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Gauhati University

MA/M.Sc in Economics

Fourth Semester

Optional: (D)
Financial System

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Syllabus for MA/M.Sc Economics

Forth Semester

Optional: (D)

Financial System

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Paper Introduction:

This paper is basically designed to give the readers a generalised concept of the financial systems with special emphasis on the Indian Financial System. Study of the paper will enable the readers to have an over all understanding of the functioning of the financial system, its various components, asset valuation and the reforms which it has gone through. It will also enhance their knowledge about various problems within the system and will give a general perspective of the remedial steps taken therefore.

The paper has the following five (5) units:—

Unit 1 : The Financial System

Unit 2 : Financial Markets- Money Market

Unit 3 : Financial Markets- Capital Market

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Unit 5 : Financial Sector Reforms

Unit-1
THE FINANCIAL SYSTEM

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1.0 Introduction

The financial system of a country is very important in determining the economic growth of the country. It helps to channelise the flow of funds from those who save to those who invest. In this chapter we basically try to know about financial system- its components, how they function, how they influence economic growth etc. A Knowledge on financial system and its related concepts help us to make better financial decision. Thus is because financial decisions are generally taken within the context of a financial system. So, to ensure effective financial decision making, an understanding of the financial system is important.

1.1 Objectives

This chapter is designed to fulfil the following objectives-

- to have an understanding of the financial system and its various components;
- to get an idea about the formal and informal sectors of a financial system;
- to have an idea about the Indian financial system;
- to understand the functions performed by the financial system; and
- also to know about the relationship between financial system and economic growth.

1.2 Financial System-Formal and Informal Sector

Definition:

A financial system is a complex and well integrated set of sub-systems like financial institutions, financial markets, instruments and services which help in the efficient transfer and allocation of funds from those who have surplus of funds to those who have a deficit.

In most countries we find financial dualism. It refers to the co-existence of both the formal and informal financial sectors.

The formal financial sector is an organized and regulated system which cater to the financial needs of the well off and literate clientele who can satisfy their stringent loan conditions. On the other hand, the informal financial sector is unorganized and unregulated system which provides savings and credit facilities for the rural spheres of the economy. The informal sector mobilizes rural savings and small savings from low income households.

1.3 Indian Financial System

The Indian financial system can be broadly classified into- formal financial sector and informal financial sector. The Ministry of Finance, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) looks after the formal financial sector of the country. The RBI established in 1935 is the Central Bank of the country. It acts as the regulator of the financial and banking system, formulates monetary policy and puts forward exchange control norms. The SEBI on the other hand is the regulatory authority for the capital markets in India.

The informal financial sector consists of moneylenders, landlords, traders, groups of people who function together as 'associations', firms consisting of local brokers, pawnbrokers etc.

The Indian financial system plays an important role in the process of development of the country by mobilizing the savings of the people and allocating them for investment. For mobilizing the savings of the people, we have in India the banks, mutual funds, investment funds, insurance companies etc. Again for investment we have the financial institutions, individual investors, etc. Another important part of the Indian financial system is the Indian money market, which deals with short term funds, and Indian capital market, which deals with long term funds.

1.4 Components of the Financial System

The formal financial sector consists of the following components-

(i) Financial Institutions

(ii) Financial Markets

(iii) Financial Instruments

(iv) Financial Services

(i) Financial Institutions :

These are the institutions which mobilize savings and helps in the efficient allocation of funds. Financial institutions act as intermediaries. They are responsible for transferring funds from investors to companies who are in need of these funds. Financial institutions help in facilitating the flow of money in the economy.

The financial institutions can be broadly classified into- banking and non-banking financial institution. The banking act as both the creator and purveyor of credit while the non-banking financial institution act only as the purveyor of credit. Some major institutional purveyors of credit in India are- developmental financial institutions (DFIS), non banking financial companies (NBFSC), housing finance companies (HFC) etc.

Finance institutions can be also classified as term finance institutions. Some example are- Industrial Development Bank of India (IDBI), Industrial Finance corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), the small Industries Development Bank of India (SIDBI) and the Industrial Investment Bank of India (IIBI).

Again there are certain specialized finance institutions like export import Bank of India (EXIM), Tourism Finance Corporation of India (TFCI), National Bank for Agricultural and Rural Development (NABARD) etc which can also be termed as financial institutions.

Institutions like UTI, LIC, GIC mutual funds etc. are also regarded as financial institutions. Then there are certain other state financial institutions like state financial corporation (SFC) and state Industrial development corporations (SIDC) etc.

In recent times, the role of the financial institutions have become more diverse and dynamic.

ii) Financial Markets:

These markets enable people to deal in financial securities at low transaction costs and at prices that reflect demand and supply. Financial securities include stocks, bonds, shares, debentures etc.

The financial market in India is broadly classified into the money market and the capital market. Money market deals with short term securities while the capital market deals with long term securities. Generally, long term securities are those securities which have maturity period of one year or more.

The capital market can be further classified into primary market and secondary market. Primary market is a market for new issues. But the secondary market is where old or existing securities are traded.

iii) Financial Instruments:

Financial instrument is like a document showing the legal agreement of some sort of monetary value. It is a claim against a person or an institution for paying a certain sum of money at a future date with or without a periodic payment of interest. Financial instruments include shares, debentures, bonds etc.

Financial securities are financial instruments which can be either primary securities or secondary securities. Primary securities include equity shares and debentures. They are also called direct securities because they are directly issued by the ultimate borrowers to the ultimate savers. But secondary securities are issued by the financial intermediaries to the ultimate savers. So, they are also called indirect securities. Some examples of secondary securities are bank deposits, mutual fund units, insurance policies etc.

Financial instruments are tradable and marketable instruments. So, people can hold a portfolio of different financial assets which would help to reduce their risk. There are different types of financial instruments which differ from each other in terms of marketability, return, risk, transaction cost, liquidity etc.

iv) Financial Services :

Financial services mainly fall into the following categories-funds intermediation, payment mechanism, provision of liquidity, risk management and financial engineering.

These services which help in borrowing and funding, buying and selling of securities enabling payments, managing risks etc. came under financial services. Financial services basically help in intermediating the funds. Fund intermediation have become even more quick and convenient due to improvement in information technology.

A very important financial service lies in risk management. People need protection from different types of risk like that of fluctuations in interest rate, exchange rate fluctuation etc. Financial services can help in transferring risks so that people can shift the burden of risks to others who are willing to bear it.

There are certain other financial services also which are provided by financial intermediaries. They are merchant banking, leasing, hire purchase and credit rating. Generally, financial services are provided by banks, insurance companies, mutual funds and stock exchanges. Financial services also help to fill in the gap in knowledge on the part of the investors. The investors prefer to be sure before they invest their money. Financial services thus protect the investors interest and their money. Thus, we see that financial services are very essential in the financial development of an economy.

The above four components of financial system that we have discussed do not function alone. They are interdependent and interact with each other for the proper and efficient functioning of the financial system.

1.5 Functions of the Financial System

The financial system performs certain important functions, which we discuss below-

(i) ***Mobilize and allocate savings :*** Financial system helps in mobilizing and allocating savings in an efficient manner and acts as a link between the savers and investors.

(ii) ***Optimum allocation of risk bearing and reduction:*** Optimum allocation of risk bearing is an important function of financial system. It helps to reduce the risk associated with the dealing of various financial assets. Financial system helps in reducing risk and also provides protection to the investors by providing insurance services. A financial system provides ways to manage risks.

(iii) ***Monitor corporate performance:*** In a financial system, financial markets and financial institutions not only help to select the projects for investment but they also help in monitoring the

performance of these investment projects through corporate control like they threaten to take over the poor performing firms.

(iv) ***Provide payment and settlement systems :*** Financial system provides payment and settlement mechanism for the quick, safe and timely movement of funds. An efficient payment and settlement mechanism helps in the economic growth. Banks provide the payment mechanism through various facilities like cheques, promissory notes, credit and debit cards etc. while the settlement mechanism is done through depositories and other such ways. Thus, we can say that a financial system provides ways to transfer economic resources through time and across geographic regions.

(v) ***Provide price related information :*** Financial system provides price related information which eventually helps in taking economic and financial decisions. Financial system by providing information related to price helps people to form a correct opinion about investment or disinvestment. It also helps the firms in selecting the appropriate investment projects. Price related information also helps in managing risks.

(vi) ***Lowers the cost of transaction:*** An efficient financial system helps in lowering the transaction cost as also the cost of borrowing. It also helps to create an incentive among people to save.

(vii) ***Promote financial deepening and broadening:*** An efficient financial system helps to promote financial deepening and financial broadening. Financial deepening refers to the rise in financial assets as a percentage of the GDP while financial broadening indicates the increase in the no. of participants and financial instruments.

Thus, these are some of the function of the financial system. A financial system may perform some other functions as well.

Check Your Progress:

1. What is financial system?
2. Who guides the formal financial sector in India?
3. Name the components of the financial system.
4. Differentiate between financial institution and financial markets.

5. Differentiate between money market and capital market.
6. What is a financial instrument?
7. What does financial services include?
8. Mention three functions of the financial system.
9. What is meant by financial deepening and financial broadening?

1.6 Relationship between the Financial System and Economic Growth

There is a two way relationship between financial system and economic growth. A well functioning and efficient financial system is very essential for the smooth functioning of the economy. In fact, an efficient financial system is considered to be a prerequisite for economic growth. There is a close interlink between financial system and economic growth. Now, we know that capital formation is highly essential for economic growth and for capital formation we need to mobilize savings. The financial system of a country helps to mobilize savings by diverting it to more productive uses. The financial system besides increasing the volume of savings also increases the level of competition in the economic scenario by providing a diverse range of financial instruments and services. This helps to direct the resources towards the most productive use which yields the highest return. This is turn stimulates growth.

A financial system also helps in increasing liquidity and evaluating the various financial assets in the economy which helps to stimulate the growth in the economy.

Economics growth, on the other hand, also helps in developing the financial system of a country. For instance, during the 1970s when there was an increasing demand for risk management services, the financial systems responded by developing many new risk management products.

Again, financial markets play a vital role in developing a well balanced and efficient financial system. The money market and the govt securities market helps the central bank to conduct its various monetary policies when the domestic financial system is linked to the international financial system it results in an increase in the flow of capital, helps reduce risk by diversifying the portfolios and results in economic growth.

Thus, we see that financial markets, financial institutions and instruments play an important role in fostering the economic growth of a nation. Likewise

higher economic growth also results in a developed and well functioning financial system.

1.7 Summing Up

Thus we have seen that financial system through its various interlinked sub-systems helps in the efficient transfer and allocation of funds and stimulates economic growth. The Indian financial system is broadly classified into formal and informal sector. The formal sectors contains financial institutions, services, instruments and markets all interdependent and interacting in efficient allocation of funds. On the other hand the informal sector consists of landlords, moneylenders, traders etc working independently and usually in small scale.

