ReserveBank takes efforts to explain to the commercial banks the need for following certain policies. This is done either through periodical conferences with commercial bank or by appealing to the sentiments of the commercial banks. The Reserve Bank uses moral force instead of resorting to the legal powers. This method is applied using the conventional relationship between the commercial banks and the ReserveBank.

Effectiveness of Credit Control Measures:
The effectiveness of credit control measures in an economy depends upon a number of factors. First, there should exist a well-organised money market. Second, a large proportion of money in circulation should form part of the organised money market. Finally, the money and capital markets should be extensive in coverage and elastic in nature.

Extensiveness enlarges the scope of credit control measures and elasticity lends it adjustability to the changed conditions. In most of the developed economies a favourable environment in terms of the factors discussed before exists, in the developing economies, on the contrary, economic conditions are such as to limit the effectiveness of the credit control measures.

l. Direct Action:
Another method od selective credit control is Direct action. Under this methodthe Reserve Bank uses coercive measures against the banks violating the central bank ruling. It may vary from general instructions to the banks to special directives to the erring banks. Though this method has the legal sanction, the Reserve Bank rarely applies this method. As a matter of direction action, the Reserve Bank is vested with vast powers ranging from refusing credit and re-discounting facilities to imposing penal rate of interest on banks.

5.5.4 ACHIEVEMENTS OF THE RESERVE BANK

The Reserve Bank has helped in building up a well-differential structure of financial institutions to cater to the requirements of the different sectors of the economy. Some of the achievements of the Reserve Bank can be summed up as under.

i. The Reserve Bank has adopted a flexible monetary policy. It has introduced changes in monetary regulations keeping in view the seasonal character of Indian money market because of which the fluctuations in money rates have been negligible.

ii. The Bank rate has remained substantially lower than the market rate of interest. The bank rate has remained more or less stable.Thus, the interest rate policy of the Reserve Bank has resulted into a relatively stable structure of interest rates in the economy.

iii. The Reserve Bank has succeeded in building up a sound modern banking and credit structure. The Bank enjoyed vast supervisory powers which enabled it to guide the development of banking on sound lines.

iv. The Reserve Bank has successfully managed the public debt. It has floated loans for the Government at low rates of interest. It has helped in raising funds for the expansion of public sector in the economy. It has also provided short term advances to the government.

v. The Reserve Bank has succeeded in maintaining the exchange stability to a large extent. The Bank has maintained the exchange value of the rupee at a relatively higher rate than would have prevailed in the market.

vi. The Reserve Bank has introduced very cheap remittance facilities. These have been widely used by the commercial banks, the Government and cooperative banks.

vii. The Reserve Bank has taken appropriate measures to enhance public confidence in the banking systems. Bank strictly supervises the working of the Commercial banks so as to avoid their failures.

viii. The Reserve Bank has adopted measures to distribute credit to all productive sectors in accordance with social objectives and priorities. The priority sector including agriculture, small scale industries, exports, trades etc., get credit at low rate of interest.

ix. The Reserve Bank has played an active role in promoting economic development of the Indian economy. It has helped in setting up a sound structure of Development Banking. Several Industrial, Agricultural, Export and other specialised financial institutions have been established.

x. Training of bank personnel has improved their efficiency. The geographical and fundamental coverage of the banking has also increased substantially.

5.5.5 FAILURES OF THE RESERVE BANK

Looking at the performance of Reserve Bank of India, it can be said with a sense of pride that Reserve Bank of India has appreciably contributed to the growth and stability of the economy. Yet there have been certain failures of the Bank too.

i. The Reserve Bank has virtually failed in regulating or controlling the activities of rural money lenders and other indigenous bankers. It has succeeded in controlling the organised sector of the Money Market, but not the unorganised one.

ii. Because of the lack of control on different sectors of the money market, different rates of interest continue to prevail. Outside the organised sector of the money market, rates of interest are extremely higher than the bank rate.

iii. Though initiatives were taken by the Reserve Bank to provide enough agricultural credit, its availability continues to be far behind its requirement. Agricultural credit it still being dominated by rural money lenders and other indigenous bankers who charge very high interest rates.

iv. Though Reserve Bank has tried to spread banking activity in all parts of the country, yet it is not sufficient in view of the large size of population. Moreover, most of the banking activities are concentrated in urban areas. People in small villages and sub-urban areas are still deprived of the banking facility.

v. The Reserve Bank has yet not succeeded in getting the Commercial Banks any notable foreign exchange business. Foreign exchange business almost continues to be a monopoly of foreign banks. Some of the Indian Banks have opened their branches abroad, but not with any notable success so far.

vi. Reserve Bank has also failed as a Bank of the Bankers. Its lack of assistance to the Commercial Banks has caused their closure. Between 1939 to 1946 nearly 444 banks failed in the country. Closure of three banks in 1985 is also a notable point. Failure of the banks erodes faith of the people in the banking system.

*Ref:*https://www.shareyouressays.com/knowledge/what-are-the-important-achievements-of-the-reserve-bank-of-india/117044

5.6 SUMMING UP

- A Central Bank is a financial institution that is responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply, and setting interest rates.
- Although their responsibilities range widely, depending on their country, central banks' duties and the justification for their existence usually fall into three areas.
- First, central banks control and manipulate the national money supply: issuing currency and setting interest rates on loans and bonds. Typically, central banks raise interest rates to slow growth and avoid inflation; they lower them to spur growth, industrial activity, and consumer spending. In this way, they manage monetary policy to guide the country's economy and achieve economic goals
- Second, they regulate member banks through capital requirements, reserve requirements and deposit guarantee among other tools. They also provide loans and services for a nation’s banks and its government and manage foreign exchange reserves.
- Finally, a central bank also acts as an emergency lender to distressed commercial banks and other institutions, and sometimes even a government. By purchasing government debt obligations, for example, the central bank provides a politically attractive alternative to taxation when a government needs to increase revenue.
- Every country has its own Central Bank. The Reserve Bank of India (RBI) is India’s Central Bank.
- As opposed to popular belief, the Reserve Bank is not controlled by the Government but instead it works as an independent institution.
- The Reserve Bank has the sole right to issue new currency notes and coins and exchange or destroy currency not fit for circulation.This gives the public adequate quantity of supplies of currency notes and coins and in good quality.
- It formulates, implements and monitors the monetary policy. It manages the interest rates offered by banks on loans and deposits and which affects the inflation and deflation in the country. In simple words, lower rates give rise to higher inflation and vice versa. This is done to maintain price stability while keeping in mind the objective of growth.
- The Reserve Bank ensures that the exchange rate value of Indian National Rupee is maintained in the international markets. This is done to facilitate external trade and

payment and promote orderly development and maintenance of foreign exchange market in India.

- It makes sure that the banks are following the issued guidelines by overlooking their financial operations and in cases of banking failures, the Reserve Bank comes ahead to safeguard the depositors' money by bailing out the distressed bank.

