BANKING AND FINANCE
VI SEMESTER

ADDITIONAL COURSE
(In lieu of Project)

BA ECONOMICS

(2011 Admission)

UNIVERSITY OF CALICUT
SCHOOL OF DISTANCE EDUCATION

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UNIVERSITY OF CALICUT

SCHOOL OF DISTANCE EDUCATION

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BANKING AND FINANCE

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COURSE TITLE: BANKING AND FINANCE

Module I : Commercial Banking

Meaning of Banks – Origin and growth – Functions of Commercial banks – Role of Commercial Banks in Economic Development – Credit Creation – Meaning and basic concepts

Module II : Reserve Bank of India (RBI)

Management and Structure of RBI - Functions of RBI - Monetary policy - Objectives of monetary policy – Instruments of Monetary Policy

Module III : Money Market

Meaning of Mone market – Constituents of Money market – Call money market – Collateral Loan market, Acceptance market, Bill market – Institutions of Money market – Commercial Banks, Central Bank, Acceptance houses, Non-banking financial intermediaries – Features of Indian Money market.

Module IV : Capital Market


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MODULE I

COMMERCIAL BANKING

Evolution of Banking (Origin and development of Banking)

The evolution of banking can be traced back to the early times of human history. The history of banking begins with the first prototype banks of merchants of the ancient world, which made grain loans to farmers and traders who carried goods between cities. This began around 2000 BC in Assyria and Babylonia. In olden times people deposited their money and valuables at temples, as they are the safest place available at that time. The practice of storing precious metals at safe places and loaning money was prevalent in ancient Rome.

However modern Banking is of recent origin. The development of banking from the traditional lines to the modern structure passes through Merchant bankers, Goldsmiths, Money lenders and Private banks. Merchant Bankers were originally traders in goods. Gradually they started to finance trade and then become bankers. Goldsmiths are considered as the men of honesty, integrity and reliability. They provided strong iron safe for keeping valuables and money. They issued deposit receipts (Promissory notes) to people when they deposit money and valuables with them. The goldsmith paid interest on these deposits. Apart from accepting deposits, Goldsmiths began to lend a part of money deposited with them. Then they became bankers who perform both the basic banking functions such as accepting deposit and lending money. Money lenders were gradually replaced by private banks. Private banks were established in a more organised manner. The growth of Joint stock commercial banking was started only after the enactment of Banking Act 1833 in England.

Evolution and Growth of banking in India

India has a long history of financial intermediation. The first bank in India to be set up on modern lines was in 1770 by a British Agency House. The earliest but short-lived attempt to establish a central bank was in 1773. India was also a forerunner in terms of development of financial markets. In the beginning of 18th century, British East India Company launched a few commercial banks. Bank of Hindustan(1770) was the first Indian bank established in India. Later on, the East India Company started three presidency banks, Bank of Bengal(1806), Bank of Bombay(1840) and Bank of Madras(1843) These bank were given the right to issue notes in their respective regions. Allahabad bank was established in 1865 and Alliance Bank in 1875. The first bank of limited liability managed by Indians was Oudh Commercial Bank founded in 1881. Subsequently, the Punjab National Bank was established in 1894. In the Beginning of the 20th century, Swadeshi movement encouraged Indian entrepreneurs to start many new banks in India. Another landmark in the history of Indian banking was the formation of Imperial bank of India in 1921 by amalgamating 3 presidency banks. It is the Imperial Bank which performed some central banking functions in India. A number of banks failed during the first half of the 20th Century. It affected the people’s belief and faith in Banks.
By independence, India had a fairly well developed commercial banking system in existence. In 1951, there were 566 private commercial banks in India with 4,151 branches, the overwhelming majority of which were confined to larger towns and cities. Savings in the form of bank deposits accounted for less than 1 per cent of national income, forming around 12 per cent of the estimated saving of the household sector. The Reserve Bank of India (RBI) was originally established in 1935 by an Act promulgated by the Government of India, but as a shareholder institution like the Bank of England. After India's independence, in the context of the need for close integration between its policies and those of the Government, the Reserve Bank became a state-owned institution from January 1, 1949. It was during this year that the Banking Regulation Act was enacted to provide a framework for regulation and supervision of commercial banking activity.

By independence, India had a fairly well developed commercial banking system in existence. Reserve bank of India was nationalized in the year 1949. The enactment of the Banking Companies Act 1949 (Later it was renamed as Banking Regulation Act) was a bold step in the history of banking in India. In 1955, Imperial Bank of India was nationalized and renamed as State bank of India(SBI). The SBI started number of branches in urban and rural areas of the country.

In 1967, Govt introduced the concept of social control on banking sector. Nationalization of 14 commercial banks in 1969 was a revolution in the history of banking in India. Six more commercial banks were nationalized in 1980. Other landmarks in the history of Indian banking were the establishment of National Bank for Agricultural and Rural Development (1988), merger of New Bank of India with Punjab National Bank (1993), merger of State Bank of Saurashtra with SBI (2008) and the merger of State Bank of Indore with SBI (2010).

At present, there are 26 Public sector banks, 21 private sector banks, 32 Foreign banks and 82 Regional Rural Banks in India.

**Origin of the word “bank”**

The term ‘Bank’ is derived from the Italian word ‘banca’, Latin word ‘bancus’ and French word ‘banque’ which means bench. In fact, Medieval European bankers transacted banking activities displaying coins on a bench.

Another view is that ‘bank’ might be originated from German word ‘banc’ which means joint stock fund.

**Definitions**

Definition of bank varies from countries to countries. Under English common law, a banker is defined as a person who carries on the business of banking, which is specified as-conducting current accounts for his customers, paying cheques drawn on him/her, and collecting cheques for his/her customers.

According to H. L. Hart, a banker is “one who in the ordinary course of his business honours cheques drawn upon him by person from and for whom he receives money on current accounts”.

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*Banking & Finance*
Banking Regulation Act of 1949 defines banking as “accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise”.

**Characteristics of Banker/Banking**

1. Banker deals with others’ money
2. Banks repay deposits either on demand or after the expiry of specified period
3. They utilise deposits for lending/investment
4. They perform subsidiary services and innovative functions
5. Banking should be dominant part of business of bank
6. A bank should hold itself out as a bank

**Importance of banks**

Bankers play very important role in the economic development of the nation. The health of the economy is closely related to the growth and soundness of its banking system. Although banks create no new wealth but their fund collection, lending and related activities facilitate the process of production, distribution, exchange and consumption of wealth. In this way, they become very effective partners in the process of economic development.

1. Banks mobilise small, scattered and idle savings of the people, and make them available for productive purposes
2. By offering attractive interests, Banks promote the habit of thrift and savings
3. By accepting savings, Banks provide safety and security to the surplus money
4. Banks provide convenient and economical means of payments
5. Banks provide convenient and economical means of transfer of funds
6. Banks facilitate the movement of funds from unused regions to useful regions
7. Banking help trade, commerce, industry and agriculture by meeting their financial requirements
8. Banking connect saving people and investing people.
9. Through their control over the supply of money, Banks influence the economic activities, employment, income level and price level in the economy.

**Types of banks**

Functional classification
1. Commercial banks/Deposit banks

Banks accept deposits from public and lend them mainly for commercial purposes for comparatively shorter periods are called Commercial Banks. They provide services to the general public, organisations and to the corporate community. They are oldest banking institution in the organised sector. Commercial banks make their profits by taking small, short-term, relatively liquid deposits and transforming these into larger, longer maturity loans. This process of asset transformation generates net income for the commercial bank. Many commercial banks do investment banking business although the latter is not considered the main business area. The commercial banking system consists of scheduled banks (registered in the second schedule of RBI) and non scheduled banks. Features of Commercial banks are:

- They accept deposits on various accounts.
- Lend funds to organisations, trade, commerce, industry, small business, agriculture etc by way of loans, overdrafts and cash credits.
- They are the manufacturers of money.
- They perform many subsidiary services to the customer.
- They perform many innovative services to the customers.

2. Industrial banks/Investment banks

Industrial banks are those banks which provide fixed capital to industries. They are also called investment banks, as they invest their funds in subscribing to the shares and debentures of industrial concerns. They are seen in countries like US, Canada, Japan, Finland, and Germany. In India industrial banks are not found. Instead, special industrial finance corporations like IFC and SFC have been set up to cater to the needs of industries. Features of Industrial Banks are:

- Participate in management.
- Advise industries in making right investment
- Advise govt. on matters relating to industries

3. Agricultural banks

Agricultural banks are banks which provide finance to agriculture and allied sectors. It is found in almost all the countries. They are organised generally on co-operative basis. In India, Co-operative banks are registered under the Co-operative Societies Act, 1912. They generally give credit facilities to small farmers, salaried employees, small-scale industries, etc. Co-operative Banks are available in rural as well as in urban areas. Agricultural banks are of two types:

Agricultural co-operative banks: They provide short term finance to farmers for purchasing fertilizers, pesticides and seeds and for the payment of wages.
Land Development Banks: They provide long term finance for making permanent improvement on land. They assist to purchase machinery, equipments, installation of pump sets, construction of irrigation works etc.

4. **Exchange banks**

Exchange banks finances foreign exchange business (export, import business) of a country. Special exchange banks are found only in some countries. The main functions of exchange banks are remitting money from one country to another country, discounting of foreign bills, buying and selling gold and silver, helping import and export trade etc.