1.8 Exercise

1. What is a financial system? What are the different components of financial system?
2. Define financial market. What are money market and capital market?
3. Mention some important functions of the financial system.
4. Discuss about the inter-relationship between financial system and economic growth.
5. Write short notes on-
   (a) Financial Institution
   (b) Financial Services

1.9 Reference and Suggested Readings

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Unit-2

FINANCIAL MARKETS- MONEY MARKET

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2.0 Introduction

Financial markets are an important component of the financial system, which provides a mechanism for people to deal in financial assets. Money market is an important component of the financial market. It deals with those financial assets which have a maturity period of one year or less than that..

2.1 Objectives

This chapter is designed to fulfil the following objectives–

- to know in details about the structure and functions of the money market;
- to have an idea about the various instruments in the money market;

- to be able to distinguish between the various money market instruments;
- to have a knowledge about the intermediaries in the money market; and
- to know about the money market derivatives.

In this chapter we basically try to know about the money market, how it functions, what are its various instruments and how do they help the people in fulfilling their financial needs.

2.2 Money Market-Structure

Money market basically deals with short term instruments which are deemed as close substitutes of money. It deals with assets for short term borrowing, lending, buying and selling maturity of one year or less.

The money market is an important constituent of the Indian financial system. The money market in India comes under the direct purview of the Reserve Bank regulations. The money market is useful as it fulfils the borrowing and investment requirement of the users of short term funds.

Some basic characteristics of the money market are highlighted below –

(i) It is a collection of markets for various instruments.

(ii) It is not a physical location; trading is usually done over the counter.

(iii) It balances the demand and supply of short term funds.

(iv) Some players of the money market are Reserve Bank of India (RBI), Discount and Finance house of India (DFHI), mutual funds banks, non banking finance companies (NBFCs), state governments etc.

2.3 Money Market-Functions

A money market generally performs the following functions-

(i) It transfers money from parties with surplus funds to parties with deficit funds.

(ii) It provides a balance between the demand for and supply of short term funds.

(iii) It influences liquidity and the level of interest rates in the economy.

(iv) It allows governments to raise funds.

(v) It helps to implement the monetary policies

(vi) It provides easy access to the users of short term fund to fulfill their various requirements.

(vii) It also helps in developing a market for long term securities.

2.4 Money Market Instruments

The money market in India is very diverse at present and it has evolved a lot in the past few years from the conventional treasury bills and call money to commercial paper, commercial bills etc and also includes FRA's and IRS more recently.

In his chapter we shall discuss about the following money market instruments:

(i) Treasury Bills (T-Bills)

(ii) Call Money Market

(iii) Commercial Papers (CPs)

(iv) Certificate of Deposist (CDs)

(v) Commercial Bills (CBs)

2.5 Treasury Bill (T-Bill)

Treasury bills are instruments of short term borrowing issued by the govt (central/ state) to overcome short term dificiencies in liquidity. Treasury bills are an important component of the money market. They are usually issued to fill in the gaps between the govt receipts and expenditure.

Treasury bills are promissory notes issued at a discount. They are highly liquid and negotiable and give an assured yield. Treasury bills are actually issued by the Reserve Bank of India and they involve low transaction cost.

There are three types of T-Bills

(a) On-Tap bills: These bills could be bought from the Reserve Bank at an interest of 4.66 percent. But with time they lost their importance and eventually they were discontinued from 1st April, 1997.

(b) Adhoc Bills: The adhoc bills which were introduced in 1955 were actually created to make up for the deficit in the govts account. The govt of India decided alongwith Reserve Bank that it would keep with the RBI a minimum balance of not less than Rs.50 crores on Fridays an Rs.4 crore on other days. If the balance was less than

this minimum value, then the adhoc bills would be issued to make up for the deficit. But these bills were also discounted from 1st April, 1997.

(c) **Auctioned T-Bills:** These bills were introduced in April 1992. The participants bid in an auction conducted by the RBI and the RBI then issues the bills. Presently, T bills are issued for 91 days, 182 days and 364 days.

2.6 Call Money Market

This is a short term money market where lending and borrowing takes place within a short period of time-between 1 days-14 days. If the transaction takes place in 1day it is called money at call but if transaction requires more than 1 day then it is called money at short notice.

The rate at which borrowing and lending takes place in the call money market is called the call rate and it is market determined. The call money market basically helps to balance the deficits and surpluses of the banks and other institutions. Since non-bank entities are not allowed to participate in the call money market so it is also called inert-bank market. But the call money market is highly liquid as the money lent can be called back at any time.

There is a linkage between the call money market and other markets. For instance, if investment in commercial paper is more lucrative then the participants can borrow money from the call money market and invest them in the profitable commercial paper.

But the call money market is not an effective instrument to mobilize resources because its scope is very much limited and the number of participants is less. Generally the participants belong to the organized sector and the unorganized sector is left out.

2.7 Commercial Papers

Commercial paper is a short term promissory note issued by large corporations, primary dealers and all India financial institutions to meet their short term debt obligations. Commercial paper is negotiable and transferable and has fixed maturity period. As commercial paper is not backed by collateral so only those firms which have excellent credit ratings from a recognized rating agency are able to sell their commercial paper at a proper price. The minimum credit rating is P2 of CRISIL or equivalent rating by other agencies.

The commercial papers were introduced by the Reserve Bank in January 1990. It is usually sold at a discount, which is determined by the market forces.

There are certain guidelines however for the issuance of commercial paper which we briefly mention below-

(i) Those corporates, primary dealers and all India financial institutions whose tangible net worth is not less than Rs.4 crores are considered to be eligible for issuing commercial paper.

(ii) They should have the minimum credit rating.

(iii) The maturity period for commercial paper is between a minimum of 7 days and maximum upto one year from the date of issue.

(iv) Commercial paper can be issued in denominations of Rs. 5 lakh or its multiples.

A commercial paper can also be issued in dematerialized form at a discount. But it is not mandatory to underwrite the issue of a commercial paper.

There are certain factors however for which this instrument is still not properly developed. There is no active secondary market for commercial paper. The issue of commercial paper involves certain administrative difficulties also. Again, the minimum maturity period of 7days also inhibit the growth of the commercial paper market. Even then, the commercial paper is a good instrument to raise short term finances.

2.8 Certificate of Deposits

Certificate of deposit is a money market instrument by which the resources can be mobilized. Certificates of deposits which were introduced in June 1989 are short term, negotiable and tradable time deposits issued by commercial banks and financial institutions. Since certificate of deposit is a time deposit, it is also subjected to the provisions of SLR and CRR but fundamentally certificate of deposit is different from time deposit.

Certificate of deposits are highly liquid and marketable. They may be issued in physical form or dematerialized form. They are issued generally by commercial banks and financial institutions. The commercial banks can issue certificate of deposits for a maturity within 7 days to 1 year. But for certificate of deposits issued by the financial institutions, the maturity period varies from 1 year to 3 years.*

The commercial banks can issue certificate of deposits according to their need. There is no limit as to how much they can invest in certificate of deposits. But in case of financial institutions, there is a ceiling limit prescribed by the RBI. This limit is set by the net assets owned by the financial institutions. The minimum denomination for certificate of deposit is 1 lakh.

There are a no. of investors who can invest in certificate of deposits like individuals, corporations, companies, trusts, funds, etc. The NRI s can also invest in certificate of deposits but in their case they are not transferable.

But the certificates of deposits are not much popular for a number if reasons-

(i) The secondary market is not well developed.

(ii) The number of participants is 1 lakh and one has to wait for minimum 1 year.

(iii) There is no buyback facilities or loan facilities.

(iv) The certificate of deposits carry a fixed rate of interest and the discounted value is also calculated on this fixed rate of interest so, some investors may not favour these certificate of deposits.

But certificate of deposits are a good instrument for the commercial banks to raise funds to fulfil their short term requirements.

2.9 Commercial Bills

Commercial bill is a short term negotiable instrument arising out of credit transaction. Whenever any good is sold for credit, the caller draws a bill on the buyer for the amount due. The buyer also agrees to pay the amount offer a certain specified date. The commercial bill has a high degree of liquidity and are riskless. The credit is paid on maturity of the bills.

The commercial bill can be of different types-

- **Demand bill or usance bill:** A demand bill is payable on demand while a usance bill is payable after a certain period of time.
- **Clean bills and documentary bills:** In clean bills the documents are enclosed and delivered against acceptance by the drawee while in case of the documentary bills, the documents are delivered against payment accepted by the drawee and the banks hold the documents till the bill is paid.

- **Inland bills and foreign bills:** Inland bills are those bills which are transacted within the country while foreign bills are these which are either drawn outside India and payable in India or drawn in India and payable outside India.

Commercial Bill is a fully secured form of investment since it is transferable by endorsement. Commercial Bill also ensure greater liquidity, better quality of lending and money management.

The commercial bills have certain advantages over other short term money market instruments like offer greater liquidity to their holders, they can be shifted to others in the market when there arises a need for each. Again, the commercial bills rate is also much higher than the treasury bill rate.

But commercial bills are not much popular in the UDCs. Their transaction is low because the credit system is still more popular than the transaction in commercial bill in the UDCs. Moreover there is the absence of secondary market in case of commercial bills. There is no uniformity in drawing commercial bills across the country and they carry high stamp duties.

Check Your Progress :

1. What is a money market?
2. How does a money market function?
3. What are Treasury Bills (T Bills)?
4. What is the transaction period in a call money market?
5. What are commercial bills?
6. Who can issue certificate of deposits?
7. Who can issue commercial paper?
8. What is the maturity period of commercial paper?
9. What are the different types of commercial bills?

2.10 Money Market Intermediaries

Money market intermediaries help to stimulate the money market instruments and enhance their functioning and also help to develop secondary market in these instruments. The money market intermediaries basically help to bring the money market instruments within the reach of the people.

Under the money market intermediaries we shall basically discuss about the discount and Finance House of India (DFHI) and Money Market Mutual Funds (MMMfs).

2.10.1 The Discount and Finance House of India (DFHI)

The DFHI is a joint stock company owned by the RBI, public sector banks and all India financial institutions. It was set up in April, 1988 but it began operating from July, 1988 onwards.

The DFHI performs certain important functions in improving the functioning of the money market. The DFHI helps to develop secondary market in the money market instruments so as to improve their activity. The DFHI also undertakes short term buy back operations for the government securities.

The DFHI basically helps to mobilize the resources from the financial institutions, commercial banks and corporate houses and then lends them in the money market. Thus, the DFHI helps both in raising short-term money and in investing the surpluses. The DFHI deals in all the money market instruments like call money markets, treasury bills, commercial bills, commercial papers and certificate of deposits and also govt securities. The DFHI provides buy back facilities to the bank and the financial institutions in terms of the above mentioned instruments.