5.7 REFERENCES AND SUGGESTED READINGS

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5.8 MODEL QUESTIONS

1. What are the functions of the Central Bank? How do they differ from the functions of a commercial bank?

2. Explain the significance of the functions of the Central Bank as a Banker's Bank and as a Banker to the government.

3. Bring out the difference between quantitative and qualitative methods of credit control.

4. How does reserve Bank of India regulate currency and credit in India?

BLOCK V : UNIT-1

Financial Institutions/Intermediaries- Banking and Non Banking Financial Institutions and Their Service and Products

Unit Structure:

1.1 Introduction

The financial system includes a range of institutions, markets and instruments. It provides the primary way by which savings are transformed into investments. Since its responsibility in the allocation of resources is crucial, the competent functioning of the financial system is of critical significance to a modem economy. Financial institutions are vital mechanism of the financial structure. The key role of a financial establishment is to serve as an intermediary between lenders and borrowers. They assist smooth working of the financial system by establishing connection between the investors and borrowers and consequently help the allocation of funds in a resourceful way.

Financial institutions are component of organized financial system since they come in the beneath of the purview of Ministry of Finance (MOF), Securities Exchange Board of India (SEBI), Reserve Bank of India (RBI), , and other regulatory institutions.

1.2 Meaning and Definition

Financial Institutions are the institutions which tender financial services for its customers or members. The most likely service is financial intermediation. The institutions include banks, insurance companies, trust, companies, and investment dealers etc.

Financial institution is defined as "an establishment that focuses on dealing with financial transactions, such as investment, loans and deposits." In simple words, the financial establishment is an organization which may be either profit or non-profit, that takes money from customers and directs it in any of a mixture of investment avenues for the advantage of both the customer and the organization.

According to Dr. LM. Bhole, "Financial institutions are business organizations that act as mobilisers and depositories of savings and as purveyors of credit or finance."

Financial institutions are also called as financial intermediaries. They are classified into
(a) Banking institutions.
(b) Non Banking Financial institutions or companies (NBFCs)

(a) Banking institutions or banks: Banks mobilize savings by accepting deposits and grating loans to the public and firms. They are called as creators of credit e.g. the RBI, commercial banks, cooperative banks, Regional rural banks etc.

(b) Non-banking institutions: Non Banking Financial institutions or companies (NBFCs) also mobilize financial wealth directly or indirectly from the public and provide funds in the form of loans but they don't create credit. They are also considered as purveyors of credit. For example; Insurance Corporation (LIC), Unit Trust of India (UTI) etc.

Financial institutions can also be divided into intermediaries and non-intermediaries. Financial intermediaries intermediate between savers and investors. They lend money in the form of loans along with mobilization of savings. All banks are intermediaries. Nonbanking intermediaries provide financial support for specific purpose, sectors, areas and regions. For example, non-banking institutions like LIC, GIC, UTI, PF channelize the funds from savers under a range of schemes and provide the money for investment.

1.2.1: Prominent characteristics of Financial Institutions:
From the above explanation, following are the prominent characteristics of financial institutions:

- They are organization as well as intermediaries.
- They mobilize savings into investment.
- They generate financial assets such as deposits, loans, securities etc.
- They consist of both banking and non-banking financial companies.
- They include both organized and unorganized organizations.
- They are regulated by the government and regulating authorities.
- They accept deposits.
- They provide different loans like commercial loans, real estate loans and mortgage loans.

- Financial institutions enable money to flow through the economy among customers, businesses and government.

1.2.2: Importance of Financial institution

Financial institutions are the prime institutions which lend loans for different economic activities. There are many benefits for having sound and robust financial institutions in a country. The importance of Financial Institutions is as follows:

- Provide funds: Financial institutions give funds for the investment as well as industrial activities.

- Infrastructural facilities: Financial institutions provide basic infrastructure needed for the development and endorsement of productive ventures.

- Promotional activities: Promotional activities are considered by the financial institutions to mobilize the funds, minimize the risk of selling financial securities, providing working and long term capital for the business and industries.

- Improvement of backward areas: Apart from the financial activities, financial organizations also undertake some social responsibilities to promote the backward areas.

- Planned development: Financial institutions undertake all structured developments in the view of economic growth of the state. All planned developments are synchronized with the government plan and social welfare.

- Promoting industrialization: Financial institutions are established to make the profit and uphold interest of its members; they speed up the industrialization to contribute industrial augmentation. They support industries by granting loans, project development and consultancy.

- Employment creation: Mobilizing the funds for investment, building of infrastructural amenities, and speeding up of industries generates employment to the educated as well as qualified people of the state.

1.3 Banking Institutions

Meaning of Bank: A bank is a financial organization that accepts deposits from the public and creates a demand deposit while giving loans as well.

Under Section 5 (1) (b) of the Banking Regulation Act 1949, banking is defined as "The accepting for the purpose of lending or investment, deposit of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise."

1.3.1 Origin of Banking

The word bank is fundamentally derived from the Italian word BANCO, a bench – that means the Jews in Lombardy place for the exchange of money or bills. Banking is as old as is the genuine history. The existences of modern commercial banking are in ancient time, the seeds of bank are plant in ancient time.

1.3.2 Evolution of Banking in India

The existence of proficient banking in India could be traced to the 500 BC. Kautilya's Arthashastra (400 BC) contained references to lenders, creditors and lending rates. Banking was fairly diverse and catered to the credit necessities of the trade, commerce, agriculture, individuals and other agents of the economy. An extensive network of Indian banking institutions existed in the country involving all cities or towns that were of commercial significance. Evolution of banking in India can be studied under two main phase i.e., Pre-Independence phase and Post-Independence phase.

Pre-Independence phase:

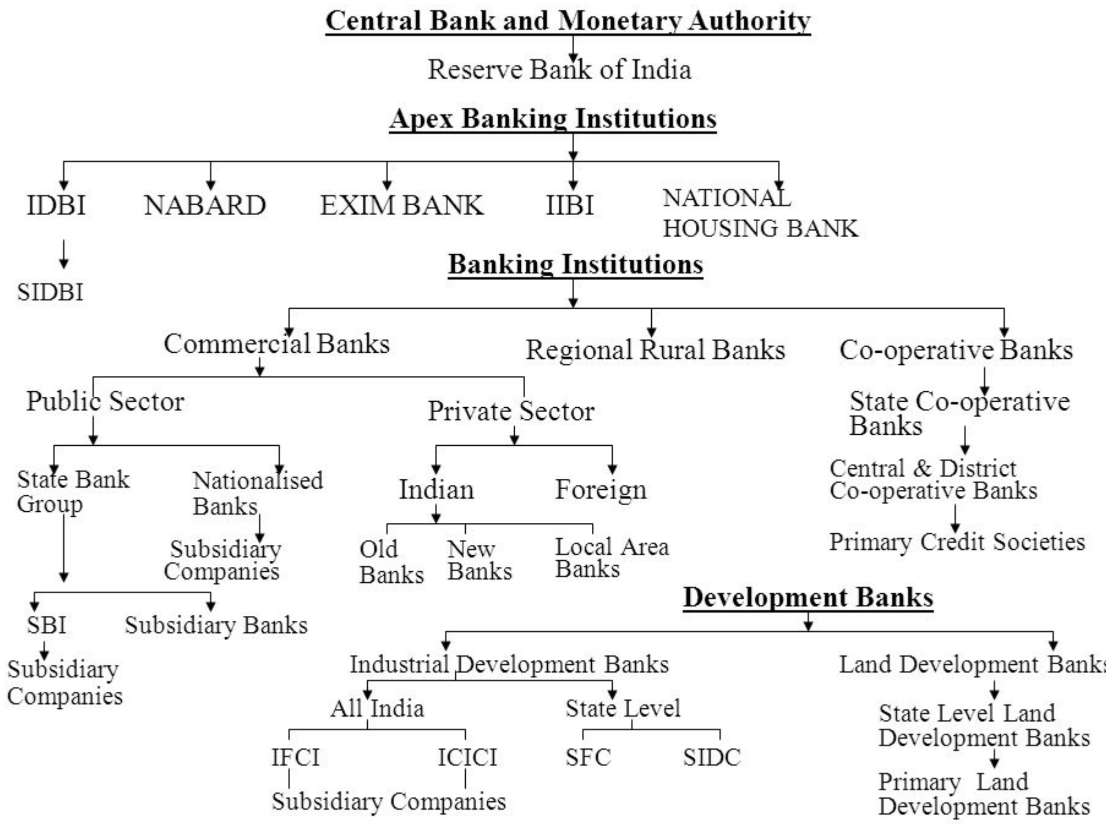
- East India Company was established The Bank of Hindustan in the year 1770
- The General Bank of India was established in the year 1786
- Modern Commercial banking started in India with the founding of three presidency banks namely the Bank of Calcutta (1809), the Bank of Bombay (1840) and the Bank of Madras (1843)
- In India, the Joint Stock Companies Act, 1850 was the first legislative that allowed the corporate sector to do the banking business.
- A great number of banks came into existence since the beginning of Swadeshi movement (1905) like Bank of India, Bank of Baroda, Punjab and Sind Bank etc.
- In 1921, three Presidency Banks were amalgamated to form a single bank named Imperial Bank of India.
- In 1935, the Reserve Bank of India (RBI) was established in 1935 as the Central Bank of India under RBI Act 1934

Post-Independence phase:

- Nationalization of Reserve Bank of India on 1st January 1949 under RBI Act 1934
- The Banking Companies Act 1949 was passed to protect the interest of depositors and to guarantee the appropriate progress of commercial banks in India.
- In 1955, Imperial Bank of India was nationalized and renamed as State Bank of India.
- Nationalization of 14 Commercial Banks in 1969 and another 6 Commercial Banks were nationalized in 1980.
- In 1975 Regional Rural Banks were established with focal point for the development of rural and agricultural sector.

Indian banking industry is subject to the regulations of the Central Bank of India i.e., RBI. RBI being the apex institution supervises, regulates and promotes the monetary system as well as the financial system of the country. Banking Regulation Act, 1949 is the main legislation governing commercial banks in our country India.

1.3.3: Structure of banking institution in India



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

1. Organized Sector
2. Unorganized Sector.

1. Organized Sector:
The organized banking sector consists of commercial banks, cooperative Banks, the Regional Rural Banks and Development Banks.

(a) Commercial Banks: Commercial Banks accept deposits from the general public and advance loans with the purpose of earning profits. The commercial banks may be classified as scheduled banks or non-scheduled banks. Banks which are included in the II schedule of the Reserve Bank of India Act, 1934 are scheduled banks. All banks which are not included in the II schedule of the Reserve Bank of India Act, 1934 are Non-scheduled Banks. Except for emergencies, non-scheduled Banks are not eligible to take loans from the RBI for normal banking purposes.

(b) Co-operative banks: Co-operative banking is another vital section of the organized sector of Indian banking system. They are represented by a group of societies registered under the Cooperative Societies Acts of the respective state. In actuality, co-operative societies are either credit societies or non-credit societies. In India, different co-operative credit societies are operating. These banks can be classified into two wide categories :(a) Rural credit societies- that are primary agriculture, (b) Urban credit societies which are mainly non-agriculture. For the purpose of agriculture credit there are different co-operative credit institutions to meet up different needs.

(c) Regional Rural Banks (RRBs): Regional Rural Banks were established by the state government and some sponsoring commercial banks with the purpose of promoting the rural economy under the Regional Rural Banks Act, 1976. RRBs were founded with the aim of ensuring adequate institutional credit for agriculture and allied rural sectors. Regional Rural Banks provide banking services and credit to small and marginal farmers as well as entrepreneurs in the rural areas. They represent a significant element of the rural financial planning in India.

(d) Foreign Banks: Foreign banks are banks that have branches in the other countries and main head office in the Home Country. A number of foreign banks have entered India with the deregulation (Elimination of Government Authority) in 1993. Some examples of Foreign Banks are: Citi Bank, Bank of Ceylon etc.

(e) Development Banks: Financial institutions that give long-term credit to promote capital-intensive investments spread over a long period and yielding lower rates of return with substantial social benefits are known as Development Banks. The primary development banks in India are; Industrial Finance Corporation of India (IFCI Ltd), 1948, Industrial Development Bank of India' (IDBI) 1964, Export-Import Banks of India (EXIM) 1982, Small Industries Development Bank of India (SIDBI) 1989, National Bank for Agriculture and Rural Development (NABARD) 1982 etc.

2. Unorganized Sector.

Participants in the unorganized banking sector are mainly the Indigenous Bankers & Money Lenders.

a. Indigenous Bankers: Indigenous Bankers are private firms or individual those operate as banks and as such both accept deposits and grant loans. They are also financial intermediaries like banks. They are supposed to be well-known professional money lenders whose principal business is not banking or money lending. The indigenous bank normally deals with the Hundies, Commercial Paper etc.

b. Money Lenders: Money lenders completely depend on their own fund. They may be rural or urban, professional or non-professional. They consist of large number of farmer, traders, and merchants. Operations of money lenders are unregulated. Money lenders normally charge very high rate of interest on their lending.

Check Your Progress

1. Financial institutions are component of organized financial system. (True or False)
2. The word bank is fundamentally derived from the Italian word …………(Fill in the blanks)
3. What is a scheduled bank?