5. **Savings bank**

Savings banks are those banks which specialise in the mobilisation of small savings of the middle and low income group. In India, saving bank activities are done by commercial banks and post offices. Features of savings banks are;

- Mobilise small and scattered savings
- Promote habit of thrift & savings
- Keep only small portion in hand and invest major part in govt. securities
- They do not lend to general public.

6. **Central / National banks**

It is the highest banking & monetary institution in a country. It is the leader of all other banks. Since it is occupying a central position, it’s known as Central Bank. It is operating under state’s control and is not a profit motive organisation. Reserve Bank of India (India), Bank of Canada (Canada), Federal Reserve System(USA) etc are the examples of Central Banks. The main functions of a Central Bank are;

- Monopoly of currency issue
- Acts as banker to the govt.
- Serves as bankers’ bank
- Act as controller of credit
- Custodian of nation’s gold and foreign exchange reserve.

**Functions of commercial banks**

Functions of a Commercial Bank can be classified into three.

1. Principal/ Primary/ Fundamental functions
2. Subsidiary/Secondary/Supplementary functions

3. Innovative functions.

**Principal functions**

Commercial banks perform many functions. They satisfy the financial needs of the sectors such as agriculture, industry, trade, communication, so they play a very significant role in a process of economic social needs. The functions performed by banks, since recently, are becoming customer-centred and are widening their functions. Generally, the functions of commercial banks are divided into two categories; primary functions and the secondary functions. Two ‘acid test’ functions of commercial banks are Accepting deposits and Lending loans. These functions along with credit creation, promotion of cheque system and investment in Government securities form basic functions of commercial banks. The secondary functions of commercial banks include agency services, general utility services and innovative services.

1. Receiving deposits

Most important function of a commercial bank is to accept deposit from those who can save but cannot profitably utilise this savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts such as current account, Savings bank account, Fixed Deposit account, Recurring deposit account and Derivative Deposit account.

**Features of Current Accounts**

- It is generally opened by trading & industrial concerns.
- It is opened not for profit or savings but for convenience in payments
- Introduction is necessary to open the account.
- Any number of transactions permitted in the account.
- Withdrawals are generally allowed by cheque
- Deposit is repayable on demand
- No interest is allowed but incidental charges claimed.
- Minimum balance requirement varies from bank to bank.

**Features of Saving Bank (SB) accounts**

- It is generally opened by middle/low income group who save a part of their income for future needs
- Introduction is necessary to open the account if cheque facility is allowed.
There are some restrictions on number of withdrawals.

Fair interest (less than FD) is offered on the deposits of this account.

Features of Fixed Deposit accounts

- It is generally opened by small investors who do not want to invest money in risky industrial securities like shares.
- No introduction is necessary to open the account.
- No maximum limit for investing.
- Minimum period of investment is 15 days
- Withdrawal is allowed only after the expiry of a fixed period.
- Withdrawal is generally allowed by surrendering FD Receipt
- Higher rate of interest is offered on the deposits of this account.

Features of Recurring Deposit accounts / Cumulative Deposit account.

- This account is meant for fixed income group, who can deposit a fixed sum regularly.
- The amount is paid back along with interest after a specified period.
- High rate of interest is offered on recurring deposits.
- Passbook is the means through which deposits and withdrawals are made

2. Lending of funds

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income. Modern banks give mostly secured loans for productive purposes. In other words, at the time of advancing loans, they demand proper security or collateral. Generally, the value of security or collateral is equal to the amount of loan. This is done mainly with a view to recover the loan money by selling the security in the event of non-refund of the loan.

Commercial banks lend money to the needy people in the form of Cash credits, Term loans, Overdrafts (OD), Discounting of bills, Money at call or short notice etc.

(i) Cash Credit: In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under this set up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.
(ii) **Term loans**: A term loan is a monetary loan that is repaid in regular payments over a set period of time. In other words, a loan from a bank for a specific amount that has a specified repayment schedule and a floating interest rate is called Term loan. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. It may be classified as short term, medium term and long term loans.

(iii) **Over-Drafts**: It is the extension of credit from a bank when the account balance reaches zero level. Banks advance loans to its customer’s up to a certain amount through over-drafts, if there are no deposits in the current account. For this, banks demand a security from the customers and charge very high rate of interest. Overdraft facility will be allowed only for current account holders.

(iv) **Discounting of Bills of Exchange**: This is the most prevalent and important method of advancing loans to the traders for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. While discounting a bill, the Bank buys the bill (i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a discount charge to the customer's account. The transaction is practically an advance against the security of the bill and the discount represents the interest on the advance from the date of purchase of the bill until it is due for payment. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

(v) **Money at Call and Short notice**: Money at call and short notice is a very short-term loan that does not have a set repayment schedule, but is payable immediately and in full upon demand. Money-at-call loans give banks a way to earn interest while retaining liquidity. These are generally lent to other institutions such as discount houses, money brokers, the stock exchange, bullion brokers, corporate customers, and increasingly to other banks. ‘At call’ means the money is repayable on demand whereas ‘At short notice’ implies the money is to be repayable on a short notice up to 14 days.

3. **Investment of funds in securities**

   Banks invest a considerable amount of their funds in government and industrial securities. In India, commercial banks are required by statute to invest a good portion of their funds in government and other approved securities. The banks invest their funds in three types of securities—Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc. Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural banks etc.

4. **Credit Creation**

   When a bank advances a loan, it does not lend cash but opens an account in the borrower’s name and credits the amount of loan to this account. Thus a loan creates an equal amount of deposit. Creation of such deposit is called credit creation. Banks have the ability to create credit many times more than their actual deposit. (The process of credit creation is explained in the last part of the module in detail)
5. Promoting cheque system

Banks also render a very useful medium of exchange in the form of cheques. Through a cheque, the depositor directs the banker to make payment to the payee. In the modern business transactions by cheques have become much more convenient method of settling debts than the use of cash. Through promoting cheque system, the banks ensure the exchange of accounted cash. At present, CTS (Cheque Truncation System) cheques are used by Indian Banks to ensure speedy settlement of transactions in between banks. In contrast to the declining importance of cheques, the use of electronic payment instruments at the retail level has been growing rapidly.

Subsidiary functions

1. Agency services: Banks act as an agent on behalf of the individual or organisations. Banks, as an agent can work for people, businesses, and other banks, providing a variety of services depending on the nature of the agreement they make with their clients. Following are the important agency services provided by commercial banks in India.

- Commercial Banks collect cheques, drafts, Bill of Exchange, interest and dividend on securities, rents etc. on behalf of customers and credit the proceeds to the customer’s account.
- Pay LIC premium, rent, newspaper bills, telephone bills etc
- Buying and selling of securities
- Advise on right type of investment
- Act as trustees (undertake management of money and property), executors (carry out the wishes of deceased customers according to will) & attorneys (collect interest & dividend and issue valid receipt) of their customers.
- Serve as correspondents and representatives of their customers. In this capacity, banks prepare I-Tax returns of their customers, correspond with IT authorities and pay IT of their customers.

2. General Utility Services: In addition to agency services, modern banks performs many general utility services for the community. Following are the important general utility services offered by Commercial Banks

- Locker facility: Bank provide locker facility to their customers. The customers can keep their valuables such as gold, silver, important documents, securities etc. in these lockers for safe custody.
- Issue travellers’ cheques: Banks issue traveller’s cheques to help their customers to travel without the fear of theft or loss of money. It enable tourists to get fund in all places they visit without carrying actual cash with them.
- Issue Letter of Credits: Banks issue letter of credit for importers certifying their credit worthiness. It is a letter issued by importer’s banker in favour of exporter informing him that issuing banker undertakes to accept the bills drawn in respect of exports made to the importer specified therein.
• Act as referee: Banks act as referees and supply information about the financial standing of their customers on enquiries made by other businessmen.

• Collect information: Banks collect information about other businessmen through the fellow bankers and supply information to their customers.

• Collection of statistics: Banks collect statistics for giving important information about industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.

• Underwriting securities: Banks underwrite securities issued by government, public or private bodies.

• Merchant banking: Some banks provide merchant banking services such as capital to companies, advice on corporate matters, underwriting etc.

**Innovative Functions**

The adoption of Information and Communication technology enable banks to provide many innovative services to the customers such as;

1. **ATM services**

   Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money. It is used to withdraw money, check balance, transfer funds, get mini statement, make payments etc. It is available at 24 hours a day and 7 days a week.

2. **Debit card and credit card facility**

   Debit card is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services. It can be used in ATMs, Point of Sale terminals, e-commerce sites etc. Debit card removes the need for cheques as it immediately transfers money from the client's account to the business account. Credit card is a card issued by a financial institution giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short-term financing.

3. **Tele-banking**

   Telephone banking is a service provided by a bank or other financial institution, that enables customers to perform financial transactions over the telephone, without the need to visit a bank branch or automated teller machine

4. **Internet Banking**

   Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer verification. Online banking can be used to check balances, transfer money, shop online, pay bills etc.
5. Bancassurance:

It means the delivery of insurance products through banking channels. It can be done by making an arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base. Banks can earn additional revenue by selling the insurance products, while insurance companies are able to expand their customer base without having to expand their sales forces.