There has been an increase in the turnover of the DFHI in its financial transactions in the past few years. But the turnover has been more in the call money market followed by the govt securities and treasury bills. There hasn't been much business dealings in the other instruments like certificates of deposits, commercial papers and commercial bills. Now if the DFHI wants to improve the activity of the money market and carry on with its objective of depending the money market it has to develop these other instruments.

The RBI disinvested its shareholders in March 2003. The SBI thus became the major shareholder and the DFHI became its subsidiary from 31st March, 2003. Again in April 2004, SBI Gilts Ltd was merged with the DFHI Ltd and this merged entity was named SBI DFHI Ltd.

2.10.2 Money Market Mutual Funds (MMMF)

These money market mutual funds (MMMFs) which were introduced in April 1991 invest exclusively in money market instruments. They provide avenues for investment and helps in bringing the money market instruments within the reach of the people.

The MMMFs were under the purview of the RBI but since March 7, 2000 they have some under the purview of the SEBI.

The MMMF mobilizes saving of the small investors and invests them in the money market instruments. So, they fill in the gap between the small investors and the money market.

A task force was set up to examine the framework of the MMMF and based on the recommendations made by this task force a new scheme of MMMF was announced by the RBI in April 1992. But since then several modifications have been made like removal of ceiling for allowed to set up MMMFs, MMMFs were allowed to invest in corporate bonds and debentures etc. All these modifications helped to make the MMMFs more attractive and flexible. But for the MMMFs to grow the money market has to grow in volume and depth.

2.11 Liquidity Management Instruments in the Money Market-Money Market Derivatives

Derivatives help in managing risks. A derivative is basically a financial contract whose value depends on some underlying asset. By absorbing risks, derivatives increase the liquidity in the market.

In July 1999, RBI laid down guidelines to introduce two money market derivatives- interest rate swaps (IRS) and forward rate agreements (FRA). These are over the counter derivatives. IRS and FRA provide depth to the money market and also enable people to hedge interest rate risk which may arise due to lending or borrowing at fixed or variable rates of interest.

2.12 Summing Up

In this unit an introduction to money market and its various instruments were made. Money market basically deals with short term instruments deemed as close substitutes of money. This chapter discussed the money market instruments as T-Bills, call Money Market, Commercial Bills etc. Further the unit also discussed the money market intermediaries such as DFHI and MMMF which helps to stimulate the money market instruments and enhance their functioning and also help to develop secondary market in these instruments. Further, the unit discussed money-market derivatives which helps in managing risks.

2.13 Exercise

1. What is money market? What are its functions?
2. Which are some of the common money market instruments?
3. What are the features of treasury bills?
4. What is a call money market?
5. What are commercial papers and commercial bills?
6. What is a certificate of deposit? What are its features?
7. What are money market intermediaries?
8. Write a short note on the Discount and Finance House of India.

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Unit-3
FINANCIAL MARKETS- CAPITAL MARKET

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3.0 Introduction

Capital market is an important constituent of the financial market. Like the money market, the capital market also plays a significant role in the financial sector of an economy. The capital market basically deals with financial assets having a longer maturity period. The capital market has a big role to play in the all round development of the economy.

3.1 Objectives

This chapter has been designed to fulfil the following objectives-

- to know about the functions and importance of the capital market;
- to discuss about the different components of the capital market;

- to discuss on details about the stock market, its functions and the various stock market index;
- to have an idea about the derivative market;
- to learn about the debt market and its various participants; and
- also to know about mutual funds, its types and its importance.

3.2 Capital Market-Structure and Functions

Capital market is a market dealing with financial assets having a longer maturity period, generally more than a year. It is market where long term funds are borrowed and lent.

Various institutions from both the public and the private sector sell securities in the capital market to raise funds. Financial institutions like IDBI, UTI, ICICI, LIC etc. act as lenders while business units corporate houses etc. act as borrowers in the capital market.

The capital market can be divided into the primary capital market and the secondary capital market. The primary capital market which deals with new issues is also called the 'Market of new issue'. The secondary market also called the 'stock market' deals with old or existing securities are traded.

A vibrant capital market is of utmost importance for the proper utilization of financial resources of an economy. Some important functions of the capital market are briefly mentioned below:

(i) **Disseminate Information:** The conditions in the financial sphere of an economy are generally not static. Any investment which is favourable today may not be favourable tomorrow, so a continuous stream of information is required. Capital market thus helps people to have complete information about investment as well as disinvestment.

(ii) **Quick Valuation:** Capital market provides a quick valuation of all the financial assets that are being held by the people.

(iii) **Insurance Against Market Fluctuation :** Capital market provides a safeguard against uncertainties like fluctuations in the market. Through derivative trading, capital market provides insurance against market fluctuations. Then there is also the investment protection fund.

(iv) **Wider Participation:** Capital market enhances the width of the market by facilitating greater participation by the public and various institutions.

(v) **Mobilise Savings:** Capital market mobilizes long-term savings to finance long term investments.

(vi) **Efficient Allocation:** Capital market facilitaties an efficient allocation of scarce resource through a system of investment.

(vii) **Operational Efficiency:** Capital market enhances operational efficiency in the following manner:

- Through simplified transaction process.
- By lowering the settlement timing.
- Through smaller transaction cost.

3.3 Primary Market: Instruments of Resource Mobilization

Primary market is a market dealing with new issues. It is also called as the market for new issues. In this market fresh funds are mobilised and these fresh funds are raised through new securities.

In India, new funds are raised through prospectus, rights issue and private placement. Thus, the instruments of resource mobilization are-

(a) **Through a Prospectus:** New issues are offered to the public through IPO (initial public offer). According to the section 67 of the companies (Amendment) Act of 2000, when an offer or invitation is made to 50 or more persons to subscribe to shares or debentures such an offer is considered to be public offering and it has to conform with the provisions of the the Act as well as with the SEBI guidelines. Earlier brokers used to handle the IPO but now a days they don't, they are done by merchant bankers.

(b) **Rights Issue:** It refers to the issue of new securities where the existing shareholders are given the rights to subscribe to the new issue on a proportionate basis. These rights are given to the existing shareholders in the form of a letter called the 'letter of offer'. The shareholder can subscribe to the shares at a predetermined price. The shareholder has four options- he can either buy the new shares at the offer price, or he can renounce his rights and sell them in the open market, or renounce a part of his right and exercise the remainder or choose to do nothing. The right issues are generally kept open for atleast 30 days but not more than 60 days.

(c) **Private Placement:** Private Placement basically refers to the direct sale of securities of a company where the company approaches

high valued investors or institutional investors for quick money through the conventional measures of security like shares, bonds, debentures etc. In case of private placement, no prospectus is issued. In this method, money can be easily assessed and is quite inexpensive as no issue expenses are involved.

The primary market has three categories of participants-

(i) Issuers of security

(ii) Investors in security

(iii) Intermediaries.

Intermediaries to an Issue:

They facilitate the buying and selling of securities and thus provide services to both the issuers and investors. There can be different intermediaries like brokers, merchant bankers, bankers, syndicate members, auditors of the company etc.

A merchant banker should be registered as per the SEBI Regulations1992. He performs most of the pre and post issue functions. Pre issue functions include drafting, examining and issuing the prospectus and application form and giving publicity to the new issue or IPO. Again, some of post issue functions include allotting the new issues among the applicants whose requests could not be honoured and dispatch the certificates to those applicants who are selected.

3.4 Pricing of New Issue

It is important to know how the new issues are priced. In the pre 1992 period, a fixed pricing mechanism was followed. The companies had to comply with the Capital Issues (Control Act, 1947) which was regulated by the controller of capital issues. Under this Act, if a company wants to raise resources, prior approval should be based on 3 aspects-

(a) Timing of the IPO, ie, when it is to be made.

(b) The quantum of the IPO.

(c) The pricing of the IPO.

The Controller also tried to distinguish between the new and the old companies. As per as the new companies were concerned the IPos have to be sold at par value. But the established, old companies were allowed to

charge a premium above the par value. How much premium would be charged depends on 2 thing-net asset value (NAV) and price earning value (PEV). But this system continued till 1992 only because in 1992 the Capital Issues Act was repealed and all sorts of controls were removed from the market. Post 1992 there was drastic liberation in the capital market. The new issues were priced as per the merchant bankers. They were free to decide the price of the new issues. But under such a free pricing regime, there was a fall out while the old companies running on losses kept on issuing more and more IPOs to raise resource, the new companies also made false claims and cheated investors to invest in them. Thus, free markets became free falling markets.

After such a disaster, various measures were taken up to regulate the actions of the merchant bankers, brokers and others. It was decided that in case of IPO, there should be full disclosures and such disclosures should justify the offer price by stating the potential of the company. It was made mandatory for the promoters to make full material disclosure about the risk factors so that the asymmetry of information between the promoters and investors can be narrowed down.

Due to the inefficiency in the functioning of the capital market system, the book building method was developed as an alternative method.

3.5 Book Building Process

The Book Building Process which is quite popular in India takes into account the investors' demand while arriving at an offer price for the IPOs. This process basically involves the auction of shares. The no. of shares open for bid and the bid prices are indicated on a chart which helps the investors to know about the price in advance.

The company appoints a book runner ie, a merchant banker who manage the entire book building program. He prepares the draft documents and submits it to SEBI. On the basis of such submission, an acknowledgement card is given to him.

The company and the book runner offers the shares within a particular band. This offer is not made to the general public, it is made to syndicate members consisting of merchant bankers, financial institutions, mutual funds, brokers etc. generally, the bid offer is kept for 5 days. Once the bids are made, a final cut-off rate is determined by the issuer (company) and the book runner. But a certain quota is fixed by them regarding the no. of shares

that can be purchased. This is done mainly to prevent any potential takeover bids.

After all this, the prospectus is then filed with the Registrar of Companies (ROC). After the placement process of the offer closes, the public issue opens. The price determined in the book building process will also be applicable to the public portion. Here we may have 3 situations-

(a) ***Oversubscription:*** If there are many subscribers the allotment is undertaken on a proportional basis.

(b) ***Undersubsciption:*** If the shares remain unsold, the unsold shares are refered back for private placement.

(c) But if the private placement is undersubscribed, shares are brought out for public offer.

Merits of the Book Building Process:

(i) This is a more genuine process because it reflects peoples' demand. The issuers or the promoters are also benefitted from the discovery of price and demand.

(ii) The problem of under subscription is dramatically reduced in this process because a certain portion of shares are pre-sold.

(iii) In this process there is cost and time reduction due to the adoption of various simplified procedures.

(iv) This process also helps to boost the investor's confidence. Individual investors are now less afraid to invest due to reduction in information asymmetry. The syndicate members know the capital market inside out. They are the expert and they bid for it. These bids are informed choices and they determine the offer price. So the investor's confidence is enhanced which again throws more fund to the particular offer.

3.6 Secondary Market-Its Functions

Secondary market is a market where the existing securities are traded. It is the market in which previously issued financial instruments such as stock, bonds, options and futures are bought and sold. The secondary market is commonly called the stock market where various stock exchanges operate.