1.3.4: Functions of a Bank

There are mainly two types of functions of banks. They are:

1. Primary functions
2. Secondary Functions

All banks perform two types of major primary functions namely:

1. Accepting deposits
2. Providing loans and advances

Accepting of Deposits:

A very basic yet significant purpose of all the commercial banks is to mobilize public funds, offer safe custody of savings & interest on the savings to their depositors. Bank accepts varied types of deposits from the public. They are:

a. Saving Deposits: Bank promotes saving habits amongst the public. It is appropriate for salary and wage earners. The rate of interest on saving deposit is low. There is no constraint on the amount and number of withdrawals. The saving deposit accounts can be opened in a single name or in joint names also. The depositors just require to maintain the minimum balance that varies from bank to bank. Bank also provides ATM cum debit card, cheque book, and Internet banking facility. .
b. Fixed Deposits: It is also well-known as Term Deposits. Money is deposited for a fixed period. Withdrawal of money is not allowed during this period. In case depositors withdraw prior to maturity, banks charge a penalty for premature withdrawal. The rate of interest is high in case of Fixed deposit as a lump-sum amount is paid at one time for a specific period but interest rate varies with the period of deposit.
c. Current Deposits: Current deposits are mainly opened by traders and businessmen. The account holders can avail an overdraft facility on current deposit account. These deposits also act as a short term loan to meet working capital need or any other urgent

needs. Bank charges a high-interest rate on current deposit along with the interest charges for overdraft facility. It is to maintain a reserve for unknown demands for the overdraft.

d. Recurring Deposits: In case of recurring deposit a certain sum of money, at a regular interval, is deposited in the bank. Money can be generally withdrawn only after the expiry of a pre specified period. In case of recurring deposits, a higher rate of interest is paid as it provides an effective gain of compounded rate of interest and enables depositors to accumulate a large amount of money. This type of account is mainly operated by petty traders and salaried persons.

Providing of Loans & Advances:

Banks provides loans to meet the needs and uncertainties of the businesses and individuals, out of deposits collected from the public. Bank takes a higher rate of interest on loans and advances than the rate of interest it gives on deposits. Profit for the bank is the difference between the interest rate on loans given and the interest rate for deposits accepted.

Bank generally offers the following types of Loans and Advances to various needy groups:

a. Bank Overdraft: Bank Overdraft is a kind of loan for the current account holders. This loan permits borrowers to withdraw money at anytime more than available balance in bank account but up to a specified limit. An overdraft facility is approved against some collateral security. The interest for overdraft is charged only on the borrowed amount for the period for which the loan is provided.
b. Cash Credits: Cash credit is short term loan facility up to a definite limit fixed in advance. Banks permit the customer to obtain a loan against a mortgage of assured property (tangible assets and guarantees). Cash credit is provided to any type of account holders and also to those who don't have a bank account with a bank. Interest is levied on the amount withdrawn in excess of the limit of the cash credit. In case of cash credit, generally a larger amount of loan is allowed than that of overdraft for a longer period.
c. Loans: Bank advances money against tangible assets to the customer for a short term or medium term periods of say 1 to 5 years. Nowadays, banks also provide loans for the long term. The borrower repays the loan amount either in a lump-sum amount or in the form of installments as per terms spread over a pre-decided duration. Whether withdrawn or not, bank takes interest on the actual amount of loan sanctioned. The interest rate of loans is generally lower than the overdrafts and cash credits facilities.
d. Discounting the bill of exchange: This is a kind of short term loan. In case of discounting of bills of exchange, the seller discounts the bill from the bank for some commission or fees at some specified rate. The bank advances money to the borrowers by discounting or purchasing the bills of exchange. Bank pays the bill amount to the drawer (seller) on behalf of the drawee (buyer) by deducting specified

discount charges. The bank presents the bill to the drawee or acceptor to collect the bill amount on maturity.

Secondary Functions of Bank:

Secondary functions of banks are also classified into two parts:

1. Agency functions
2. Utility functions

Agency Functions of Bank:

Banks are the agents for their customers; hence it has to carry out a variety of agency functions as given below:

- Transfer of Funds: Banks transfer funds from one branch to another branch. Inter bank fund transfer is also provided.

- Annuity or Periodic Collections: Bank also gives service like collecting dividend, wages, salary, pension, and similar annuity or periodic collections on the behalf of clients.

- Annuity or Periodic Payments: Banks also provide services of making annuity payment or periodic payments of rents, electricity bills, etc on behalf of the client.

- Collection of Cheques: Banks also provide the service of collecting money from the bills of exchanges. The bank collects the money of the cheques on behalf of the customers through the clearing and settlement section of its customers.

- Portfolio Management: Banks supervise the portfolio of their customers or clients. They undertake the activity to purchase and sell the shares and debentures of the clients by debiting or crediting the customer's account.

- Other Agency Functions: Under agency functions, bank performs as a representative of its customers or clients for other institutions. Banks act as an executor, administrators, advisers, trustee, etc. of the customers.

Utility Functions of Bank:

- Bank issues letters of credit, traveller's cheque, etc to its customers.
- Bank provides safe deposit vaults or lockers for safe custody of valuables, important documents, and securities to its customers.
- Bank provides customers with services of foreign exchange dealings.
- Bank provide the service of underwriting of shares and debentures under merchant banking.
- Banks deal in foreign exchanges and charge fees.

- Banks also run social welfare programmes for the benefit of customers and society
- Bank prepares project reports
- Bank gives standing guarantee on behalf of its customers.

1.3.5: Role of a banking institution in the economic development of a nation can be discussed as follows:

- Formation of capital - Commercial banks endorses savings and investment that help to reduce capital paucity. They put these resources to productive use, boosting capital construction in the country.
- Creation of Credit - Apart from escalating the money in circulation, bank deposits also make their means to industries, to help them to generate productive assets. This credit has a multiplier impact on the economy.
- Trading functions: Commercial banks are allowed to function as market makers for government, municipal and corporate bonds. Banks can give issuers with counseling, advisory, and technical direction through their market-making actions.
- Growth of entrepreneurship: Banks provide capital to entrepreneurs and invest in productive purposes; banks promote self-sufficiency, lessen joblessness and encourage the right industries.
- Mobilization of savings: Commercial banks are a secure place to save money in the form of deposits.
- Funds transfer: Commercial banks help in sending funds to anywhere in India or abroad easily.
- Wealth creation: By providing consulting and advisory services, bank experts can direct investors to mutual funds or direct investments. The bank can operate as custodian for all investment securities, and provide safety deposit boxes, letters of credit for investment opportunities, as well as act as a trustee for wills and investment funds.

1.4 Non Banking Financial Institutions

1.4.1 Meaning & Concept

Non- Banking Financial Intermediaries (NBFIS) play a significant role of adding to the rate of development of financial market. Because of which the rate of economic development of a country is accelerated. NBFIs play an important role in escalating saving and investment. It influences the economy by mobilization savings, filling the credit gaps and channelizing the investments in proper directions. Indian financial intermediaries are mostly privately owned, decentralized and relatively small sized. Some of the NBFIs are engaged in fund based business while others offer financial services to the investors.

There has been an essential transformation in the functioning of NBFCs since post 1995 period. There were many small NBFCs working in India, whose information is not available. NBFCs perform a wide range of functions and they also provide financial services to the investors. NBFI as a financial intermediary, also keep up safety and liquidity in the procedure of resource mobilization. They play a significant role in the saving - investment process by increasing the level of saving and investment and by proper allotment of savings in productive investments. Many a times, commercial banks have the limitations to fulfill the financial requirements of a country and its investors. This leaves a room for growth to the Non - bank financial companies.