6. Mobile Banking:

Mobile banking is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone. Customers can access their banking information and make transactions on Savings Accounts, Demat Accounts, Loan Accounts and Credit Cards at absolutely no cost.

7. Electronic Clearing Services:

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a Clearing House. This is normally for bulk transfers from one account to many accounts or vice-versa. This can be used both for making payments like distribution of dividend, interest, salary, pension, etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax etc.

8. Electronic Fund Transfer/National Electronic Fund Transfer (NEFT):

National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. In NEFT, the funds are transferred based on a deferred net settlement in which there are 11 settlements in week days and 5 settlements in Saturdays.

9. Real Time Gross Settlement System (RTGS):

It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis. 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

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<th>RTGS</th>
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<tr>
<td>• Based on Deferred Net Settlement (DNS)</td>
<td>• Based on Gross Settlement</td>
</tr>
<tr>
<td>• Fastest method of money transfer</td>
<td>• Slower than RTGS transfer</td>
</tr>
<tr>
<td>• Complete transactions in batches</td>
<td>• Complete transactions individually</td>
</tr>
<tr>
<td>• There is no minimum limit of transactions.</td>
<td>• Minimum amount to be remitted is 2 lakhs</td>
</tr>
<tr>
<td>• Settlement on hour basis. (11 settlements from 9am to 7pm)</td>
<td>• Settlement in real time (at the time the transfer order is processed)</td>
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Role of commercial banks in a developing economy

A well developed banking system is necessary pre-condition for economic development of any economy. Apart from providing resources for growth of industrialisation, banks also influence direction in which these resources are utilised.

In underdeveloped and developing nations banking facilities are limited to few developed cities and their activities are focussed on trade & commerce paying little attention to industry & agriculture.

Commercial banks contribute to a country’s economic development in the following ways.

1. Capital formation

Most important determinant of economic development is capital formation. It has 3 distinctive stages

- Generation of savings
- Mobilisation of savings
- Canalisation of saving

Banks promote capital formation in all these stages. They promote habit of savings by offering attractive rate of return for savers. Banks are maintaining different types of accounts to mobilise savings aiming different types of customers. They make widespread arrangements to collect savings by opening branches even in remote villages. Moreover, banks offer their resources for productive activities only.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allow money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy to monetised sectors.
4. **Influencing economic activity**

   They can directly influence the economic activity & pace of economic development through its influence on

   (a) The rate of interest (reduction in rates make investment more profitable and stimulates economic activity)

   (b) Availability of credit. (Through Credit creation banks helps in increasing supply of purchasing power)

5. **Implementation of monetary policy**

   Well developed banking system is necessary for effective implementation of monetary policy. Control and regulation of credit is not possible without active co-operation of banks.

6. **Promotion of trade and industry**

   Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade & industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and BoE as a medium of exchange has revolutionised the internal and international trade which in turn accelerated the pace of industrialisation.

7. **Encouraging right type of industries**

   In a planned economy it is necessary that banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

8. **Regional development**

   Banks can play a role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

9. **Development of agricultural & other neglected sectors**

   Under developed economies primarily agricultural economies and majority of the population live in rural areas. So far banks were paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must diversify their activities not only to extend credit to trade, but also to provide medium and long term loans to industry and agriculture.

**Credit Creation**

(‘Loans create deposits’ and ‘deposits create loans’)

Banks, unlike other financial institutions, have a peculiar ability to create credit i.e., to expand their demand deposits as a multiple of their cash reserves. This is because of the fact that
demand deposits of the banks serve as the principal medium of exchange, and in this way, the banks manage the payment system of the country. In short multiple expansion of deposits is called credit creation.

When a bank extends loans it is not directly paid to the borrower, but is only credited to his account and a cheque book is given. Thus every bank loan creates an equivalent amount of derivative deposit. By using this deposit, banker can again extend loan to some other parties after keeping a specified amount as reserve. Thus with a little cash in hand the banks can create additional purchasing power to a considerable degree.

Credit can be created by a single bank or by more than one banker. When it is created by more than one banker, it is called multiple credit creation.

Imagine that the CRR maintained by the bank is 20%. Now, Mr. A deposits Rs.10,000 with Federal Bank. The bank need not keep the entire cash in reserve to meet its day to day demand for cash. After keeping a 20% (Rs.2,000) in hand, bank extends a credit of Rs.8,000 (initial excess) to Mr. B by opening a credit account in his name. This creates another derivative deposit of Rs.8,000 in the bank. By keeping 20% (Rs.1,600) of this in hand bank again advances Rs.6,400 to Mr.C and he deposits the same in his bank, SBT. This creates a primary deposit to SBT, and it extend a credit of Rs.5120 to Mr.D after keeping 1,280 (20%) in the bank. This process continues until the initial primary deposit of Rs.10,000 lead to the creation of total deposits (both primary and derivative) of Rs.50,000 or initial excess reserve of Rs. 8,000 creates a total derivative deposit of Rs.40,000 (8,000+6,400+5120+4096+……... = 40,000)

From the above illustration, it is clear that the initial primary deposit of Rs.10,000 in Federal Bank leads to the expansion of total deposit of Rs. 50,000. Initial excess reserve of Rs.8,000 creates multiple derivative deposits of Rs. 40,000. Credit creation is 5 times (Rs.40,000) of the initial excess reserve (Rs.8,000)

Credit multiplier (5) is =

\[
\text{Total derivative deposits} \div \text{Initial excess reserve}
\]

\[
\frac{4000}{800} = 5
\]

Or 1/ CRR i.e., 1/20%

**Destruction of credit:**

Banks create credit by advancing loans. Similarly banks can destroy credit by reducing loans. Extend of destruction depends on CRR. Higher the CRR greater will be the destruction of credit.
Various ways of creating money

- by advancing loans
- by allowing Overdrafts
- by providing Cash Credits
- by discounting bill of exchange
- by purchasing securities

Limitations of credit creation

Bank cannot expand deposits to an unlimited extent by granting loans and advances even though this process of granting loans and advances is profitable to them. Their power to create credit is subject to the following limitations:

- Amount of Cash available with the Bank: Credit creation depends on the amount of cash available with the banking system, greater will be the credit creation and vice versa.

- Cash Reserve Ratio: CRR is the minimum cash required to be maintained by a bank with the Reserve Bank of India (RBI). CRR sets the limit for the creation of credit. Higher the CRR smaller will be the credit creation and vice versa.

- Leakages: The credit creation by the banks is subject to certain conditions. If there is any leakage in this process, the credit creation by the banks will be limited. In credit creation, it is expected that the banks lend the entire amount of excess deposits over the minimum statutory reserve. If there is any downfall in such lending, it will affect the creation of credit to that extent. Leakage may occur either because of unwillingness of banks to utilise their surplus funds for granting loans or unwillingness of borrowers to keep whole amount of loan in the bank. Both will lead to lesser credit creation.

- Security for loans: The securities acceptable to the bank places a limit on credit creation by the banks. While lending, the banks insist upon the securities from the customers. All types of assets are not acceptable to banks as securities. If borrowers are not able to provide sufficient security, credit creation is not possible.

- Credit policy of banks: If banks want to create excess reserves, the credit creation will be limited to that extent.

- Monetary Policy of the Central Bank: The capacity of credit creation by banks is largely dependent upon the policies followed by the Central Bank from time to time. The total supply of cash depends upon the policy of the Central Bank.

- Banking habit of the people: The banking habit of the people also sets the limit for the capacity of banks to create credit. The volume of employed population, monetary habits, etc., determines the amount of cash that the public wishes to hold. If people prefer to make transactions by
using cash instead of using cheques, the banks will be left with smaller amount of cash and there will be lesser credit creation.

- Effect of Trade Cycle: The effects of trade cycles also place the limitation on the credit creation, i.e., the conditions of inflation and deflation set a limit on the creation. During the period of economic prosperity there will be greater demand for bank loans and therefore, they can create greater volume of credit. But in times of recession, there is no prosperity and the business people will hesitate to borrow.

**Leaf-cannon criticism**

Walter Leaf and Edwin Cannon raised serious objection against theory of credit creation. They are of the view that it is the depositor who creates credit and not the banker, because, credit creation is possible only if depositors do not take home their deposits. The banks cannot loan more than what is deposited by customers. But this criticism was rejected by Crowther both on theoretical and on practical grounds citing the empirical evidences of the UK.

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MODULE II
RESERVE BANK OF INDIA

Introduction

As per the recommendation of the Central Banking Enquiry (Hilton Young) Commission, an Act was passed in the parliament called RBI Act in 1934 and accordingly RBI started its operation in April 1935 with a share capital of Rs. 5 crores. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. On establishment it took over the function of management of currency from Govt. of India and power of credit control from the then Imperial Bank of India.

The Central Office of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937. The Central Office is where the Governor sits and where policies are formulated. RBI was taken over by GOI in 1948 by passing the RBI (transfer of public ownership) Act 1948. It started functioning as a state owned and state controlled central bank from 1st January 1948 onwards.

The Reserve Bank of India (RBI) is now the apex financial institution of the country which is entrusted with the task of controlling, supervising, promoting, developing and planning the financial system. RBI is the queen bee of the Indian financial system which influences the commercial banks’ management in more than one way. The RBI influences the management of commercial banks through its various policies, directions and regulations. Its role in banking is quite unique. In fact, the RBI performs the four basic functions of management, viz., planning, organizing, directing and controlling in laying a strong foundation for the functioning of commercial banks.