Functions of Secondary Market:

The secondary market performs the following main functions-

(i) It helps in economic growth by allocating the funds to the efficient channels.

(ii) It enhances the liquidity of the existing securities and also facilitaties their marketability.

(iii) It provides a quick valuation of the securities, which helps to measure the cost capital, rate of return etc.

(iv) It also helps to protect investors' interest by regulating the firms.

(v) Secondary markets provides a continuous evaluation regarding the company's performance. The stock prices act as the indicators and induce the company to improve performance.

3.7 Stock Market and Its Operation-The BSE Sensex and the NSE Nifty

Secondary market also called the stock market consists if the various stock exchanges which operate under various rules and regulations.

The securities contracts (Regulation) Act of 1956 defines Stock Exchange under section 2 (3) as a body of individuals, incorporated or not, which are constituted for the purpose of regulating and controlling the buying and selling of securities.

In India Stock Exchanges basically initiated after the Companies Act was enacted in 1850. The Bombay Stock Exchange (BSE) was formed in Bombay (Mumbai) in 1875. The Bombay Stock Exchange was then called the Native Share and Stock Broker's Association. After the BSE, stock exchanges were set up in other parts of India as well like in Ahmedabad in 1894, in Calcutta (Kolkata) in 1908 and Madras (Chennai) in 1937. But with Securities Contracts Act in 1956, the stock market was developed in a more organized manner.

With the financial reforms in 1991, we now have 3 tiers of secondary market-

- National stock exchange (NSE).
- Regional stock exchanges.
- Over the Counter Exchanges of India (OTCEI)

The NSE was established in 1994 while the OTCEI was established in 1992. Presently there are 23 stock exchanges in India-19 regional stock

exchanges, the NSE, BSE, the OTCEI and the Interconnected stock exchange of India (ICSE).

These stock exchanges are regulated by the Securities and Exchange Board of India (SEBI). The SEBI mainly tries to protect the interests of the investors and to develop and regulate the securities market.

Stock-Market Operations:

To understand how a stock market operates, we need to first know about the listing of securities. The companies trading in shares must be first listed in the nearest stock exchange. But it is also possible for a company to be listed in many stock exchanges. for listing also there are certain conditions like-

(i) Companies can obtain listing only when they offer atleast 10% of their securities for subscription by the public.

(ii) The net public offer shouldn't be less than Rs.100 crores and 60% of the issue has to be allocated to the qualified institutional buyers (QIBS) or we can say that atleast 25% of the securities have to be offered to the general public.

Once a company is listed, it has certain obligations like it has to continuously disclose information which might have a bearing on the company's performance. Again the companies are also required to come out with their balance sheet every quarter so as to enhance transparency.

Earlier there was the Open Outcry System (OOS) in the stock exchanges where trading took place in the floor of the stock market. Some people would make the selling bids while some would make the buying bids and a co-incidence between the two would result in a transaction. But then the online screen based electronic trading system came to replace the OOS. In this system, the broker sits in front of the computer, all the computers are hooked to a common terminus where all the price sensitive information's are available. Once a bid is made, the broker feeds it into the computer terminus, once the counterbids match, transaction takes place. This system is far better than the previous system because it imparts a let of depth and liquidity to the market.

Generally, there are two types of trading- order driven trading, where orders from all over the country are entered into the electronic system and matched. The other type is the quote driven trading, where there is a market maker who offers both the buy and sell quotes. The BSE has both these two types of trading while the NSE has only the order driven system of trading.

Stock Market Index:

The stock market index is basically an indicator which reflects the market behaviour. It indicates the day-to-day fluctuations in the stock prices and also informs the investors about the price of the shares. The stock market index is also used to indicate what can happen or might happen in the future.

We shall briefly mention here about the BSE sensex and NSE Nifty

BSE Sensex :

The Native share and stock Broker's Association, popularly called the Bombay Stock Exchange (BSE), was established in 1875. The Bombay Stock Exchange is Asia's first stock exchange. Its popular equity index is SENSEX, it is the most widely tracked stock market benchmark index.

NSE Nifty:

The National Stock Exchange (NSE) was set up based on recommendations made by the Pherwani Committee. The NSE is also a tax paying company as per the Companies Act, 1956. The NSE's main index is NSE NIFTY-an index of 50 major stocks mighted by market capitalization.

3.8 Derivative Market

In the financial system, derivative is basically a contract. The value of derivative is derived from an asset called the underlying asset. This underlying asset may be either a share, or stock market index, or interest rate, or commodity, or currency etc. since a derivative doesn't have any value of its own so its value fluctuates with the value of the underlying asset.

Derivative is quite similar to that of insurance. Derivatives provides protection against market risks associated with volatility in interest rates, prices of commodities, currency rates, share prices etc. derivative is a good instrument for protecting people against market insecurities in the financial world.

Derivatives carry a lot of benefits. We briefly mention some of the benefit of derivatives below-

(i) It increases the liquidity of the underlying asset by allowing fair participation.

(ii) It helps to reduce various market risks. It also increase the willingness of the people to own underlying assets.

(iii) It reduces transaction cost.

(iv) Each market participant has his/her unique risk-return preference, so derivatives help the investors to adjust the risk and return of their portfolio.

(v) It results in better price discovery.

The main need for financial derivatives arises from the fact that they help in shifting risks. Broadly speaking, there are 3 types of price risks- market risk, interst rate risk and exchange rate risk. Derivatives help in hedging these risks.

Traders in a Derivative Market:

There are mainly three types of traders in the derivatives market-

(i) ***Hedger:*** A hedger is a risk averse person who enters the futures market mainly to reduce risk.

(ii) ***Speculator:*** Speculator is a risk lover who buys and sells securities to make profit by bearing increased risk on the basis of speculations of future price movement of the underlying asset.

(iii) ***Arbitrageur:*** An arbitrageur is someone who enters into two or more markets simultaneously to take advantage of the price differences in those markets.

Types of Financial Derivatives:

Derivatives can be of different types- forwards, futures, options, warrants, swaps or swaptions. In the following we briefly mention about these derivatives.

(i) ***Forwards:*** It offers to a contract between two parties obliging each to exchange a good or instrument at a definite price in future.

(ii) ***Futures:*** These are some standardized contracts between the buyers and the sellers with fixed exchange terms in a pre-assigned future date. They are legally binding instruments.

(iii) ***Options:*** These are contracts between the option writers and the buyers. The option writers are obliged to sell the assets according to the provisions of the contract. Likewise the buyers are also entitled to buy the given assets as per as decided in the contract.

(iv) *Warrants:* These are of longer duration, generally from 3-7 years. They are usually issued by companies to raise finance without any initial service cost such as dividend or interest.

(v) *Swaps:* They refer to certain customised arrangements between the counterparts to exchange some financial obligations for another.

(vi) *Swaptions:* These are basically options on swaps. This gives the holder the right to either cancel or accept the swap at a future date.

Check Your Progress:

(i) What is a capital market?
(ii) What are the functions of a capital market?
(iii) How are resources mobilised in a primary market?
(iv) Who is a merchant banker?
(v) What is the book building process?
(vi) What are the functions of the secondary (stock) market?
(vii) What is the BSE?
(viii) What is a stock market index?
(ix) What is a derivative market?
(x) Why do we need to go for financial derivative?
(xi) Who are the main traders in a derivative market?
(xii) What are the different types of financial derivatives?

3.9 Debt Market: Participants in the Debt Market

The debt market is another important component of an economy. While the money market deals with short term debt instruments, the debt market deals with long term debt instruments.

The debt market helps in the mobilization and allocation of resources. It also helps in financing the developing activities of the govt and in managing liquidity for of the govt and in managing liquidity for both short term and long term objectives.

A debt market basically comprises of the following-

- Private corporate debt market
- Public sector undertaking bond market
- Govt securities market.

While the government securities market and the money market are regulated by the RBI, the corporate debt market is regulated by the SEBI. The govt securities market constitutes a major segment of the debt market.

Earlier the debt market had only a few participants like the banks but now a days the debt market has a large no. of participants like co-operative banks, corporate houses, mutual funds, public sector undertakings, insurance companies, foreign institutional investors (FIIS), primary dealers etc.

3.10 Private Corporate Debt Market

The private corporate debt market is a market where the bonds/debentures of the corporates are issued and traded. Now as we know the private corporate sector needs a lot of money for various purposes like expansions, mergers etc, they can do so by raising money through equity or through debt. But equity is risky so the corporate try to raise funds by borrowing from the banks. But then again providing long term loans create problem for the banks because they generally accepts short term deposits and that might cause a problem in their assets and liabilities. So, the option lies in issuing bonds/debentures in the debt market. The corporate debt market thereby provides the opportunity to issue and trade the debt securities of the corporates. Banks are also willing to invest in the corporate debt market because there is an exit route ie, whenever they are in need they can sell the bonds. Besides banks, financial institutions, mutual investors etc. also participate in the corporate debt market.

The corporates can issue bonds/debentures either by public offering or by private placement. Before the public issues are made, the issuer and the manager fix the coupon rates and the issues are made available for the public. Generally, the allotment is done on a proportionate basis. For the privately placed issues, however, the terms are decided by the issuers and the bidders.

Thus, the corporate debt market plays a very important role in the economy by providing long term funds and hence supplements the banks in providing funds.

3.11 PSU Bond Market

The Public sector undertaking bond market is a market which deals with the bonds issued by the public sector. These bonds are generally to meet medium and long term obligations. The PSU bonds are privately placed

with banks and large investors. They have a maturity period from 5 to 10 years and they are usually issued in denominations of Rs. 1000.

The public sector undertakings had to issue bonds to raise money mainly after the central govt stopped providing them funds from the late 1980s. But with the passage of time the market for the PSU bonds has grown tremendously. The PSU s can issue both tax free and taxable bonds.

3.12 Government Securities Market

The government securities market is a market dealing with debt instruments issued by the government for meeting its various financial requirements. Any govt needs a lot of money for various purposes like regulating the economy, helping economic growth, maintaining law and order, providing various public services etc. The best way for the govt to raise revenue is through taxes. But sometimes when the expenses are more than the revenue earned the govt has to resort to borrowing from banks, other financial institutions or sometimes even from the public.

The government securities market is one place where the govt can issue securities to meet various short term as well as long term obligations. The govt securities generally are backed by the government ie, the govt guarantees the repayment of principal as well as the payment of interest. Since the govt securities are guaranteed by the govt, so they are safe and are referred to as "gilt-edged securities."

These securities are issued by the government-central, state and local. The main investors in the govt securities market are the RBI, banks, state governments, financial institutions, insurance companies, FIIs, NRIs etc.

The government securities are mainly of 2 types- treasury bills and government dated securities.

The primary market segment of the govt securities market enables the people to raise funds from this market in a cost effective manner while the secondary market segment of this market helps in the operation of various measures of monetary control like-open market operation (OMO).