Meaning: Non - Bank Financial Companies is a group of intermediaries other than commercial bank and cooperative banks. They comprise institutions like insurance companies, merchant banks, development banks, etc.

The RBI (Amendment) Act, 1997 defines NBFCs as "an institution or company whose principle business is to accept deposits under any scheme of arrangement or in any other manner and lend in any manner.''

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares, stocks, bonds, debentures, securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

1.4.2 Classification of Non- Banking Financial Companies (NBFCS)

On the basis of Liability Structure: On the basis of liability structure, the NBFCs may be divided into two categories. They are NBFCs accepting public deposits (referred to as NBFCs-D), and NBFCs that doesn't raise public deposits (known as NBFCs-ND).

1. Deposit taking NBFCs (known as NBFCs-D): These NBFCs are subject to the requirements of Capital adequacy norms, liquid assets maintenance norms, Exposure norms (including limits on exposure to investments in land, building and unquoted shares), Asset Liability Management (ALM) discipline and other reporting requirements.

2. Non-Deposit taking NBFCs (referred to as NBFCs-ND): Till 2006, NBFCs-ND was subject to minimal regulations. However, since 2007, NBFCs-ND with assets Rs 100 crores and above is being categorized as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI).

Currently, in the light of the overall augment in the development of the NBFC sector, the threshold for defining systemic significance for NBFCs-ND (non-deposit taking NBFCs) has been revised. Accordingly, the NBFCs-ND-SI will henceforth be the NBFCs-ND which have asset size of Rs 500 crore and above as per the last audited balance sheet.

Thus, the NBFCs-ND shall be categorized into two broad categories in accordance with the revised limit for systemic significance:

- NBFCs-ND (with assets of less than Rs 500 crore)
- NBFCs-ND-SI (with assets of Rs 500 crore and above).

The prudential regulations like capital adequacy and risk exposure norms in addition to reporting requirements have been made pertinent to the NBFCs-ND-SIs. At different points of time the ALM reporting and disclosure norms have also been made applicable to NBFCs.

NBFCs can be classified into the following classifications on the basis of nature of primary actions performed:

1. Asset Finance Company: Asset Finance Company is a company that finances physical assets that support productive or economic activities in addition to general purpose assets.

2. Leasing company: Leasing Company is a company that does the business of leasing of equipments or the financing of such activity.

3. Investment company: Investment companies are the companies that do the business of acquisition of securities on some fee basis.

4. Loan company: Loan company is a financial organization that provides loans or advances or otherwise for any activity other than its own. It does not comprise of an Asset Finance Company.

5. Infrastructure finance company: It is a company which carries on as its principle business, the financing of the acquisition or construction of infrastructure facilities of various kinds.

6. Infrastructure Debt Fund Company: Infrastructure Debt Fund Company is a company registered as NBFC to assist the flow of long term debt into infrastructure development projects.

7. Venture capital company: Venture Capital Company is a company that provides funds for seed capital to new business ventures.

8. NBFC-Factor is a non-deposit taking NBFC that mainly engage in the business of factoring.

9. NBFC- Non-Operative Financial Holding Company (NOFHC): NOFHC is a financial organization through which promoter or promoter groups will be allowed to set up a new bank .It’s a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent allowable under the appropriate regulatory guidelines.

Distinction between Bank and NBFCs:

NBFCs are not banks, even though this is a common misconception. Following are the differences between Banks and NBFCs:

Basis of Difference	**Banks**	**NBFCs**
1. Licensing and Regulation	Banks are licensed financial organizations regulated by the government under the Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949.	NBFCs are not authorized; they are licensed financial institutions. They are constituted as per the Companies Act and regulated by the Reserve Bank of India Act of 1934.
2. Types of Services	Banks give services in loan advancements, remittance of funds, guarantees, credit card facilities, cheque payments, etc.	NBFCs give services such as savings and investment plans, insurance facilities, mutual funds, stocks, etc.
3. Deposit Function,	The main function of banks’ business is accepting deposits and advancing loans.	NBFCs deal in deposits in the system of securitization.
4. Acceptance of Demand Deposits	Banks accept deposits repayable on demand.	NBFCs are not allowable to accept demand deposits.
5. Extend Foreign Investment	A foreign investment up to 74% is allowed in case of Bank.	A foreign investment up to 100 % is allowed in case of NBFCs.
6. Payment and Settlement Cycle	Banks are part of the payment and settlement system.	NBFCs are not a part of payment and settlement system.
7. Maintenance of CRR and SLR	Banks should maintain ratios like Cash Reserve Ratios (CRR) and Statutory Liquidity Ratios (SLR) as per the rule.	NBFCs need not to maintain CRR and SLR.
8. Facility of DICGC	Banks' Facility has deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC).	NBFCs have no such access to this kind of facility.
9. Creation of Credits	Banks are involved in creating credits.	NBFCs can’t create credit.

10. Provision of Transactional Services	Banks usually give transactional services like deposits, cash withdrawals, cheques, debit card payments, or online payments.	NBFCs do not give such types of monetary service.

1.4.4 Registration & Regulation of NBFC

NBFC registration refers to the procedure by which a non-banking financial company (NBFC) obtains authorization and permission from the regulatory authority, normally the Reserve Bank of India (RBI) in India, to operate as a financial organization and give certain financial services to the public. The registration procedure involves fulfilling specific conditions, submitting required documents, fulfilling regulatory guidelines, and complying with financial and operational norms set by the regulatory authority. After registration, an NBFC can engage in financial activities such as lending, investment, and other financial services, subject to the regulations and guidelines provided by the regulatory authority.

To regulate and govern the functioning and operations of non-banking financial companies (NBFCs), NBFCs need to comply with some set of rules, guidelines, and norms established by regulatory authorities, such as the Reserve Bank of India (RBI) in India,

- Regulatory Authority: NBFC regulations are overseen by regulatory bodies like the Reserve Bank of India (RBI) in India.
- Licensing and Registration: NBFCs are required to obtain proper licenses and registration from the regulatory authority to operate legally.
- Capital Adequacy: NBFCs are required to maintain a fixed level of capital to ensure financial stability and solvency.
- Asset Classification: Regulations prescribes NBFCs categorize their assets and loans, ensuring transparency and risk assessment.
- Risk Management: NBFCs must have sufficient risk management strategies in place to lessen financial risks.
- Corporate Governance: Regulations focus on good governance practices including transparency, board composition and accountability.
- Prudential Norms: NBFCs have to fulfill specific norms related to income recognition, and provisioning lending practices.
- Disclosure Requirements: NBFCs are needed to reveal financial information at regular interval to provide transparency to investors and stakeholders.
- Interest Rates: Regulations often guide NBFCs on the maximum interest rates they can charge on loans.
- Anti-Money Laundering (AML) and KYC: NBFCs need to implement AML and Know Your Customer (KYC) policies to prevent illegal activities and ensure customer identification.