RBI possesses special status in our country. It is the authority to regulate and control monetary system of our country. It controls money market and the entire banking system of our country.
**Preamble**

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

"...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

**Management**

The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act.

The organization structure of RBI consists of a Central Board and Local Board.

**Central Board:** The general supervision and control of the bank’s affairs is vested in the Central Board of Directors which consists of 20 member team including a Governor, 4 Deputy Governors and 15 Directors (of which 4 are from local boards, and one is a finance secretary of Central Government). All these persons are appointed or nominated by Central Govt. The chairman of the Board and its Chief Executive authority is the Governor. Governors and Deputy Governors hold office for such a period as fixed by Central Government not exceeding 5 years and are eligible for reappointment. Directors hold office for 4 years and their retirement is by rotation.

As a matter of practical convenience, the Board has delegated some of its functions to a committee called the Committee of the Central Board. It meets once in a week, generally Wednesdays. There are sub committees to assist committees such as building committee and staff sub-committee.

**Local Board:** For each regional areas of the country viz., Western, Eastern, Northern and Southern, there is a Local Board with head quarters at Bombay, Calcutta, New Delhi and Madras. Local boards consist of 5 members each appointed by the Central Government. The functions of the local boards are to advise the central board on local matters and to represent territorial and economic interests of local cooperative and indigenous banks; advice on such matters that may generally be referred to them and perform such duties as the Central Board may delegate to them.

The Central office of the RBI, located at Mumbai is divided into several specialized departments. The main departments are:

1. Issue Department: - It arranges for the issue and distribution of currency notes among the different centers of the country.
2. Banking Department: - It deals with Government transactions and maintains the cash reserves of the commercial banks.
3. Department of Banking development:- It is concerned with the development of banking facilities in the unbanked and rural areas in the country.
4. Department of Banking operations: - This department supervises and controls the working of the banking institutions in the country.

5. Non-Banking Companies Department: - It regulates the activities of non-banking financial companies existing in the country.

6. Agricultural credit Department: - This department studies the problems connected with the agricultural credit in the country.

7. Industrial finance Department: - It is concerned with the provision of finance to the industrial units in the country.

8. Exchange control Department: - The entire business of sale and purchase of foreign exchange is conducted by this department.

9. Legal Department: - The main function of this department is to give legal advices to the other departments of RBI.

10. Department of Research and Statistics: - This department is concerned with conducting research on problems relating to money, credit, finance, production etc.

**Objectives of RBI**

Prior to the establishment of the Reserve Bank, the Indian financial system was totally inadequate on account of the inherent weakness of the dual control of currency by the Central Government and of credit by the Imperial Bank of India.

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as: “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.”

The important objectives are:

1. To act as Monetary Authority: Formulates implements and monitors the monetary policy to maintain price stability and ensuring adequate flow of credit to productive sectors.

2. To Regulate and supervise the financial system of the country: It prescribes broad parameters of banking operations within which the country's banking and financial system functions. It helps to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3. To Manage the Exchange Control: Manages the Foreign Exchange Management Act, 1999 to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. To issue currency: Issues and exchanges or destroys currency and coins not fit for circulation to give the public adequate quantity of supplies of currency notes and coins and in good quality.
5. To undertake developmental role: RBI performs a wide range of promotional functions to support national objectives.

6. To undertake related Functions by acting as:

- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks: maintains banking accounts of all scheduled banks.
- Owner and operator of the depository (SGL-Subsidiary General Ledger account) and exchange (NDS)

Negotiated Dealing System is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments that will facilitate electronic submission of bids/application for government bonds.

To sum up the objectives include:

1. To manage the monetary and credit system of the country.
2. To stabilizes internal and external value of rupee.
3. For balanced and systematic development of banking in the country.
4. For the development of organized money market in the country.
5. For facilitating proper arrangement of agriculture finance and be in successful for maintaining financial stability and credit in agricultural sector.
6. For proper arrangement of industrial finance.
7. For proper management of public debts.
8. To establish monetary relations with other countries of the world and international financial institutions.
9. For centralization of cash reserves of commercial banks.
10. To maintain balance between the demand and supply of currency.
11. To regulate the financial policy and develop banking facilities throughout the country.
12. To remain free from political influence while making financial decisions.
13. To assist the planned process of development of the Indian economy. Besides the traditional central banking functions, with the launching of the five-year plans in the country, the Reserve Bank of India has been moving ahead in performing a host of developmental and promotional functions, which are normally beyond the purview of a traditional Central Bank.
Functions of RBI

RBI performs various traditional banking function as well as promotional and developmental measures to meet the dynamic requirements of the country. Main functions of RBI can be broadly classified into three. These are

I. Monetary functions or Central banking functions
II. Supervisory functions
III. Promotional and Developmental functions.

I. Monetary functions include

A. Issue of currency notes
B. Acting as banker to the Government
C. Serving as banker of other banks
D. Controlling credit
E. Controlling foreign exchange operations

A. Issue of currency notes: -

Under Section 22 of the Reserve Bank of India Act of 1934, the Reserve Bank of India is given the monopoly of note issue. Now RBI is the sole authority for the issue of currency notes of all denominations except one rupee notes and coins in the country. One rupee notes and coins are issued by Ministry of Finance of GOI. The RBI has a separate department called the Issue Department for the issue of currency notes

Since 1956 system of Note Issue changed from Proportional Reserve System to minimum reserve system. Under Proportional reserve system of note issue, not less than 40% of the total volume of notes issue by the RBI was to be covered by gold coins, bullion and foreign securities. But under the Minimum reserve system of note issue, RBI is required to maintain a minimum reserve of gold or foreign securities or both against the notes issued. No maximum limit is fixed on the volume of notes. RBI maintains gold and foreign exchange reserves of Rs.200 crores of which 115 crores is in gold & balance in foreign securities, Govt. of India securities, eligible commercial bills, Pro-notes of NABARD for any loans etc.

This change from Proportional Reserve system to Minimum Reserve system is made because of two major reasons. Firstly, the planned economic development of the country called for an increased supply of money, which could not be had under the proportional reserve system. Secondly, the foreign exchange held as reserve by the Reserve bank had to be released for financing the five year plans. In short, this was to enable the expanding currency requirements of the economy.

B. Acting as Banker to government: -

The Reserve bank act as a banker to the Central and State Governments. As a banker to the Government RBI acts in three capacities, viz., (a) as a banker, (b) as a financial agent, and (c) as a financial advisor
(a) As a banker: - RBI renders the following services

1. Accepts deposits from the Central and State Government.
2. Collects money on behalf of Government.
3. Makes payments on behalf of the Government, in accordance with their instructions.
4. Arranges for the transfer of funds from one place to another on behalf of the Governments.
5. Makes arrangements for the supply of foreign exchange to the Central and State Governments.
6. It maintains currency chests with treasuries and other agencies in places prescribed by the Government of India. These chests are supplied with sufficient currency notes to meet the requirements for the transactions of the Government.
7. Short term advances are granted to Central and State Governments for a period not exceeding three months. These advances are granted up to a certain limit without any collateral securities.
8. In times of emergencies like war, extraordinary loans are also granted to the Governments by the RBI.

(b) As a financial agent: - The services given are

1. Acts as an agent of the Central and State Governments in the matter of floatation of loans. On account of Reserve Bank’s intimate knowledge of the financial markets, it is able to obtain the best possible terms for the Government in this matter. Further by coordinating the borrowing programmers of the various Governments, it is able to minimize the adverse effects of Government borrowings on the money and securities market.
2. On behalf of Central Government RBI sells treasury bills of 90 days maturity at weekly auctions and secures short-term finance for the Central Government. Apart from that RBI also sells adhoc treasury bills of 90 day’s maturity to the State Governments, Semi-Government Departments and foreign central banks on behalf of the Central Government.
3. RBI manages and keeps the accounts of the public debts of the Central and State Governments. It arranges for the payment of interest and principal amount on the public debt on the due dates.
4. As an agent RBI also represents Government of India in the International institutions like the IMF, the IBRD etc.

The Reserve Bank is agent of Central Government and of all State Governments in India except for that of Jammu and Kashmir and Sikkim.

(c) As a Financial Adviser: - renders following services

1. It advises the Central and State Government on all financial and economic matters such as the floating of loans, agricultural and industrial finance etc.
2. Advice on matters of International finance is also given to Central Government.
3. It collects the recent information on current economic and financial developments in India and abroad, with the help of its Research and Statistics Department and keeps Government informed periodically.
C. **Banker’s bank:** -

RBI acts as banker to Scheduled banks. Scheduled Banks include commercial banks, foreign exchange banks, public sector banks, state co-operative banks and the regional rural banks. As a bankers’ bank it renders the following services:

1. **It holds a part of the cash balances of the commercial banks:** Every commercial bank in India is required to keep with the Reserve Bank a cash balance of not less than 6% of its demand and time liabilities. This rate can be increased up to 20%. The two main purposes of maintaining cash reserve by commercial banks are as follows. Firstly to protect the interest of the depositors, secondly to enable the Reserve Bank to accommodate the commercial banks on times of difficulties and thirdly the Reserve Bank can control the credit created by the commercial banks by varying the statutory cash reserve requirements.