The government securities market is therefore very significant in the economy and its importance can be highlighted by the following points-

(i) It enables the govt to raise resources to meet its various needs.

(ii) It acts as a benchmark for other markets.

(iii) The price of governments securities can be used as a benchmark for pricing other securities.

(iv) It also helps in the various policies of the government and in the operation of the various measures of monetary control like OMO and Statutory Liquidity Ratio (SLR).

Thus, government securities are very safe and are traded for both short term and long term.

3.13 Mutual Fund

Mutual fund is basically a collective investment vehicle which collects and brings together the savings of different investors and invests them collectively in diversified set of portfolio securities. Mutual fund is mutual in the sense that all the returns from the proceeds are shared among the unit holders minus a fee taken by the fund manager.

The Mutual fund has been set up under the Indian Trust Act. It plays a vital role by mobilizing the savings of the investors and then investing them in various securities.

Investing in mutual funds provides a number of benefits to the investors which we briefly mention below-

(i) As mutual funds invests in a no. of diversified portfolios so it helps to reduce risk.

(ii) Investing in mutual funds is also less expensive.

(iii) The asymmetry in information is wiped out in the long run because mutual fund provides expertise advice to the retail investors.

(iv) Investing in mutual funds enhances liquidity because if the investor needs money he/she can sell his/her unit in case of an open-ended scheme or by selling it in the stock exchange in case of a close ended scheme.

(v) In case of mutual funds, there is regular disclosure of the portfolio of assets. They keep informing the investors about the market value of their units/funds. So, they are transparent.

(vi) Mutual funds offer flexibility because it offers a number of schemes and provides the opportunity to shift to other schemes.

(vii) Investing in mutual funds is very convenient because it saves time and reduces paperwork.

Thus, we see how mutual funds can be beneficial for the investors.

Types of Mutual Funds:

Now, mutual funds can be of various types. Based on functional classification, mutual funds are of the following types-

(i) **Open Ended Schemes:** In this type of scheme, the mutual fund offers to sell and repurchase units at any point of time. These sales and repurchases are undertaken on the basis of the NAV related price.

Since the open ended schemes can be sold and repurchased continuously at any point of time so they help to increase the liquidity of the investors. Another thing about the open ended scheme is that they don't have a fixed reserve fund (Corpus Fund).

(ii) **Close Ended Schemes:** In this type of schemes, there is a fixed corpus fund. They have a maturity period ranging from 2 to 5 years. If an investor makes an investment in this fund it is locked for 45 days after which it is open for trading after maturity..

(iii) **Interval Scheme:** This scheme is a combination of the earlier mentioned two schemes and it incorporates the characteristics of both close-ended and open-ended schemes. At pre-determined time they are opened for sale and repurchase at the NAV related price.

Net Asset Value (NAV):

The net asset value (NAV) of a fund is the market value of the assets minus the liabilities on the day of valuation. The NAV of a unit is the NAV of the fund divided by the number of outstanding units. The NAV is calculated every day and on the basis of this NAV, sale and purchase price and announced.

The NAV, sale price and the repurchase price are calculated as follows–

$$\bullet \text{NAV} = \frac{\left\{\begin{array}{c}\text{total market value of} \\ \text{assets and securities} \\ \text{in portfelio}\end{array}\right\} - \text{liabilities}}{\text{No. of units outstanding}}$$

$$\bullet\textbf{Sale Price} = \frac{\left\{\begin{array}{c}\text{Market value of assets}\\ \text{liabilities including}\\ \text{contingent liabilities,}\\ \text{imitial capital share}\\ \text{resources}\end{array}\right\} + \left\{\begin{array}{c}\text{Brokerage, taxes}\\ \text{commission, stamp duty}\\ \text{and other administrative}\\ \text{expenditure}\end{array}\right\}}{\text{No. of units outstanding}}$$

$$\bullet\textbf{Repurchase Price} = \frac{\left\{\begin{array}{c}\text{Market value of assets}\\ \text{liabilities including}\\ \text{contingent liabilities,}\\ \text{imitial capital share}\\ \text{resources}\end{array}\right\} - \left\{\begin{array}{c}\text{Brokerage,}\\ \text{commission etc}\end{array}\right\}}{\text{No. of units outstanding}}$$

The NAV of a fund is influenced generally by the following factors–

(i) Purchase and sale of the investment securities.

(ii) Valuation of all investment securities held.

(iii) Others assets and liabilities and

(iv) Units sold or redeemed.

3.14 Summing Up

In this unit we discussed the capital and its various instruments, structure and functions. We now know that capital market is a market dealing with financial assets having a maturity period of more than a year. It consist of primary market dealing with new issue and secondary market dealing with old issue. Further we learn about the stock indices of India viz BSE Sensex and NSE Nifty, and the derivative equity market and its nature and benefits. The concepts of NPV was also introduced.

3.15 Exercise

1. What is a capital market? What are its functions?
2. How is resource mobilised in a primary market?
3. How is a new issue priced under the book building process?
4. What is a stock market? What are its functions? How does a stock market operate?

5. What is a derivative market? What are the different types of financial derivatives?

6. Discuss about the govt securities market.

7. What is a mutual fund? What are the different types of mutual funds?

3.16 Reference and Suggested Readings

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Unit- 4
VALUATION OF FINANCIAL ASSETS

Content:

4.0 Introduction
4.1 Objectives
4.2 The Time Value of Money and Asset Pricing
4.3 The valuation of Debt Instruments
4.4 The Equilibrium Price and Quantity of Bonds
  4.4.1 Loanable Fund Approach
  4.4.2 Demand and Supply Approach
4.5 Valuing Stock and Other Assets
  4.5.1 Income Stocks and Growth Stocks
  4.5.2 Equilibrium Price and Value of Stock Transactions
4.6 Summing Up
4.7 Exercise
4.8 Reference and Suggested Readings

4.0 Introduction

This chapter will analyse how do the investors determine the value of a share or a bond and how do changes in taxes, inflation, risk or other economic variables affect the price of stocks or treasury bills. Again this chapter will show that various financial instruments will have different prices due to differences in payment schedule.

4.1 Objectives

This chapter has been designed to fulfil the following objectives–

- to have an idea about the present value of any asset.
- to determine the value of bonds, stocks and other financial instruments.
- to show how the supply and demand analysis can be used to analyse the impact of changes in such things as taxes and inflationary expectations on the prices of different financial instruments.

4.2 The time value of Money and Asset Pricing

The time value of money reflects the fact that Rs100 received in the future is worth less than Rs 100 today. The present value of an amount received in the future is the amount one has to invest today, at the prevailing interest rate, to end up with the future amount.

In a sense, present value analysis is the reverse of future value analysis. If one deposit Rs. 100 today in a bank account that pays 5% interest per year, at the end of the year you will have Rs. 105. Thus Rs. 105 is the future value of 100 today. Stated in reverse, Rs. 100 is the present value of Rs. 105 received in the future. The present value of a future sum of money depends on—

(i) The interest rate.

(ii) The length of time

(iii) The size of the future amount.

Suppose a single market interest rate, i, is available to all borrowers and lenders. The present amount to be invested at the interest rate is PV, the future value (FV) of the present amount in T year is—

$$FV_1 = PV + iPV$$

$$= (1+i)\ PV$$

After 2 years,

$$FV_2 = PV_1 + iPV_1$$

$$= (1+i)\ PV_1$$

$$= (1+i)\ (1+i)\ PV$$

$$= (1+i)^2 PV$$

After T years

$$FV_T = (1+i)^T PV \text{........(1)}$$

$$Or\ \ PV = \frac{FV^T}{(1+i)^T} \text{..........(2)}$$

Equation (2) tells us the present value (PV) of an amount (FV) received T years in the future when the interest rate is i% per year. It illustrates the time value of money.

(a) The PV of a future amount receivable is inversely related to the time in which that amount is received.

(b) The PV of a future amount (FV) receivable is inversely related to the interest rate.

Equation (2) can be adopted to account for the present value of a series of future values over T periods, i.e.

$$PV = \frac{FV_1}{(1+i)} + \frac{FV_2}{(1+i)^2} + \frac{FV_3}{(1+i)^3} + \ldots\ldots + \frac{FV_T}{(1+i)^T}$$

4.3 The valuation of Debt Instruments

A debt instrument is simply a written promise by a borrower to pay the owner of the instrument a specified amount in the future. When a debt instrument is first issued by a borrower and sold it to a lender in the primary market, the owner of the instrument is the original lender. However, debt instruments can often be resold is secondary market, so the current owner is not necessarily the original lender.

Debt instruments like treasury bills, banker's acceptances and some other corporate bonds are issued in the form of discount bonds. Discount bonds do not directly pay interest but are sold at a discount. Hence, the return from such bonds is the difference between their face value and purchase value.

Return from Discount Bonds=Face value-Purchase value.

(A) Discount Yield and Yield to Maturity:

The yield on a discount bond is a measure of the percentage annual return earned by the owner of the instrument. There are two methods of measuring the yield of debt instrument sold on a discount basis:-

(i) The Discount Yield Method.

(ii) The Yield to Maturity Method.

(i) The Discount Yield Method:

The discount yield, which is frequently used to measure yields on treasury bills, is defined as-

$$Discount\,Yield = \frac{FV - PP}{FV} + \frac{360}{Maturity\ periods\ (in\,days)}$$

Where , FV= Face value of the treasury bills.

PP= Price paid for the treasury bill.

This method understate the return because of two reasons-

(a) The formula is based on a 360- day year, not on the standard 365-day year.

(b) The return should be based on the instrument, but here it is based on the face value rather than on the purchase price as the denominator which does not represent the actual return to the investor.

(ii) The Yield to Maturity Method:

A measure of yield that does not suffer from these two deficiencies is the yield to maturity. The yield to maturity is the interest rate at which the amount used to purchase the (Treasury bill) discount bill would have to be invested to grow up the face value paid at maturity. The yield to maturity methods does away with the limitation of Discount Yield Method.

4.4 The Equilibrium Price and Quantity of Bonds

An inverse relationship exists between the price of a bond and the market interest rate. For this reason, it is important to understand how changes in the economy affect interest rates and thus bond prices. Here we introduced two different but equivalent methods of bond markets.

(a) One approach relates the interest rate to the supply of and demand for loanable funds- the Loanable Fund Approach.

(b) Other relates the prices of bonds to the supply of and demand for bonds- The Supply and Demand of Bonds Approach.

4.4.1 The Loanable Fund Approach

One way to analyse bond prices is to combine the interest rate determination and present value analysis into a convenient framework. The following figure illustrate this approach.