1.4.5: Functions or services of NBFCs

NBFCs play a significant role in diversifying the financial landscape by offering a wide range of services that complement traditional banking services. Here are the functions of Non-Banking Financial Companies (NBFCs):

- Financial Intermediation: Without being full-fledged banks, NBFCs act as intermediaries between borrowers and lenders and give various financial services.
- Credit Provision: NBFCs give loans and credit to individuals, businesses, and sectors that might have limited access to traditional banking services.
- Investment Activities: NBFCs invest in various financial assets such as stocks, bonds, mutual funds, and other securities.
- Leasing and Hire-Purchase: NBFCs offer services like leasing and hire-purchase, allowing individuals and businesses to obtain assets without the immediate need for bulky upfront payments.
- Factoring and Bill Discounting: NBFCs give factoring services to the lenders where they purchase accounts receivable from debtors and other businesses to provide immediate funds, to ensure efficient cash flow management.
- Insurance Services: Some NBFCs offer insurance-related services, particularly in rural areas, to give coverage to those that are underserved by traditional insurance companies.
- Foreign Exchange Services: Certain NBFCs give forex services for individuals and businesses that need currency exchange and fund remittance.
- Microfinance: NBFCs give microfinance services to financially underserved sections of the society, mainly in rural areas, by giving small loans and other financial products.
- Advisory Services: NBFCs offer financial advisory services like helping clients with financial planning, investment decisions, and other portfolio management services.
- Mortgage Services: NBFCs give mortgage loans to individuals to buy or develop real estate assets and properties.
- Vehicle Finance: Both for personal use and commercial purposes, NBFCs give loans for purchasing vehicles,
- Retail Financing: They give loans and advances for consumer goods, electronics, furnitures and other retail products through partnerships with retailers.

Check your Progress

1. Overdraft is a kind of loan for the current account holders/ savings account holders. (Chose the correct option)
2. Portfolio Management is a _________function of a bank. (Chose the correct option)
   a. Primary
   b. General Utility

    c. Agency
3. NBFCs need not to maintain CRR and SLR. (True or False)

Questions:

a. What is a bank? Write the differences between schedule and non schedule bank.
b. Discuss the role of Financial institutions in the economic development of a country
c. What are differences between Banks and NBFCs? Write.
d. Write a note on the regulations of NBFCs.

BLOCK V : Unit-3
Regulating Framework for Financial System and Its Importance

Unit Structure:

3.1 Introduction

The financial system in India is a complex and diverse ecosystem that serves as a fundamental pillar for the nation's economic progress and advancement. The system encompasses a range of businesses, including as banks, non-banking financial corporations (NBFCs), insurance companies, mutual funds, stock exchanges, and other similar entities. In order to guarantee the stability, integrity, and efficiency of this complex network, it is imperative to establish a comprehensive and resilient regulatory framework.

This chapter examines the regulatory framework that oversees the Indian financial system. In this chapter, we will examine the historical development of the Indian Financial System, explore the various functions and duties of prominent regulatory authorities, and analyze the current obstacles and prospects encountered within the contemporary regulatory framework.

3.2 The Historical Evolution of Financial Regulation in India

3.2.1 The Origins of the Phenomenon

The historical trajectory of financial regulation in India can be traced back to the colonial era. The Bank Charter Act of 1844, introduced by the British East India Company, represents an early endeavour in regulating measures. The primary objective of this legislation was to

establish regulations and oversight mechanisms pertaining to the issuing of banknotes by privately owned financial institutions.
In 1935, a significant milestone was achieved with the creation of the Reserve Bank of India (RBI). The Reserve Bank of India (RBI) was established as the central bank of India, primarily tasked with the regulation and oversight of banking and currency operations. The formation of the Reserve Bank of India (RBI) served as a pivotal milestone in shaping contemporary financial regulation in India.

3.2.2 The Banking Regulation Act of 1949 is a significant legislative measure.

The year 1949 witnessed the implementation of the Banking Regulation Act, which established the necessary legislative structure to oversee and control banking institutions. The legislation bestowed considerable jurisdiction upon the Reserve Bank of India (RBI), encompassing the ability to grant banking licenses, oversee and regulate their activities, and, if deemed appropriate, conduct inspections and exercise managerial control over banks. The enactment of the Banking Regulation Act was a noteworthy juncture in the progression of financial regulation in India, underscoring the significance of establishing a robust and secure banking framework.

3.2.3 The Process of Nationalizing Banks

During the 1960s and 1970s, there was a notable surge in the process of nationalization of banks in India. In the year 1969, a significant event occurred whereby 14 prominent private banks underwent nationalization in order to advance social and economic goals. This initiative aimed to enhance credit accessibility for sectors such as agriculture and small enterprises. In the year 1980, an additional six banks underwent the process of nationalization. The actions were implemented with the objective of ensuring that the banking industry effectively served the wider national interests and made substantial contributions to fostering inclusive economic growth.

3.2.4 The Process of Liberalization and Diversification

The decade of the 1990s witnessed a significant juncture in the economic trajectory of India, characterized by the implementation of economic liberalization measures. With the adoption of globalization and deregulation, India experienced notable diversity and innovation within its financial industry. Non-banking financial firms (NBFCs) have evolved as significant entities, providing a diverse array of financial services encompassing loan, investment, and asset management.

Stop to Consider, Check Your Progress & Self Asking

1. What role did the establishment of the Reserve Bank of India (RBI) play in shaping India's financial regulatory landscape?
   a) It decentralized banking operations in India.

b) It focused on promoting speculative trading.
c) It provided a framework for stock exchange regulation.
d) It became the central bank, regulating banking and currency operations.

2. Why did India nationalize banks in the 1960s and 70s, and what objectives were aimed at through this process?
a) To promote social and economic objectives and expand credit to agriculture and small industries.
b) To privatize the banking sector for greater efficiency.
c) To encourage foreign banks to operate in India.
d) To reduce government intervention in banking operations.

3. How did economic liberalization in the 1990s impact financial regulation and diversification in India?
a) It led to the nationalization of banks.
b) It resulted in stricter control of NBFCs.
c) It encouraged the emergence of NBFCs and innovations in the financial sector.
d) It promoted a closed financial system.