2. **It acts as the clearing house:** By acting as clearing house the Reserve bank helps the member banks in the settlement of the mutual indebtedness without physical transfer of cash.

3. **It provides cheap remittance facilities** to the commercial banks

4. **It provides financial accommodation to the commercial banks:** At times of financial crisis the RBI is the lender of last resort for the commercial banks. Financial assistance is given by The Reserve bank either by rediscounting eligible bills or by granting loans against approved securities.

D. **Control of Credit:** -

RBI undertakes the responsibility of controlling credit in order to ensure internal price stability and promote sufficient credit for the economic growth of the country. Price stability is essential for economic development. To control credit, RBI makes use of both quantitative and qualitative weapons by virtue of the powers given to it by Reserve Bank of India Act of 1934 and the Indian Banking Regulation Act of 1949. These weapons are listed below.

(a) **Quantitative weapons**

1. **Bank rate policy:**

   Bank rate is the lending rate of central bank. It is the official minimum rate at which central bank of a country rediscounts the eligible bills of exchange of the commercial banks and other financial institutions or grants short term loans to them. By increasing bank rate, RBI can make bank credit costlier.

2. **Open Market Operations:**

   RBI Act authorizes the RBI to engage in the purchase of securities of central and State Government and such other securities as specified by Central Govt. But by and large, its open market operations are confined to Central Government Securities and to a very limited extend to State Government Securities.

   RBI uses this weapon to offset the seasonal fluctuations in money market. When there is an excessive supply of money, RBI sells the securities in the open market. In that way RBI is able
to withdraw the excess money from circulation. But when there is shortage of money supply in the market, it purchases securities from the open market and as a result, more money is arrived at for circulation.

3. Variable Cash reserve ratio:

Under the RBI Act of 1934, every scheduled and non-scheduled bank is required to maintain a fixed percentage of total time and demand liabilities as cash reserve with RBI. It is called statutory Cash Reserve Ratio (CRR). An increase in CRR reduces lending capacity of the bank and a decrease in CRR increases the lending capacity. RBI can prescribe a CRR ranging up to 15% which is at present 4% (as on Jan ’2014).

4. Variable Statutory Liquidity Ratio

According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (As on Jan ’2014).

5. Repo Rate and Reverse Repo Rate

Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00 %.

b. Selective credit controls (Qualitative weapons)

1. Credit Ceiling

In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.
2. Credit Authorization Scheme

Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI’s prior authorization for sanctioning any fresh credit beyond the authorized limits.

3. Moral Suasion

Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

4. Regulation of margin requirements:

Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For eg, if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

5. Issuing of directives:

BRA empowers RBI to issue directives to banks and banks are bound to comply with such directives. RBI directives may relate to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or individual
- Rate of interest and other terms and conditions on which loans may be given

E. Control of foreign Exchange operations

One of the central banking functions of the RBI is the control of foreign exchange operations. For the control of foreign exchange business, the RBI has set up a separate department called the Exchange Control Department in September, 1939. This Department has been granted wide powers to regulate the foreign exchange business of the country. As the central bank of India, it is the responsibility of the RBI to maintain the external value of the Indian rupee stable. India being member of the IMF, the RBI is required to maintain stable exchange rates between the Indian rupee and the currencies of all other member countries of the I.M.F.

Besides maintaining stable exchange rates, RBI also acts as the custodian of the foreign exchange reserves of the country. The foreign exchange reserves of the country held by RBI includes Euro, U.S. dollars, Japanese yen etc.
RBI also acts as the administrator of exchange control. It ensures that the foreign exchange reserves of the country are utilized only for approved purposes and the limited foreign exchange reserves of the country are conserved for the future.

II. Supervisory functions

RBI has been given several supervisory powers over the different banking institutions in the country. The supervisory functions relate to licensing and establishment, branch expansion, liquidity of assets, amalgamation, reconstruction and liquidation of commercial banks and co-operative banks.

III. Promotional and developmental functions

RBI is also performing promotional and developmental functions. These functions include the following:

a) Provision of Agricultural Credit: - For the promotion of agricultural credit RBI has set up a separate department called the Agricultural Credit Department. It has also set up two funds namely – 1. The National Agricultural Credit (Long term operations) and 2. The National Agricultural credit (stabilization) fund for facilitating Long term, Medium term and Short term finance for agricultural purposes.

b) Provision for Industrial finance: - RBI has played a very significant role in the field of industrial finance by helping the setting up of a number of public sector industrial finance corporations that provide short term, medium term, and long term finance for industrial purpose. These industrial finance corporations include 1. Industrial finance Corporation of India (IFCI), 2. State Finance Corporations (SFC), Industrial Development Bank of India (IDBI), 3.Industrial Reconstruction Corporation of India (IRCI), 4. Refinance Corporation of India, and 5. Unit Trust of India (UTI).

Besides the above RBI also renders the Credit Guarantee Scheme which intends to give protection to banks against possible losses in respect of their advances to small scale industrial units.

c.) Development of Bill Market: - A bill market is a place where short term bill of 3 month duration are generally discounted or rediscounted. RBI plays a very important role in the promotion of Bill Market as a well-developed bill market is essential for the smooth functioning of the credit system.

d.) Collection and publication of statistics on financial and economic matters: - These functions of RBI are extremely useful to the Government in knowing and solving the various economic problems. They are also of immense help to financial institutions, business and industry and for general public.

e.) Miscellaneous functions:- RBI has established training centers for staff for its own staff and other banks. Bankers’ training college Mumbai, National Institute of Bank Management Mumbai, Staff Training College Madras, and College of Agricultural Banking at Pune are the institutions run by RBI.
Monetary policy

Meaning

Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising its control over interest rates in order to maintain price stability and achieve high economic growth. In India, the central monetary authority is the Reserve Bank of India (RBI). It is so designed as to maintain the price stability in the economy.

Monetary policy can be either expansionary or contractionary. Under an expansionary policy the total supply of money are increased in the economy more rapidly than usual, and under contractionary policy the money supply expands more slowly than usual or even shrinks. Expansionary policy is traditionally used to reduce unemployment in a recession by lowering interest rates in the hope that easy credit will encourage the entrepreneurs to begin new enterprise or expand their existing businesses. Contractionary policy is intended to slow inflation in order to avoid the resulting distortions and deterioration of asset values.

Definition

According to Prof. Harry Johnson,

"A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

According to A.G. Hart,

"A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

Objectives of the monetary policy

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, stability and social justice. The objectives of the monetary policy of India, as stated by RBI, is:

1. Price Stability:

   It implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favorable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability. All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both
are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

2. **Rapid Economic Growth**:

   It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

3. **Controlled Expansion of Bank Credit**

   One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

4. **Exchange Rate Stability**:

   Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.

5. **Balance of Payments (BOP) Equilibrium**:

   Many developing countries like India suffer from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be achieved.

6. **Equal Income Distribution**:

   Many economists used to justify the role of the fiscal policy in maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attaining an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.
7. **Neutrality of Money:**

Economist such as **Wicksteed, Robertson** has always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

8. **Full Employment:**

The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is Zero unemployment. In that sense the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.

9. **Promotion of Fixed Investment:**

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

10. **Promotion of Exports and Food Procurement Operations**

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

11. **Desired Distribution of Credit**

Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.

12. **Equitable Distribution of Credit**

The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people

13. **To Promote Efficiency**

It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.
14. Reducing the Rigidity

RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

Instruments of Monetary policy:

Instruments of Monetary operations involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain Price Stability, Stable exchange rate, Healthy Balance of Payment, Financial stability, Economic growth etc. RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation. RBI takes into account the following monetary policies:

The instruments of monetary policy and control can be classified into two:-

I. Quantitative weapons (Indirect Instruments): Quantitative methods or weapons are those which control total volume or size of credit in the country without any reference to the purpose for which it is used. They affect indiscriminately all sections of the economy. Important quantitative weapons are:

   a. Bank rate policy
   b. Open market operations
   c. Variable Cash Reserve Ratio (CRR)
   d. Variable Statutory Liquidity Ratio (SLR)
   e. Liquidity Adjustment Facility (LAF) includes Repo rate and Reverse Repo rate
   f. Marginal Standing Facility (MSF)

II. Qualitative weapons (Direct Instruments): Qualitative weapons are those which regulate the quality of credit i.e., uses to which credit is put. They are concerned with the encouragement of credit to productive uses, and discouragement of credit to non essential activities. The main qualitative credit control weapons are:

   a. Regulation of margin requirements
   b. Regulation of consumer credit
   c. Issuing of Directives
   d. Rationing of credit
   e. Credit authorisation scheme
f. Moral suasion

g. Direct action

The details review of the quantitative methods of monetary policy are discussed here under.

a. **Bank rate policy:** Section 49 of RBI Act, 1934 defines the bank rate as “the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the Act”. Thus bank rate is the minimum rate at which the RBI is ready to rediscount eligible bills of exchange or other commercial papers presented to it by the commercial banks or grant loans to the commercial banks against approved securities. By manipulating the bank rate the RBI can control the bank credit and the general price level of the country.

By raising the bank rate, it can make the bank credit costlier and thereby cause contraction of bank credit. By lowering the bank rate, on the other hand, it can make the bank credit cheaper and thereby cause contraction of bank credit.

Though the bank rate policy of RBI has had some effects on some occasions, on a whole, it has not been very effective. The ineffectiveness of bank rate in controlling credit is due to the following factors.