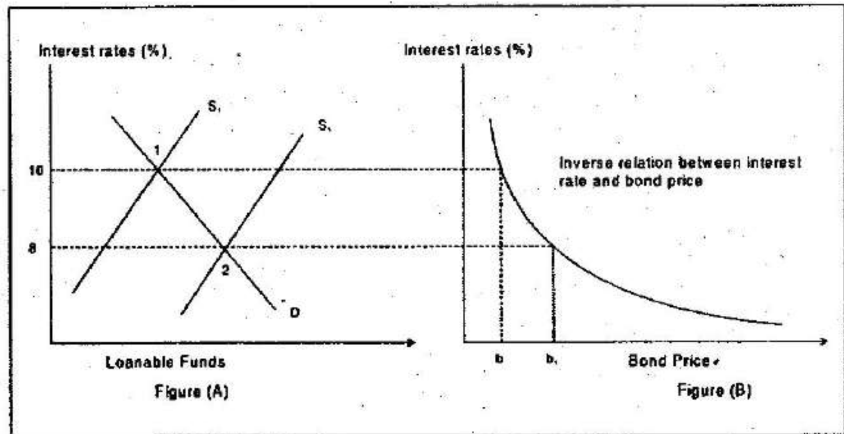


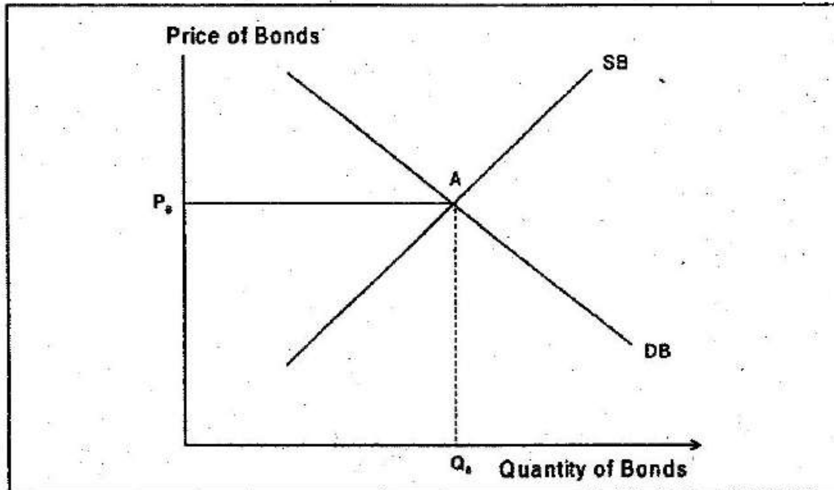
Figure A depicts the supply of and demand for loanable funds, with the interest rate on the vertical axis and loanable funds on the horizontal axis. This supply of loanable funds is provided by lenders, who are willing to offer more loanable funds at higher interest rates. The supply of loanable funds is therefore, an upward sloping curve, Borrowers, on the other hand, seek more funds as the interest rate falls. Thus, the demand curve for loanable fund slopes downward. Equilibrium is determined by the intersection of the supply and demand curves for loanable funds and changes with fluctuations in either supply or demand. For example, when the supply curve is S_1, equilibrium is at point 1 and the interest rate is 10%. If the supply of loanable funds increases to S_2, as would occur if the tax rate on interest income were reduced, equilibrium moves to point 2 and the equilibrium interest rate falls to 8%.

Figure B illustrates the inverse relationship between the interest rate and the price of a bond. When equilibrium is at point 1 in figure A, the interest rate is 10%. Tracing this interest rate over to figure B, we see that the corresponding price of a 10% coupon bond is 'b'. When equilibrium in figure A shifts to point 2, the interest rate falls to 8%. Tracing this over to figure B, we see that the price of the bond rises to b_1.

The above two figures shows a graphical techniques for determining the impact of changes in the supply of and demand for loanable funds on bond prices. Any changes is demand a supply that leads to a lower interest rate in figure A well lead to higher bond prices in figure B. Thus, bond prices will systematically fluctuate with changes in such variable as inflationary expectations taxes, budget deficits and wealth.

4.4.2 The Supply and Demand of Bonds Approach

An alternative way to determine the equilibrium prices of bonds is to directly graph the demand and supply curves for bonds as a functions of bond's price instead of using the two figure approach used in the loanable funds approach.



In the figure, A is the equilibrium point and P_B is the equilibrium price of a bond and Q_B is the equilibrium Quantity of the Bond.

Since a bond is a promise to pay a set of amount over the life of the bond and the coupon rate is assumed to be 10%, the lower the price of the bond, the higher the bond's yield to maturity. In turn the higher the yield to maturity relative to the market interest rate, the more attractive the bond is to investors. For this reason, the demand for a bond is a decreasing function of the bond's price, as illustrated by the curve D^B in the figure. This demand curve hold everything constant except the price and quantity of bonds sold. The demand curve for bonds is composed of those wishing to give up money today in return for the future stream of funds promised by the bond with a given coupon rate. The lower the price of the bond, the more bonds investors will want to hold.

The supplier of bonds, on the other hand, wish to sell the right to a specified amount over the life of the bond. Since the seller of a bond receives money today in return for future payments promised over the bond's life, the higher the price of a given bond, the more lucrative it is to sell the bond, holding other things constant. For this reason, the supply of bonds is an increasing function of the price of a bond, as illustrated by the curve S^B in the above figure.

Equilibrium in the bond market is determined by the intersection of the supply and demand for bonds, such as at point A. the equilibrium price of bond is P_B and equilibrium quantity of bond is Q_B.

4.5 Valuing Stock and other Assets

Unlike debt instrument, equity instrument represent the ownership of a share of a firm. Accordingly the owner of a share of common stock owns a share of the future earnings of the company issuing the stock. Individuals, insurance companies, mutual funds, and pension funds hold stocks in their portfolio and continually seek out stock that are undervalued.

The value of a firm at any point in time is the present value of the firm's future earnings.

$$\text{Value of a firm} = \frac{EE_1}{(1+i)} + \frac{EE_2}{(1+i)^2} + \frac{EE_3}{(1+i)^3} + \ldots\ldots + \frac{EE_T}{(1+i)^T}$$

Where, EE_T present the firm's expected earnings at the end of year T, 'i' is the interest rate, and t is the number of years over which the firm will operate.

Two aspects of corporate stock make stock valuation more difficult than valuing bond.

(a) The stream of future payments that occur to the bonds is known which makes it easier to value it. On the other hand, in stock, one purchases a share of the company's future expected earning which is uncertain making the valuation much more difficult.

(b) Again if the maturity of a bond is known, in contrast, the firm may operate forever or it could go bankrupt at any point of time.

In particular, the price of a share of stock is simply the value of the firm divided by the number of shares of stock issued by the company.

$$\text{Stock Price} = \frac{\textit{Value of the firm}}{\textit{Number of shares}}$$

(c) However once the firm is valued, price of the share of the stock is determined by dividing the value of the firm by the number of shares outstanding.

4.5.1 Income stocks and Growth Stocks

Income stocks are the stocks of companies that have a low level of retained earnings and thus pay most of their earnings to shareholders. Earnings paid

to shareholders are called dividends. And investor who purchase an income stock primarily purchase a future stream of dividend payment. In contrast, growth stocks are the stock of companies that retain most of their earnings to reinvest them within the firm. The purchase of a growth stock essentially purchases a company that acquires more and more assets today to pay higher dividends in the future.

4.5.2 Equilibrium Price and value of stock Transactions: Valuation and Price of Income Stock

The valuation of income stock is very difficult because the earnings and dividends paid out may vary considerably over time. Suppose a company does not retain any of its earnings but instead pays them all out as dividends. Furthermore, suppose the maker for the firm's product is stable and annual earnings are expected to remain constant at a level of EE from now on. In this case, the firm is expected to pay out dividends per share of $d = \frac{EE}{N}$ each year, where N is the number of shares of stock issued by the firm. Effectively the ownership of such a stock is a perpetuity that pay dividends per share of d= EE/N in every year from now on. The value of this perpetuity is the price of a share of this income stock (P_{IS}):

Price and value of Growth Stock:

Like income stock, the valuation of growth stock is too difficult because the firm's future earnings are far from certain.

Suppose a firm's earnings last year were EE, as investors expected. These earnings are expected to grow at a rate of 'g' each year from now on. Thus, at the end of this year, expected earnings are EE=(1+g)EE, at the end of next year they are expected to be $EE_{IS} = (1+g)^2 EE$ and so on. The present value of the growth firm in this case is given by

$$\text{Value of growth from} = \frac{EE_1}{(1+i)} + \frac{EE_2}{(1+i)^2} + \frac{EE_3}{(1+i)^3} + \ldots\ldots$$

$$= \sum_{t=1}^{\alpha} \frac{EE_t}{(1+i)^t}$$

Using the fact that $EE_t = (1+g)^t EE$, we can simplify equation (1) to

$$\text{Value of growth firm} = EE \times \sum_{t=1}^{\alpha} \left[\frac{1+g}{1+i}\right]^t$$

If expected earnings growth exceeded the interest rate (g>i), the expression would be infinite, reflecting the fact that the firm is infinitely valuable. Of cource, this is unlikely since a firm cannot continue to grow forever at a rate that exceeds the market rate of interest. The more plausible case is that where the expected growth rate is less than the market rate of interest.

When g<i, the formula for the value of a growth firm can be simplified to

$$\text{Value of growth firm} = EE \times \left[\frac{1+g}{i-g}\right]$$

If N shares of stock are outstanding, the price of a share of the firm's & stock will be the fractions $^1/_N$ of the value of the firm. In other words, the price of a growth stock will be

$$P_{GS} = \frac{EE}{N} \times \left(\frac{1+g}{i-g}\right)$$

Where, EE= expected earnings last year.

g= expected annual growth in those earnings

i= interest rate.

N= number of shares of stock outstanding.

4.6 Summing Up

This unit broadly dealt with the valuation of financial assets. The time value of money reflects the fact a sum of money received in future is worth less than the same amount of money received today. Again the valuation of debt instruments are done through the discount yield method and yield to maturity method. Also two methods of equilibrium price and quantity of bonds viz. the loanable fund approach were discussed in this unit. Further valuing of stock and other assets are also discussed in the unit.

4.7 Exercise

1. What is the time value of money?
2. How are debt instruments valued?

3. Discuss the Loanable Fund. Approach for the equilibrium pricing of bonds.

4. What are income stocks and growth stocks?

5. How is the price and value of growth stock deteremined?

4.8 Reference and Suggested Readings

1. S. B. Gupta: *"Monetary Economics: Institutions, Theory and Policy."*

2. Bharati V. Pathak: *"Indian Financial system"*, Pearson Publication.

3. Bodie, Merton and Cleeton: *"Financial Economics"*, Pearsons Education.

4. V.A. Anadani: *"Studies in Indian Financial System"*.

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Unit- 5
FINANCIAL SECTOR REFORMS

Contents:

- **5.0 Introduction**
- **5.1 Objectives**
- **5.1 Evolution of Banking System**
- **5.3 Banking Sector Reforms**
- **5.4 Reforms in the Capital Market**
- **5.5 Summing Up**
- **5.6 Exercise**
- **5.7 Reference and Suggested Readings**

5.0 Introduction

Financial sector reforms have long been regarded as an important part of the agenda for policy reform in developing countries. Traditionally, this was because they were expected to increase the efficiency of resource mobilization and allocation in the real economy which in turn was expected to generate higher rates of growth. More recently, they are also seen to be critical for macroeconomic stability. Developing countries can expect increasing scrutiny on this front by international financial institutions, and rating agencies and countries which fail to come up to the new standards are likely to suffer through lower credit ratings and poorer investor perceptions.