3.3 Principal Regulatory Authorities

In order to ensure efficient supervision of the several components of the Indian financial system, several regulatory bodies have been formed. Each regulatory body possesses a distinct mandate and exercises jurisdiction within its corresponding sector. The following are the principal regulatory authorities in India:

3.3.1 The Reserve Bank of India (RBI)

The Reserve Bank of India serves as the primary monetary authority and central banking institution in India, assuming a crucial position within the country's financial framework. The primary functions of this entity include:

i) Monetary Policy: Monetary policy refers to the actions and decisions undertaken by a central bank or monetary authority to manage and control the money supply and interest. The Reserve Bank of India (RBI) is responsible for the formulation and implementation of monetary policies aimed at ensuring price stability and fostering economic growth. This is accomplished through several processes such as the repo rate, reverse repo rate, and open market operations.

ii) Banking regulation: The Reserve Bank of India (RBI) assumes the responsibility of overseeing and controlling banks and financial institutions to guarantee their robustness and stability. The regulatory body is responsible for the issuance of licenses, establishment of prudential rules, and implementation of inspections to uphold the integrity of the banking system.

iii) Currency management: The Reserve Bank of India (RBI) assumes the role of the official authority responsible for the issuance and management of the Indian Rupee. Its primary functions encompass the oversight of currency supply, preservation of its authenticity, and facilitation of its widespread acceptance.

iv) Payment systems: Payment systems refer to the various methods and mechanisms used to facilitate the transfer of funds between individuals, businesses, and other entities. The Reserve Bank of India (RBI) is responsible for the supervision and regulation of payment and settlement systems to ensure the efficient execution of financial transactions. This includes the oversight of key systems such as Real-Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT), which play a crucial role in facilitating seamless monetary transfers.

v) Foreign exchange management: Foreign exchange control refers to the regulation and supervision of the flow of currency across national borders. It involves the use of various measures by governments or central banks to manage and monitor. The Reserve Bank of India (RBI) is responsible for the management of India's foreign exchange reserves and the regulation of foreign exchange transactions in order to ensure the stability of the country's external sector.

3.3.2 The Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) is a regulatory body responsible for overseeing and regulating the securities market in India.The Securities and Exchange Board of India (SEBI) is the regulatory body entrusted with the responsibility of managing and regulating the securities market in India. The primary functions encompassed by this entity are:

i) Regulation of capital markets: The Securities and Exchange Board of India (SEBI) is responsible for overseeing and regulating the functioning of capital markets in order to uphold principles of equity, transparency, and safeguard the interests of investors. The primary functions of this entity encompass the surveillance of stock exchanges, the maintenance of market integrity, and the enforcement of regulatory measures.

ii) Registration of Market Participants: SEBI is responsible for registering and supervising entities such as stock exchanges, brokers, merchant bankers, and mutual funds. This ensures that these entities comply with regulatory standards and conduct their activities in a transparent manner.

iii) Enforcement of regulations: The Securities and Exchange Board of India (SEBI) have the requisite jurisdiction to uphold securities legislation and regulations, conduct inquiries into market manipulation, insider trading, and fraudulent practices, with the overarching objective of preserving the integrity of the market.

iv) Investor education and protection: The Securities and Exchange Board of India (SEBI) places significant importance on the promotion of investor awareness and education to encourage market participation and protect the interests of investors.

The role of the Securities and Exchange Board of India (SEBI) in safeguarding the integrity and transparency of capital markets is crucial in attracting both domestic and foreign investments.

3.3.3 The Insurance Regulatory and Development Authority of India (IRDAI)

The Insurance Regulatory and Development Authority of India (IRDAI) is a regulatory body responsible for overseeing and promoting the development of the insurance sector in India.Insurance Regulatory and Development Authority of India (IRDAI) serves as the authoritative authority responsible for overseeing and regulating the insurance industry in India. The key responsibilities encompassed by this entity are:

i) Regulation and Licensing: IRDAI licenses insurance companies and oversees their activities, ensuring that prudential standards and solvency criteria are met.

ii) Product Certification: The regulator approves insurance products to ensure that they meet regulatory standards and protect the interests of policyholders.

iii) Policyholder Defence: IRDAI protects policyholders' interests by ensuring that insurance companies fulfil their agreements and treat policyholders properly.

iv) Market Expansion: By encouraging innovation and competition, IRDAI plays a critical role in promoting the development and expansion of the insurance business.

The insurance business is critical for risk management and long-term financial planning, and IRDAI regulation assures its stability and efficacy.

3.3.4 The Pension Fund Regulatory and Development Authority (PFRDA)

The Pension Fund Regulatory and Development Authority (PFRDA) is an organization responsible for the regulation and development of pension funds. The Pension Fund Regulatory and Development Authority (PFRDA) is the regulatory body entrusted with the responsibility of overseeing and fostering the development of the pension sector in India. The primary functions encompassed by this entity are:

i) The regulation governing the National Pension System (NPS): The Pension Fund Regulatory and Development Authority (PFRDA) is responsible for the regulation and administration of the National Pension System (NPS) for both individual and corporate participants, with the aim of promoting long-term retirement planning.

ii) Pension Fund Management: The Pension Fund Regulatory and Development Authority (PFRDA) is responsible for the oversight of pension fund managers, with the primary objective of guaranteeing the implementation of sensible investment methods and effective risk management strategies. This regulatory body aims to safeguard the interests of pension subscribers.

iii) Education for Subscribers: The primary objective of the Pension Fund Regulatory and Development Authority (PFRDA) is to foster pension awareness and education among individuals, with the aim of motivating them to engage in retirement planning and make well-informed decisions on their pension arrangements.

The pension industry plays a vital role in ensuring financial stability during an individual's post-retirement phase, and the PFRDA (Pension Fund Regulatory and Development Authority) plays a pivotal role in facilitating its growth and progress.

Stop to Consider, Check Your Progress & Self Asking

1. How does the Securities and Exchange Board of India (SEBI) contribute to ensuring fairness and transparency in India's capital markets?
   a) By providing loans to stock market participants.
   b) By regulating banks' interest rates.
   c) By enforcing regulations, monitoring stock exchanges, and promoting investor education.
   d) By managing India's foreign exchange reserves.

2. What role does the Insurance Regulatory and Development Authority of India (IRDAI) play in safeguarding policyholders' interests in the insurance sector?
   a) Approving insurance products for marketing.
   b) Promoting foreign insurance companies.
   c) Safeguarding policyholders' interests, ensuring fair treatment, and regulating insurance companies.
   d) Regulating the capital markets.

3. What are the key functions of the Pension Fund Regulatory and Development Authority (PFRDA) in regulating the pension sector?

   a) Regulating mutual funds.
   b) Promoting foreign investment in pensions.
   c) Regulating agricultural finance.
   d) Regulating and administering the National Pension System (NPS).

3.4 Other regulatory bodies

In addition to the aforementioned basic regulatory bodies, India is home to specialized organizations that play a crucial role in promoting financial inclusion and sector-specific growth. These institutions work in collaboration with the principal regulators to accomplish diverse developmental goals.

3.4.1 NABARD: The National Bank for Agriculture and Rural Development (NABARD) is a financial institution that operates at the national level and focuses on providing support and development for agriculture and rural areas.The National Bank for Agriculture and Rural Development (NABARD) was created in the year 1982 with the primary aim of facilitating and fostering rural development and agricultural activities. The program offers financial and developmental assistance to those engaged in agriculture, rural entrepreneurship, and cooperative organizations. The National Bank for Agriculture and Rural Development (NABARD) assumes a crucial role in the facilitation of loan flow to the agricultural sector and the provision of support for the development of rural infrastructure.

3.4.2 SIDBI: The Small Industries Development Bank of India (SIDBI) is a financial institution focusing on developing and supporting small industries in India.The Small Industries Development Bank of India (SIDBI) is committed to the advancement and growth of micro, small, and medium-sized firms (MSMEs) within the Indian context. The organization provides a diverse array of financial and non-financial services to micro, small, and medium enterprises (MSMEs), encompassing loan provisions, venture capital investments, and technical support. The endeavours of SIDBI make a substantial contribution to the advancement and enduring viability of this pivotal industry.