- A major portion of credit requirements is met by indigenous bankers, who are not under the control of RBI.
- Lack of co-ordination between various sectors of money market: There is a wide disparity of interest rates in Indian money market.
- Market rate of interest does not change in same proportion of bank rate.
- There is scarcity of eligible bills in Indian money market and rediscounting is not so popular in India.
- Banks are left with large deposits even after meeting the minimum statutory reserves. So they did not feel the necessity of seeking financial assistance from RBI.

b. **Open Market Operations(OMO):** An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market.

Apart from outright purchase and sales of securities, RBI also involves in the Switch operations i.e., purchase of one type of securities against the sales of another type of securities. The main objectives of open market operations are:

**Objectives of OMO**

- To facilitate borrowing of funds by the govt. from the public.
• To maintain the prices of Government Securities stable. When there is a fall, RBI purchases them to raise their prices.

• To offset the seasonal changes in the supply of money in money market.

• To support the bank rate policy.

• To control credit.

c. **Variable Cash Reserve Ratio (CRR):** Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances. Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa. RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimham committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of October 2013, the CRR is 4.00 percent.

  Though the RBI was empowered to make use of the weapon of variable cash reserve ratio as early as 1951, the RBI made use of this weapon only since March, 1960.

d. **Variable Statutory Liquidity ratio (SLR):** The current SLR is 23%. According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (as on jan’2014)

e. **Liquidity Adjustment Facility (LAF)** includes Repo rare and Reverse Repo: LAF consists of daily infusion or absorption of liquidity on a repurchase basis, through repo (liquidity injection) and reverse repo (liquidity absorption) auction operations through government securities as collateral securities.

  - Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.

  - Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation.

  This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75% and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00%

f. **Marginal Standing Facility** - This was instituted under which the scheduled commercial banks can borrow over night at their discretion up to one percent of their respective NDTL at 100 basis points above the repo rate to provide a safety valve against unanticipated liquidity shocks.
The detailed explanations of the major qualitative methods are given here under.

a. **Regulation of margin requirement**: Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

b. **Issuing of Directives**: Under section 21, of the BRA of 1949, RBI is empowered to issue directives to any particular bank or to the entire banking system and the banks are bound to comply with the directives issued to them. RBI directives can be in regard to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or person.
- Rate of interest and other terms and conditions on which loans may be given

c. **Credit Ceiling**: In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

d. **Credit Authorization Scheme**: Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI’s prior authorization for sanctioning any fresh credit beyond the authorized limits.

e. **Moral Suasion**: Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

f. **Direct Action**: This method is rarely used by RBI. But it is adopted when all other measures fail. It implies refusal of RBI to extend rediscounting facilities to banks which follows unsound banking practices and such other measures.
Key Indicators and their rates as on January 2014

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td>7.52%</td>
</tr>
<tr>
<td>Bank rate</td>
<td>9%</td>
</tr>
<tr>
<td>CRR</td>
<td>4.00%</td>
</tr>
<tr>
<td>SLR</td>
<td>23%</td>
</tr>
<tr>
<td>Repo rate</td>
<td>8.00%</td>
</tr>
<tr>
<td>Reverse repo rate</td>
<td>7.00%</td>
</tr>
<tr>
<td>Marginal Standing facility rate</td>
<td>9.00%</td>
</tr>
</tbody>
</table>

References:

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MODULE III

MONEY MARKET

MEANING OF MONEY MARKET

Market is a place where goods are bought and sold. It is aggregate of buyers and sellers of a certain good or service and the transactions between them. Financial market is a type of market that deals in financial assets and credit instruments such as currency, cheques, bank deposits, shares, debentures, govt. securities, treasury bills, bill of exchange etc.

On the basis of maturity of assets that is dealt with, financial market is divided into two categories viz., money market & capital market. **Money market** deals in highly liquid short term financial assets (maturity ranging between several days to one year) whereas **capital market** deals in long term financial instruments (say, with a maturity of more than one year) like equity shares.

But money market does not refer to a particular place where money is borrowed and lent by the parties concerned. Mostly, transactions between takes place over phone or mail or through agents. No personal contact or presence of the two parties is essential.

Thus money market refers to the institutional arrangements facilitating borrowing and lending of short term funds. According to Crowther “Money Market is the collective name given to the various firms and institutions that deal in various grades of near money”.

RBI defined money market as “a market for short term financial assets that are close substitute for money, facilitate the exchange of money, in primary and secondary markets”

**Constituents of Indian money market**

Main constituents of money market are the lenders who supply funds and borrowers who demand short term credit. Suppliers of funds may belong to either

1. Unorganised sector whose activities are not controlled or coordinated by RBI (comprising of indigenous bankers and village money lenders) or
2. Organised sector (comprising of RBI, commercial banks, Development Financial Institutions, co-operative banks and other financial institutions such as LIC)

The main borrowers of short term funds are central government, state governments, local authorities (such as municipal corporations), traders and industrialists, farmers, exporters, importers and general public.
Sub- markets of organised money market

1. Call/Notice/Term money market

Call/Notice money is an amount borrowed or lent on demand for a very short period say, a few hours to 14 days. If the period is less than 24 hours it is ‘Call money’. They can be recalled on demand and that is why it is known as call money. If the period of loan is more than one day and up to 14 days it is called 'Notice money'. Term money refers to borrowing/lending of funds for a period exceeding 14 days. No collateral security is required to cover these transactions. Banks are the major borrower and lender of call money. Banks with temporary deficit of funds, to meet their CRR requirements, form the demand side and banks with temporary excess of funds from the supply side of call money market. In India major suppliers of call money are Non-Banking Financial Institutions like LIC, GIC etc. It is a completely inter-bank market hence non-bank entities are not allowed access to this market. Interest rates in the call and notice money market are ‘market determined’. In view of the short tenure of such transactions, both the borrowers and the lenders are required to have current accounts with the RBI.

2. Commercial bill market:

A bill of exchange is a written, unconditional order by one party (the seller of goods/the drawer) to another (the buyer/the drawee) to pay a certain sum, either immediately (a sight bill) or on a fixed date (a term bill), for payment of goods and/or services received. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks. Maturity of the bill is generally three months.

If the bill is payable at a future date and the seller needs money during the currency of the bill then he may approach his bank for discounting the bill. The maturity proceeds (face value of discounted bill), from the drawee, will be received by the bank.

If the bank needs fund during the currency of the bill then it can rediscount the bill already discounted by it in the commercial bill rediscount market at the market related discount rate.

The bill discounting market is not so popular in India. It barely constitute 10% of total bank credit. The establishment of Discount and Finance House of India (DFHI) in 1988 has been an important step towards the development of an active discount market in India. In India, the major reason cited for the non-development of bill financing is the hesitation of the industry and trade to subject themselves to the rigours of bill discipline.

3. Bankers acceptance

Bankers’ acceptances date back to the 12th century when they emerged as a means to finance uncertain trade, as banks bought bills of exchange at a discount. A short-term debt instrument issued by a firm that is guaranteed by a commercial bank. Banker's acceptances are issued by firms as part of a commercial transaction. It is a promised future payment which is accepted and guaranteed by a bank and drawn on a deposit at the bank. The banker's acceptance specifies the amount of money, the date, and the person to which the payment is due. After
acceptance, the draft becomes an unconditional liability of the bank. The party that holds the banker's acceptance may keep the acceptance until it matures, and thereby allow the bank to make the promised payment, or it may sell the acceptance at a discount today to any party willing to wait for the face value payment of the deposit on the maturity date.

Banker's acceptances make a transaction between two parties who do not know each other safer because they allow the parties to substitute the bank's credit worthiness for that who owes the payment.

4. Treasury bill (T bill) market

Treasury Bill Market refers to the market where treasury bills are bought and sold. T Bill is a promissory note issued by RBI on behalf of central/state government. It is issued to meet short term requirements of the govt. TBs are highly secured and liquid as repayment is guaranteed by RBI. Treasury bills are available for a minimum amount of Rs.25000 and in multiples of Rs. 25000. Treasury bills are issued at a discount and are redeemed at par.

Types of T-bills

In India, there are 2 types of treasury bills viz

1. Ordinary or regular
2. 'Ad-hoc' known as 'ad hocs'.

Ordinary are issued to the public and other financial institutions for meeting the short-term financial requirements of the Central Government. These are freely marketable and they can be bought and sold at any time and they have a secondary market also.

On the other hand, 'ad-hocs' are always issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI and the RBI is authorised to issue currency notes against them. They aren't marketable in India. Holders of these bills can always sell them back to the RBI.

On the basis of periodicity, Treasury bills may be classified into three

1. 91-day (3 months) T bill- maturity is in 91 days. Its auction is on every Wednesdays of every week.
2. 182-day (6 months) T bill- maturity is in 182 days. Its auction is on every alternate Wednesdays preceding non-reporting Fridays. (Banks are required to furnish various data to RBI on every alternate Friday, called reporting Fridays).
3. 364-Day (1 year) T bill- maturity is in 364 days. Its auction is on every alternate Wednesdays preceding reporting Fridays.
A considerable part of the government’s borrowings happen through T Bills of various maturities. Based on the bids received at the auctions, RBI decides the cut off yield and accepts all bids below this yield.

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills.

These T bills which are issued at a discount can be traded in the market. The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialised form.