In this background it is both relevant and timely to examine how far India's financial sector measures up to what is now expected. Reform of the financial sector was identified, from the very beginning, as an integral part of the economic reforms initiated in 1991. As early as August 1991, the government appointed a high level Committee on the Financial System (the Narasimham Committee) to look into all aspects of the financial system and make comprehensive recommendations for reforms. The Committee submitted its report in November 1991, making a number of recommendations for reforms in the banking sector and also in the capital market. Shortly thereafter, the government announced broad acceptance of the approach of the Narasimham Committee and a process of gradualist reform in the banking sector and in the capital market was set in motion.

5.1 Objectives

The Present study is addressed on the backdrop of following two objectives–

- to evaluate the overall scenario of banking system in India;
- to know the reforms that took place in the financial sector;
- to develop a market-oriented, competitive, world-integrated, diversified, autonomous, transparent financial system;
- to increase the allocative efficiency of available savings and to promote accelerated growth of the real sector;
- to increase or bring about the effectiveness, accountability, profitability, viability, vibrancy, balanced growth, operational economy and flexibility, professionalism and depoliticisation in the financial sector;
- to increase the rate of return on real investment; and
- to build a financial infrastructure relating to supervision, audit, technology, and legal matters.

5.2 Evolution of Banking System in India

A bank is a financial institution that provides banking and other financial services to their Customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. There are also nonbanking institutions that provide certain banking services without meeting the legal definition of a bank. Banks are a subset of the financial services industry.

History of Indian Banking System:

The first bank in India, called The General Bank of India was established in the year1786.

The East India Company established The Bank of Bengal/Calcutta (1809), Bank of

Bombay(1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865, was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913,

Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935. At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955.Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19thJuly, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government's ownership. On the suggestions of Narsimham Committee, the Banking Regulation Act was amended in 1993 and thus gates for the new private sector banks were opened.

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

1949: Enactment of Banking Regulation Act.

1955:Nationalization of State Bank of India.

1959: Nationalization of SBI subsidiaries.

1961: Insurance cover extended to deposits.

1969:Nationalization of 14 major Banks.

1971: Creation of credit guarantee corporation.

1975: Creation of regional rural banks.

1980:Nationalization of seven banks with deposits over 200 Crores.

Nationalization:

By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensured about the possibility to nationalize the banking industry. Indira Gandhi, the-then Prime Minister of India expressed the intention of the Government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalization". The paper was received with positive enthusiasm.

Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969.

Jayaprakash Narayan, a national leader of India, described the step as a "Masterstroke of political sagacity" Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August, 1969. A second step of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second step of nationalization, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. The nationalized banks were credited by some; including Home minister P. Chidambaram, to have helped the Indian economy withstand the global financial crisis of 2007-2009.

Liberalization:

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier as UTI Bank), ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely government banks, private banks and

foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 49% with some restrictions.

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.

In March 2006, the Reserve Bank of India allowed Warburg Pincus to increase its stake in Kotak Mahindra Bank (a private sector bank) to 10%. This is the first time an investor has been allowed to hold more than 5% in a private sector bank since the RBI announced norms in 2005 that any stake exceeding 5% in the private sector banks would need to be voted by them. In recent years critics have charged that the non-government owned banks are too aggressive in their loan recovery efforts in connection with housing, vehicle and personal loans. There are press reports that the banks' loan recovery efforts have driven Defaulting borrowers to suicide.

Classification of Banking Industry in India:

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks and Specialized Financial Institutions (IDBI, ICICI, IFC etc.). The Unorganized sector, which is not homogeneous, is largely made up of money lenders and Indigenous bankers.

An outline of the Indian Banking structure may be presented as follows–

1. Reserve banks of India.

2. Indian Scheduled Commercial Banks.

   a) State Bank of India and its associate banks.

   b) Twenty nationalized banks.

   c) Regional rural banks.

   d) Other scheduled commercial banks.

3. Foreign Banks

4. Non-scheduled banks.

5. Co-operative banks.

Check Your Progress:

1. In which year was the first Bank in India establish?
2. Which banks were termed as "Presidency Banks"?
3. When was the RBI establish?
4. When was the first and second step of Nationalization of Banks take place in India?
5. What is Liberalization and its impact on banking industry?
6. How the Banking industry in India be classified?

5.3 Banking Sector Reforms

The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits our country too embarked upon economic reforms. The Government of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic.

The recommendations of the Narasimham Commission-I in 1991 provided the blue print for the first generation reforms of the financial sector, the period 1992-97 witnessed the laying of the foundations for reforms in the banking system. This period saw the implementation of prudential norms (relating to capital adequacy, income recognition, asset classification and provisioning, exposure norms etc.). The structural changes accomplished

during the period provided foundation of further reforms. Against such backdrop, the Report of the Narasimham Committee- II in 1998 provided the road map of the second generation reforms processes. V.V. Reddy noted that the first generation reforms were undertaken early in the reform cycle, and the reforms in the financial sector were initiated in a well-structured, sequenced and phased manner with cautious and proper sequencing, mutually reinforcing measures; complimentarily between forms in banking sector and changes in fiscal, external and monetary policies, developing financial infrastructure and developing markets. By way of visible impact, one finds the presence of a diversified banking system. Another important aspect is that apart from the growth of banks and commercial banks there are various other financial intermediaries including mutual funds. NBFCs, primary dealers housing financing companies etc., the roles played by the commercial banks in promoting these institutions are equally significant. Other important developments are:—

1) Financial regulation through statutory pre-emotions (Bank rate, deposit rate, Credit Reserve Ratio, Statutory Liquidity ratio) has been lowered while stepping up prudential regulations at the same time.

2) Interest rates have been deregulated, allowing banks the freedom to determine deposits.

3) Steps have been initiated to strengthen public sector banks, through increasing their autonomy recapitalization from the fiscal, several banks capital base has been written off and some have even returned capital to govt. Allowing new private sector banks and more liberal entry of foreign banks has infused competition.

4) A set of prudential measures have been stipulated to impart greater strength to the banking system and also, ensure their safety and soundness with the objective of moving towards international practices.

5) Measures have also been taken to broaden the ownership base of PSB; consequently, the private sector holding has gone up, ranging from 23% to 43%.

6) The banking sector has also witnessed greater levels of transparency and standards of disclosure.

7) As the banking system has liberalized and become increasingly market oriented, the financial markets have been concurrently developed; while the conduct of monetary policy has been tailored

to take into account the realities of the changing environment (switching to indirect instruments)

The reforms that took place are:

- Reduction of Statutory Liquidity Ratio (SLR) to 25 per cent over a period of five years.
- Progressive reduction in Cash Reserve Ratio (CRR).
- Phasing out of directed credit programs and redefinition of the priority sector.
- Stipulation of minimum capital adequacy ratio of 4 per cent to risk weighted assets.
- Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts.
- Imparting transparency to bank balance sheets and making more disclosures.
- Setting up of special tribunals to speed up the process of recovery of loans.
- Setting up of Asset Reconstruction Funds (ARFs) to take over from banks a portion of their bad and doubtful advances at a discount.
- Restructuring of the banking system, so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks and local banks confined to specific regions. Rural banks, including RRBs, confined to rural areas.
- Abolition of branch licensing
- Liberalizing the policy with regard to allowing foreign banks to open offices in India.
- Rationalization of foreign operations of Indian banks.
- Giving freedom to individual banks to recruit officers.
- Inspection by supervisory authorities based essentially on the internal audit and inspection reports.
- Ending duality of control over banking system by Banking Division and RBI.
- A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI.

- Revised procedure for selection of Chief Executives and Directors of Boards of public sector banks.
- Obtaining resources from the market on competitive terms by DFIs.
- Speedy liberalization of capital market.

1. Reduced CRR and SLR:

The Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are gradually reduced during the economic reforms period in India. By Law in India the CRR remains between 3-15% of the Net Demand and Time Liabilities. It is reduced from the earlier high level of 15% plus incremental CRR of 10% to current 4% level. Similarly, the SLR Is also reduced from early 38.5% to current minimum of 25% level. This has left more loanable funds with commercial banks, solving the liquidity problem.

2. Deregulation of Interest Rate:

During the economic reforms period, interest rates of commercial banks were deregulated. Banks now enjoy freedom of fixing the lower and upper limit of interest on deposits. Interest rate slabs are reduced from Rs.20 Lakhs to just Rs. 2 Lakhs. Interest rates on the bank loans above Rs.2 lakhs are fully decontrolled. These measures have resulted in more freedom to commercial banks in interest rate regime.

3. Fixing prudential Norms:

In order to induce professionalism in its operations, the RBI fixed prudential norms for commercial banks. It includes recognition of income sources. Classification of assets, provisions for bad debts, maintaining international standards in accounting practices, etc. It helped banks in reducing and restructuring Non-performing assets (NPAs).

4. Introduction of CRAR:

Capital to Risk Weighted Asset Ratio (CRAR) was introduced in 1992. It resulted in an improvement in the capital position of commercial banks, all most all the banks in India has reached the Capital Adequacy Ratio (CAR) above the statutory level of 9%.

5. Operational Autonomy:

During the reforms period commercial banks enjoyed the operational

freedom. If a bank satisfies the CAR then it gets freedom in opening new branches, upgrading the extension counters, closing down existing branches and they get liberal lending norms.

6. Banking Diversification:

The Indian banking sector was well diversified, during the economic reforms period. Many of the banks have stared new services and new products. Some of them have established subsidiaries in merchant banking, mutual funds, insurance, venture capital, etc. which has led to diversified sources of income of them.

7. New Generation Banks:

During the reforms period many new generation banks have successfully emerged on the financial horizon. Banks such as ICiCI Bank, HDFC Bank, UTI Bank have given a big challenge to the public sector banks leading to a greater degree of competition.

8. Improved Profitability and Efficiency:

During the reform period, the productivity and efficiency of many commercial banks has improved. It has happened due to the reduced Non-performing loans, increased use of technology, more computerization and some other relevant measures adopted by the government.

The Future of Banking Reform Prior to the economic reforms, the financial sector of India was on the crossroads. To improve the performance of the Indian commercial banks, first phase of banking sector reforms were introduced in 1991 and after its success; government gave much importance to the second phase of the reforms in 1998. The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits adverse exchange rate effects etc. our country too embarked upon economic reforms. The govt. of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic.