3.4.3 The National Housing Bank (NHB) is a financial institution operating at the national level.The National Housing Bank (NHB) was founded with the purpose of overseeing and advancing the housing finance industry within the Indian context. The provision of liquidity support to housing finance companies (HFCs) and the promotion of affordable housing initiatives are of utmost importance. The activities of the National Housing Bank (NHB) are in accordance with the government's objective of achieving "Housing for All" and promoting the growth of the real estate industry.

Stop to Consider, Check Your Progress & Self Asking

1. How do institutions like the National Bank for Agriculture and Rural Development (NABARD) contribute to rural development and agriculture in India?
   a) By providing financial support to urban entrepreneurs.
   b) By regulating rural credit cooperatives.
   c) By promoting rural development, offering financial support to farmers, and supporting rural infrastructure development.
   d) By regulating housing finance companies.

2. What role does the Small Industries Development Bank of India (SIDBI) play in

supporting micro, small, and medium-sized enterprises (MSMEs)?
a) It promotes foreign direct investment in MSMEs.
b) It provides loans to large industries.
c) It offers financial and non-financial services to MSMEs, including loans, venture capital, and technical assistance.
d) It regulates stock exchanges.

3. How does the National Housing Bank (NHB) contribute to promoting housing finance and real estate development in India?
a) By providing loans to housing finance companies.
b) By promoting the development of luxury housing.
c) By regulating housing prices.
d) By providing liquidity support to housing finance companies (HFCs) and fostering affordable housing initiatives.

3.5 Future Prospects and Challenges

Despite progress in developing a comprehensive regulatory framework for the Indian financial industry, significant difficulties and opportunities remain. These are:

i) Technological Progress: Rapid technical breakthroughs are occurring in the financial sector, including the rise of fintech companies, digital banking, and blockchain-based solutions. While these advances increase efficiency and convenience, they also raise regulatory concerns about data security, consumer protection, and cyber dangers. To keep up with these advancements while preserving the safety and security of financial transactions, regulators must react quickly.

ii) Regulatory Harmonization: With the rising convergence of financial services, authorities must work together to regulate conglomerates that operate across numerous areas. Financial conglomerates, which provide banking, insurance, and securities services under one roof, require coordinated regulation to successfully limit systemic risks.

iii) Financial Inclusion: Financial inclusion is still a high priority. Regulators must guarantee that their rules and laws make financial services available to underrepresented and underprivileged communities. Initiatives such as the Jan Dhan Yojana and Aadhar-enabled payment systems have made great progress in this area, but more work remains to be done.

iv) Sustainable Finance: The global emphasis on responsible finance and investment is expanding. In India, regulators have begun to include environmental, social, and governance (ESG) considerations into financial decision-making. Incorporating ESG principles into legislative frameworks will be critical to encouraging responsible and sustainable finance in the country.

Stop to Consider, Check Your Progress & Self Asking

1. What are the key challenges posed by technological advancements in the financial sector, and how can regulators address them?
   a) There are no challenges associated with technological advancements in the financial sector.
   b) Challenges include data security, consumer protection, and cyber threats. Regulators can address them by ignoring technological advancements.
   c) Challenges include data security, consumer protection, and cyber threats. Regulators can address them by adapting swiftly and ensuring safety and security.
   d) Challenges include promoting speculative trading and unregulated financial activities.

2. How can regulatory convergence be achieved to effectively oversee financial conglomerates operating across multiple domains?
   a) By having separate regulators for each financial domain.
   b) By not regulating financial conglomerates.
   c) By ensuring coordinated regulation among different financial regulators.
   d) By promoting competition among regulators.

3. What initiatives are needed to further promote financial inclusion in India, and how can regulators contribute to these efforts?
   a) There is no need for financial inclusion in India.
   b) Initiatives may include promoting access to financial services for underserved populations, and regulators can contribute by ignoring these initiatives.
   c) Initiatives may include promoting access to financial services for underserved populations, and regulators can contribute by ensuring that policies and regulations facilitate financial inclusion.
   d) Initiatives may include promoting speculative trading among underserved populations.

3.6 Summary

A stable and efficient financial system relies heavily on the presence of a robust regulatory framework. The financial regulatory bodies in India, such as the Reserve Bank of India, Securities and Exchange Board of India, Insurance Regulatory and Development Authority of India, and Pension Fund Regulatory and Development Authority, have undergone significant transformations in response to the evolving dynamics of the financial industry.
As India progresses in its pursuit of economic growth and development, it is imperative to maintain the adaptability, innovation, and responsiveness of its regulatory framework to address growing difficulties and capitalize on possibilities. The future of the Indian financial system would be significantly influenced by the combined efforts of regulators and cooperative and developmental institutions like as NABARD, SIDBI, and NHB.

3.7 References and suggested readings:

1. "Indian Financial System" by H.R. Machiraju

2. "Financial Institutions and Markets in India" by Bhole, L. M.
3. "Indian Financial System: Theory and Practice" by B. S. Bhatia
4. "Financial Market Regulation and Reforms in Emerging Markets" edited by Subhash C. Jain
5. "Indian Banking: Emerging Prospects and Challenges" edited by S. R. Rajagopalan

3.8 Model Questions

Short Answer Questions:

1. What was the primary objective behind the establishment of the Reserve Bank of India (RBI) in 1935?

2. Explain the significance of the Banking Regulation Act of 1949 in India's financial regulatory framework.

3. Name one key function of the Securities and Exchange Board of India (SEBI) and how it contributes to investor protection.

4. What role does the Insurance Regulatory and Development Authority of India (IRDAI) play in the insurance sector, and how does it safeguard policyholders?

5. Briefly describe the primary responsibilities of the Pension Fund Regulatory and Development Authority (PFRDA) in India's pension sector.

Long Answer Questions:

1. Trace the historical evolution of financial regulation in India from the colonial era to post-independence, highlighting significant milestones and changes in the regulatory landscape.

2. Discuss the impact of economic liberalization in the 1990s on India's financial sector, including the emergence of non-banking financial companies (NBFCs) and the diversification of financial services.

3. Provide an in-depth analysis of the functions and responsibilities of the Reserve Bank of India (RBI) in the Indian financial system, emphasizing its role in monetary policy and banking regulation.

4. Explain the concept of financial inclusion and outline the initiatives needed to promote it in India. Discuss how regulators can contribute to these efforts.

5. Explore the challenges and opportunities presented by technological advancements in the financial sector. Discuss the role of regulators in addressing issues such as data security, consumer protection, and cyber threats while fostering innovation.

3.9 Answer keys to check your progress:

Know your Progress 3.2
1. d) 2. a) 3. c)

Know your Progress 3.3
1. c) 2. c) 3. d)

Know your Progress 3.4
1. c) 2. c) 3. d)

Know your Progress 3.5
1. c) 2. c) 3. c)