**Advantages of investment in TB**

1. No tax deducted at source
2. Zero default risk being sovereign paper
3. Highly liquid money market instrument
4. Better returns especially in the short term
5. Transparency
6. Simplified settlement
7. High degree of tradability and active secondary market facilitates meeting unplanned fund requirements.

4. **Certificates of Deposits**

Certificate of Deposit (CD) is a negotiable money market instrument issued against funds deposited at a bank or other eligible financial institution for a specified time period. After treasury bills, this is the next lowest risk category investment option.

Allowed in 1989, CD is a negotiable promissory note, secure and short term in nature. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. The maturity most quoted in the market is for 90 days. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor.

CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs. It can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs.
The minimum issue of CD to single investor is Rs.1 lakh and additional amount in multiples of Rs.1 lakh each.

CDs are issued by banks and FIs mainly to augment funds by attracting deposits from corporates, high net worth individuals, trusts, etc. Those foreign and private banks which do not have large branch networks and hence lower deposit base, use this instrument to raise funds.

5. Commercial Paper Market

Introduced in 1990, CPs are negotiable, short-term, unsecured promissory notes with fixed maturities, issued by well rated companies. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Companies having a net worth of Rs.4 crores and whose shares are listed in a stock exchange can issue CPs either directly to the investors or through merchant banks. All eligible participants shall obtain the credit rating for issuance of Commercial Paper from a credit rating agency as notified by RBI such as CRISIL. These are basically instruments evidencing the liability of the issuer to pay the holder in due course a fixed amount (face value of the instrument) on the specified due date. These are issued for a fixed period of time at a discount to the face value and mature at par.

CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. These instruments are normally issued in the multiples of five lakhs for 30/ 45/ 60/ 90/ 120/ 180/ 270/ 364 days. CP can be issued either in the form of a promissory note or in a dematerialised form through any of the depositories approved by and registered with SEBI. Banks, FIs and PDs can hold CP only in dematerialised form.

Funds raised through CPs do not represent fresh borrowings for the corporate issuer but merely substitute a part of the banking limits available to it. Hence a company issues CPs mostly to save on interest costs i.e. it will issue CPs only when the CP rate is lower than the bank’s lending rate.

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time.

The maximum amount a company can raise through CP is up to 75 % of its total working capital limit. Fixed Income Money Market and Derivatives Association of India (FIMMDA), may prescribe, in consultation with the RBI, any standardised procedure and documentation for operational flexibility and smooth functioning of CP market.

On October 15 1997, total outstanding amount on Commercial paper transaction in Indian money market was Rs. 3377 crore. This outstanding amount increased substantially to Rs. 1,28,347 crore on July 15, 2011. This growth of Commercial paper market may be attributed to the rapid
expansion of corporate manufacturing and financial companies in liberalized and Globalized Indian economy.

6. **REPO Market**

A repurchase agreement, also known as a repo, is the sale of securities together with an agreement for the seller to buy back the securities at a later date. Predominantly, repos are undertaken on overnight basis, i.e., for one day period. The repurchase price should be greater than the original sale price, the difference representing interest, sometimes called the repo rate. The party that originally buys the securities effectively acts as a lender and the original seller is acting as a borrower.

Different instruments can be considered as collateral security for undertaking the ready forward deals and they include Government dated securities, Treasury Bills, corporate bonds, money market securities and equity. Legal title to the collateral security which is used in repo transaction, passes to the buyer during the repo period. As a result in case the seller defaults the buyer does not require to establish right on the collateral security.

The Repo/Reverse Repo transaction can only be done at Mumbai between parties approved by RBI and in securities as approved by RBI. The repo rate is the rate at which the banks borrow from RBI, while the reverse repo rate is the rate offered by RBI for funds borrowed from banks.

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction.

As part of the measures to develop the corporate debt market, RBI has permitted select entities (scheduled commercial banks excluding RRBs and LABs, Primary Dealers, all-India FIs, NBFCs, mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities. This is similar to repo in Government securities except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities that are rated ‘AA’ or above by the rating agencies are eligible to be used for repo. Commercial paper, certificate of deposit, non-convertible debentures of original maturity less than one year are not eligible for the purpose.

7. **Collateralised Borrowing and Lending Obligation**

CBLO is another money market instrument operated by the Clearing Corporation of India Ltd. (CCIL), for the benefit of the entities who have either no access to the interbank call money market or have restricted access in terms of ceiling on call borrowing and lending transactions. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (up to one year as per RBI guidelines). In order to enable the market participants to borrow and lend funds, CCIL provides the Dealing System through Indian Financial Network (INFINET), a closed user group to the Members of the Negotiated Dealing
System (NDS) who maintain Current account with RBI and through Internet for other entities who do not maintain Current account with RBI.

Membership to the CBLO segment is extended to entities who are RBI- NDS members, viz., Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, etc. Associate Membership to CBLO segment is extended to entities who are not members of RBI- NDS, viz., Co-operative Banks, Mutual Funds, Insurance companies, NBFCs, Corporates, Provident/ Pension Funds, etc.

By participating in the CBLO market, CCIL members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury Bills, and such other securities as specified by CCIL from time to time. Borrowers in CBLO have to deposit the required amount of eligible securities with the CCIL based on which CCIL fixes the borrowing limits.

### Difference-Capital Market & Money Market

<table>
<thead>
<tr>
<th>Money Market</th>
<th>Capital Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concerned with short term funds, for a period not exceeding one year</td>
<td>Concerned with long term funds for a period exceeding one year.</td>
</tr>
<tr>
<td>Meets short term requirements of govt. &amp; working capital requirement of business concerns</td>
<td>Meet long term requirements of govt and fixed capital requirement of business concerns</td>
</tr>
<tr>
<td>Instruments are TBs, BoEs, CPs, CDs &amp; govt. Bonds etc.</td>
<td>Instruments are shares, debentures govt. Bonds etc.</td>
</tr>
<tr>
<td>Major players are central bank and commercial banks</td>
<td>Major players are development banks, insurance co’s, MFs etc.</td>
</tr>
<tr>
<td>Central bank and other banks are working as part of money market</td>
<td>Capital market is functioning through money market and it has no direct contact with central bank.</td>
</tr>
<tr>
<td>Transactions are of larger amount</td>
<td>Transactions are of smaller amount.</td>
</tr>
<tr>
<td>Instruments do not have an active secondary market</td>
<td>Instruments have active secondary market.</td>
</tr>
<tr>
<td>Transactions normally takes place over phone and there is no formal place</td>
<td>Transactions take place at formal place.</td>
</tr>
<tr>
<td>Transactions have to be conducted without the help of brokers</td>
<td>Transactions are conducted with the help of brokers.</td>
</tr>
</tbody>
</table>
Defects /Features of Indian money market

A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. RBI controls and regulates the money supply in the country through the money market. However, unfortunately, the Indian money market is inadequately developed, loosely organised and suffers from many weaknesses. Major defects are discussed below

1. Existence of unorganized money market: unorganised money market comprises of indigenous bankers and money lenders. Substantially higher rate of interest prevails in unorganised sector. They follow their own rules of banking and finance. RBI’s attempt to bring them under control has failed many times.

2. Absence of integration: Different sections of money market are loosely connected with one another. Organised and unorganised sector of money market do not have any contact between them. With the setting up of RBI and passing of BRA 1949, the conditions have improved.

3. Multiplicity in rates of interest: The immobility of funds from one section to another creates diversity in interest rates. Immobility arises due to difficulty of making cheap and quick remittance of funds from one centre to another. At present wide divergence does not exist.

4. Seasonal stringency of funds: The demand for money in Indian money market is seasonal in nature. During busy season from October to April money is needed for financing and marketing of agricultural products and seasonal industries such as sugar. RBI attempt to lessen the fluctuations in money rates by increasing money supply during busy season and withdrawing the same in lean season.

5. Absence of bill market: a well organised bill market is essential for smooth functioning of a credit system. An important shortcoming of Indian Money Market is the absence of a well-developed bill market. Though both inland and foreign bills are traded in Indian Money Market yet its scope is very limited. In spite of the efforts of Reserve Bank in 1952 and in 1970, only a limited bill market exists in India. Thus, an organised bill market in the real sense of the term has not yet been fully developed in India. The establishment of DFHI has improved the situation now. The main obstacles in the development of bill market appear to be the following:

- The lack of uniformity in drawing bills in different parts of the country,
- The large use of cash credit as the main form of borrowing from commercial banks,
- Presence of Inter-call money market and
- The pressure of cash transactions. Thus, Bill Market is relatively underdeveloped.

6. Absence of Acceptance and Discount Houses

There is almost complete absence of acceptance and discount houses in the Indian money market. This is due to the underdeveloped bill market in India.
7. No contact with foreign money market: Indian money market is an insular one with little contact with money market in other countries. Indian money market does not attract any foreign fund as western money markets do.

8. Limited instruments: Supply of money market instruments like bills, TBs etc. is very limited and inadequate in nature considering the varied requirements of short term funds.

9. Limited secondary market: Secondary market is very limited in the case of money market instruments. Practically it is restricted to rediscounting of commercial and treasury bills. In India banks have the tendency to hold these bills till maturity, thus preventing an active trade in these bills.

10. Limited participants: participants in Indian money market are also limited. Entry into the market is strictly regulated. In fact there are a large number of borrowers but a few lenders. Hence, the market is not very active.