Rationale of Banking Sector Reforms:

To cope up with the changing economic environment, banking sector needs some dose to improve its performance. Since 1991, the banking sector was faced with the problems such as tight control of RBI, eroded productivity and efficiency of public sector banks, continuous losses by public sector banks year after year, increasing NPAs, deteriorated portfolio quality, poor customer service, obsolete work technology and unable to meet competitive environment. Therefore, Narasimham Committee was appointed in 1991 and it submitted its report in November 1991, with detailed measures to improve the adverse situation of the banking industry. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability.

First Phase of Banking Sector Reforms:

The first phase of banking sector reforms essentially focused on the following:

1. Reduction in SLR & CRR
2. Deregulation of interest rates
3. Transparent guidelines or norms for entry and exit of private sector banks
4. Public sector banks allowed for direct access to capital markets
5. Branch licensing policy has been liberalized
6. Setting up of Debt Recovery Tribunals
7. Asset classification and provisioning
8. Income recognition
9. Asset Reconstruction Fund (ARF)

Second Phase of Banking Sector Reforms:

In spite of the optimistic views about the growth of banking industry in terms of branch expansion, deposit mobilization etc., several distortions such as increasing NPAs and obsolete technology crept into the system, mainly due to the global changes occurring in the world economy. In this context, the government of India appointed second Narasimham Committee under the chairmanship of Mr. M. Narasimhan to review the first phase of banking reforms and chart a programme for further reforms necessary to strengthen India's financial system so as to make it internationally competitive.

The committee reviewed the performance of the banks in light of first phase of banking sector reforms and submitted its report with some more focus and new recommendations. There were no new recommendations in the second Narasimhan Committee except the followings:

- Merger of strong units of banks
- Adaptation of the 'narrow banking' concept to rehabilitate weak banks.

As the process of second banking sector reforms is going on since 1999, one may say that there is an improvement in the performance of banks. However, there have been many changes and challenges now due to the entry of our banks into the global market.

Third Phase of banking sector reforms rethinking for financial sector reforms have to be accorded, restructuring of the public sector banks in particular, to strengthen the Indian financial system and make it able to meet the challenges of globalization. The on-going reform process and the agenda for third reforms will focus mainly to make the banking sector reforms viable and efficient so that it could contribute to enhance the competitiveness of the real economy and face the challenges of an increasingly integrated global financial architecture.

Historically, a crucial difference between public and private sector banks has been their willingness to lend to the priority sector. The recent broadening of the definition of priority sector has mechanically increased the share of credit from both public and private sector banks that qualify as priority sector. The share of priority sector lending from public sector banks was 42.5 percent in 2003, up from 36.6 percent in 1995. Private sector lending has shown a similar increase from its 1995 level of 30 percent. In 2003 it may have surpassed for the first time ever public sector banks, with a share of net bank credit to the priority sector at 44.4 percent to the priority sector.

It could be noted that there has been no banking crisis at the same time, efficiency of banking system as a whole, measured by declining spread has improved. This is not say that they have no challenges. There are emerging challenges, which appear in the forms of consolidation; recapitalization, prudential regulation weak banks, and non-performing assets, legal framework etc. needs urgent attention.

Conclusion:

In the post-era of IT Act, global environment is continuously changing and providing new direction, dimensions and immense opportunities for the

banking industry. Keeping in mind all the changes, RBI should appoint another committee to evaluate the on-going banking sector reforms and suggest third phase of the banking sector reforms in the light of above said recommendations. Need of the hour is to provide some effective measures to guard the banks against financial fragilities and vulnerability in an environment of growing financial integration, competition and global challenges. The challenge for the banks is to harmonize and coordinate with banks in other countries to reduce the scope for contagion and maintain financial stability. However, a few trends are evident, and the coming decade should be as interesting as the last one.

Check Your Progress:

1. When did the Government of India introduce "Economic Reform"?
2. The recommendation of which Commission provided the Blue-Print for the first generation reforms of the financial sector?
3. What were the reforms that took place in the Banking sector?
4. Give a rationale for banking sector reforms.

5.4 Reforms in the Capital Market

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

Trading was at that time limited to a dozen brokers, their trading place was under a banyan tree in front of the Town Hall in Bombay. These stockbrokers organized an informal association in 1875-Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmedabad, also industrial and trading centres; came up later. The Bombay Stock

Exchange was recognized in May 1927 under the Bombay Securities Contracts Control Act, 1925.

The capital market was not well organized and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence period also, the size of the capital market remained small. During the first and second five-year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. The public sector undertakings were healthier than the private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closed, supervised and controlled the timing ,composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades. 50, there is a need for capital market reforms which are mentioned below:

1. **Control over Issue of Capital:** A major initiative of liberalization was the repeal of the Capital Issues (Control) Act, 1947 in May 1992. With this, Government's control over issue of capital, pricing of the issues, fixing of premium and rates of interest of debentures etc. ceased and the market was allowed to allocate resources to competing uses. In the interest of investors, SEBI issued Disclosure and Investor Protection (DIP) guidelines. The guidelines allow issuers, complying with the eligibility criteria, to issue securities the securities at market determined rates. The market moved from merit based to disclosure based regulation.

2. **Establishment of Regulator:** A major initiative of regulation was establishment of a statutory autonomous agency, called SEBI, to provide reassurance that it is safe to undertake transactions in securities. It was empowered adequately and assigned the responsibility to (a) protect the interests of investors in securities. (b) Promote the development of the securities market, and (c) regulate the securities market. Its regulatory jurisdiction extends over corporate in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market.

All market intermediaries are registered and regulated by SEBI. They are also required to appoint a compliance officer who is responsible for monitoring compliance with securities laws and for redressal of investor grievances.

3. **Screen Based Trading:** A major developmental initiative was a nation-wide on-line fully- automated screen based trading system (SBTS) where a member can punch into the computer, quantities of securities and the prices at which he likes to transact and the transaction is executed as soon as it finds a matching sale or buy order from a counter party. SBTS electronically matches orders on a strict price/time priority and hence cut down on time, cost and risk of error, as well as on fraud resulting in improved operational efficiency. It allowed faster incorporation of price sensitive information into prevailing prices, thus increasing the informational efficiency of markets. It enabled market participants to see the full market on real-time, making the market transparent. It allowed a large number of participants, irrespective of their geographical locations, to trade with one another simultaneously, improving the depth and liquidity of the market - over 10,000 terminals creating waves by clicks from over 400 towns / cities in India. It provided full anonymity by accepting orders, big or small, from members without revealing their identity, thus providing equal access to everybody. it also provided a perfect audit trail, which helps to resolve disputes by logging in the trade execution process in entirety.

4. **Risk Management:** A number of measures were taken to manage the risks in the market so that the participants are safe and market integrity is protected. These include:

a. *Trading Cycle:* The trading cycle varied form 14 days for and settlement took another fortnight. Often this cycle was not adhered to. This was euphemistically often described at T + anything. Many things could happen between entering into a trade and its performance providing incentives for either of the parties to go back on its promise. This had on several occasions led to defaults and risks in settlement. in order to reduce large open position, the trading cycle was reduced over a period of time to a week initially. Rolling settlement on T +5 basis was introduced in phases. All scrips moved to rolling settlement from December 2001. T +5 gave way to T +3 from April 2002 and T +2 from April 2003.

b. *Dematerialization:* Settlement system on Indian Stock Exchanges gave rise to settlement risk due to the time that elapsed before trades are settled. Trades were settled by physical movement of paper. This had two aspects. First, the settlement of trade in stock exchanged by delivery of shares by the seller and payment by the Purchaser. The process of physically moving the securities from the seller to the ultimate buyer through the seller's broker and buyer's broker took time with the risk of delay somewhere along the chain. The second aspect related to transfer of shares in favour of the purchaser by the company. The system of transfer of ownership was grossly inefficient as every transfer involved physical movement of paper securities to the issuer for registration, with the change of ownership being evidenced by an endorsement on the security certificate. In many cases the process of transfer took much longer, and a significant proportion of transactions ended up as bad delivery, delivery due to faulty compliance of paperwork. Theft, forgery, mutilation of certificates and other irregularities were rampant, and in addition the issuer had the right to refuse the transfer of a security.

c. *Derivatives:* To assist market participants to manage risks better through hedging, speculation and arbitrage, SC(R)A was amended in 1995 to lift the ban on options securities. The SC(R)A was amended further in December 1999 to expand the definition of securities to include derivatives so that the whole regulatory framework governing trading of securities could apply to trading of derivatives also. A three-decade old ban on forward trading, better known as BADLA, which had lost its relevance and was hindering introduction of derivatives trading, was withdrawn. Derivative trading took off in June 2000 on two exchanges.

d. *Settlement Guarantee:* A variety of measures were taken to address the risk in the market. Clearing corporations emerged to assume counter party risk. Trade and settlement guarantee funds were set up to guarantee settlement of trades irrespective of default by brokers. These funds provide full motivation and work as central counter party. The Exchanges / clearing corporations monitor the positions of the brokers on real times basis.

SEBI is working continuously and in close co-ordination with the regulated and the government, to improve market design to bring in further efficiency and transparency to market and make available newer and newer products

to meet the varying needs of market participants, while protecting investors in securities. The aim is to make Indian securities market a model for other jurisdictions to follow and make SEBI the most dynamic and respected regulator globally. Some of the initiatives on which SEBI is working are:–

- set up a national institute to build a cadre of professionals to meet the specialized functions in the securities market. We are also working on a nationwide certification to ensure that any person or agent working with a market intermediary has the necessary knowledge and skill to render quality intermediation.
- corporatize and demutualize exchanges where the ownership, management and trading rights would be with three different sets of people in order to avoid conflict of interest.
- introduce market wide straight through processing from trade initiation to settlement.
- migrate to T+1 rolling settlement.
- continuously review and upgrade accounting standards, disclosures, corporate governance practices in the interest of investors.
- continuously review and amend the various regulations to bring them in tune with dynamics of market requirements.
- introduce new products in the market to meet all kinds of needs of market participants.

These were some important reforms that took place in the Capital Market.

Check Your Progress:

1. What was the chief trading center in India until the end of the nineteenth century?
2. Why the Capital Market was not organized and developed during the British Rule in India?
3. Briefly outline the position of the Capital Market in the Post-independence period.
4. Briefly mention the capital market reforms.

5.5 Summing Up

In this unit the financial sector reforms dealt in specially two banking sector and capital reforms in India. An introduction was given to the evolution of

banking system in India, starting with the history of banking system and its classification into organized and unorganized sectors. Further banking system in India is discussed in context of nationalization and liberalization.

5.6 Exercises

1. Give a brief outline of the evolution of Banking System in India.
2. Describe how Nationalization and Liberalization process affect the banking industry in India.
3. What were the banking sector reforms that take place in the banking industry?
4. Give a brief outline of reforms that took place in the Capital Market.

5.7 Reference and Suggested Readings

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