11. Absence of specialized financial institutions: Specialised institutions are lacking to carry out specialised jobs in certain fields like bank for tourism, bank for financing SSIs. etc.

12. Underdeveloped Banking Habits: In spite of rapid branches expansion of banks and spread of banking to unbanked and rural centres, the banking habits in India are still underdeveloped. There are several reasons for it.

   ✓ Whereas in U.S.A. for every 1400 persons there is a branch of a commercial bank, in India there is a branch for every 13,000 people,
   ✓ The use of cheques is restricted,
   ✓ The majority of transactions are settled in cash,
   ✓ The hoarding habit is widespread.

**IMPORTANCE OF MONEY MARKET**

If the money market is well developed and broad based in a country, it greatly helps in the economic development. The central bank can use its monetary policy effectively and can bring desired changes in the economy for the industrial and commercial progress of the country. The importance of money market is given, in brief, below:

**Financing Industry**: A well-developed money market helps the industries to secure short term loans for meeting their working capital requirements. It thus saves a number of industrial units from becoming sick.

**Financing trade**: An outward and a well-knit money market system play an important role in financing the domestic as well as international trade. The traders can get short term finance from banks by discounting bills of exchange. The acceptance houses and discount market help in financing foreign trade.
**Profitable investment:** The money market helps the commercial banks to earn profit by investing their surplus funds in the purchase of Treasury bills and bills of exchange, these short term credit instruments are not only safe but also highly liquid. The banks can easily convert them into cash at a short notice.

**Self sufficiency of banks:** The money market is useful for the commercial banks themselves. If the commercial banks are at any time in need of funds, they can meet their requirements by recalling their old short term loans from the money market.

**Encourages economic growth:** If the money market is well organized, it safeguards the liquidity and safety of financial asset. This encourages the twin functions of economic growth, savings and investments.

**Effective implementation of monetary policy:** The well-developed money market helps the central bank in shaping and controlling the flow of money in the country. The central bank mops up excess short term liquidity through the sale of treasury bills and injects liquidity by purchase of treasury bills.

**Proper allocation of resources:** In the money market, the demand for and supply of loan able funds are brought at equilibrium. The savings of the community are converted into investment which leads to pro allocation of resources in the country.

**Help to government:** The organized money market helps the government of a country to borrow funds through the sale of Treasury bills at low rate of interest. The government thus would not go for deficit financing through the printing of notes and issuing of more money which generally leads to rise in an increase in general prices.

**COMPONENTS OF THE MONEY MARKET**

The money market operates through various institutions

1. Central bank/RBI
2. Commercial Banks
3. Non-Banking Financial Intermediaries
4. Discount Houses
5. Acceptance Houses

**CENTRAL BANK (RESERVE BANK OF INDIA)**

The Central Bank is the leader and supreme authority of Money market. It is the main source of supply of funds to the money market. It also controls and channelise the credit facilities through methods such as open market operations, rediscounting of securities etc. It is the lender of last resort. It does not enter into direct transactions with public. It regulates money supply by changing bank rates.
Detailed discussion on RBI, its functions etc. are given as a separate chapter elsewhere in this book

COMMERCIAL BANKS

Commercial banks are the oldest banking institutions in the organised sector. They constitute the predominant segment of the banking system in India. They cater to the needs of trade, commerce, industries, agriculture, small business etc. through its wide network of branches. The commercial banks form the most important part of the money market. They make advances, grant overdraft and discount bills of exchange to the business community. They also borrow from central bank directly or indirectly.

The commercial banking system consists of scheduled banks and non-scheduled banks. Scheduled Banks are those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42 (6) (a) of the Act.

Scheduled Commercial Banks are grouped under following categories:
1. State Bank of India and its 5 Associates (public sector banks)
2. Nationalised Banks (20 including IDBI Bank) (public sector banks)
3. Foreign Banks (43 Numbers)
4. Regional Rural Banks (61 Numbers)
5. Other Scheduled Commercial Banks (21 numbers) (Private Sector Banks)

Functions of commercial banks

1. Principal/primary/fundamental
2. Subsidiary/secondary/supplementary

Principal functions
Two ‘acid test’ functions of commercial banks are
1. Accepting deposits and
2. Lending or advancing loans

These functions along with credit creation, promotion of cheque system and investment in govt. securities form basic functions of commercial banks.
1. Receiving deposits

Most important function of a bank is to accept deposit from those who can save but cannot profitably utilise this savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts.

- Current accounts
- Savings Bank accounts
- Fixed Deposit accounts
- Recurring Deposit Accounts or Cumulative Deposit Account.

2. Lending of funds by means of

- Term Loans
- Overdrafts (OD)
- Cash credit
- Discounting of bills
- Money at call or short notice

3. Investment of funds in securities

Banks invest a considerable amount of their funds in govt. and industrial securities. In India, commercial banks are required by statute to invest a good portion of their funds in government and other approved securities.

4. Credit Creation

When a bank advances a loan, it does not lend cash but opens an account in the borrower’s name and credits the amount of loan to this account. Thus a loan creates an equal amount of deposit. Creation of such deposit is called credit creation. Banks have the ability to create credit many times more than their actual deposit.

5. Promoting cheque system

Banks also render a very useful medium of exchange in the form of cheques. Through a cheque the depositor directs the banker to make payment to the payee. In the modern business transactions cheques have become much more convenient method of settling debts than the use of cash.
Subsidiary functions

1. Agency services

- Collect cheques, drafts, BoE, interest and dividend on securities, rents etc. on behalf of customers and credit the proceeds to the customer’s a/c.
- Pay LIC premium, rent, newspaper bills, telephone bills etc.
- Buying and selling of securities
- Advise on right type of investment
- Act as trustees (undertake management of money and property), executors (carry out the wishes of deceased customers according to will) & attorneys (collect interest & dividend and issue valid receipt) of their customers.
- Serve as correspondents and representatives of their customers. In this capacity, banks prepare I-Tax returns of their customers, correspond with IT authorities and pay IT of their customers.

2. General utility services

- Locker facility to keep valuables.
- Issue travellers’ cheques which enable tourists to get fund in all places they visit without carrying actual cash with them.
- Issue Letter of Credits for importers. It is a letter issued by importer’s banker in favour of exporter informing him that issuing banker undertakes to accept the bills drawn in respect of exports made to the importer specified therein.
- Act as referees and supply information about the financial standing of their customers on enquiries made by other businessmen.
- Collect information about other businessmen through the fellow bankers and supply information to their customers.
- Collection of statistics, giving important information about industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.
- Underwriting securities issued by government, public or private bodies.
- Deals in foreign currencies.
Role of commercial banks in a developing economy

A well-developed banking system is necessary pre-condition for economic development of any economy. Apart from providing resources for growth of industrialisation, banks also influence direction in which these resources are utilised.

In underdeveloped and developing nations banking facilities are limited to few developed cities and their activities are focussed on trade & commerce paying little attention to industry & agriculture.

Commercial banks contribute to a country’s economic development in the following ways.

1. Capital formation

Most important determinant of economic development is capital formation. It has 3 distinctive stages

- Generation of savings
- Mobilisation of savings
- Canalisation of saving

Banks promote capital formation in all these stages. They promote habit of savings by offering attractive rate of return for savers. Banks are maintaining different types of accounts to mobilise savings aiming different types of customers. They make widespread arrangements to collect savings by opening branches even in remote villages. Moreover, banks offer their resources for productive activities only.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allow money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy to monetised sectors.

4. Influencing economic activity
They can directly influence the economic activity & pace of economic development through its influence on

(a) The rate of interest (reduction in rates make investment more profitable and stimulates economic activity)

(b) Availability of credit. (Through Credit creation banks helps in increasing supply of purchasing power)

5. Implementation of monetary policy

Well-developed banking system is necessary for effective implementation of monetary policy. Control and regulation of credit is not possible without active co-operation of banks.

6. Promotion of trade and industry

Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade & industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and BoE as a medium of exchange has revolutionised the internal and international trade which in turn accelerated the pace of industrialisation.

7. Encouraging right type of industries

In a planned economy it is necessary that banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

8. Regional development

Banks can play role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

9. Development of agricultural & other neglected sectors

Under developed economies primarily agricultural economies and majority of the population live in rural areas. So far banks were paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must diversify their activities not only to extend credit to trade, but also to provide medium and long term loans to industry and agriculture.

**NON-BANKING FINANCIAL INSTITUTIONS (NBFIs)**

The function of transferring funds from savers to investors is performed by financial intermediaries. Financial intermediaries are generally classified into two groups viz. banking institutions and NBFIs. NBFIs includes institutions such as life insurance companies, mutual funds, pension funds, chit funds etc.

A banking institution is different from non-banking institution in the following respects
✓ A cheque can be issued by a banking company where as no such facility is available for NBFIs

✓ Commercial banks can manufacture credit (credit creation) while NBFIs cannot

✓ Commercial banks are able to enjoy certain facilities like rediscounting facilities, deposit insurance coverage, refinancing facilities etc. these facilities are not available for NBFIs

✓ Commercial banks offer/charges lesser rate of interest than that of NBFIs

✓ Commercial banks are subject to strict control of RBI than that of NBFIs

Functions of NBFIs

1. Mobilisation of savings by offering schemes to suit the needs of different classes of people.

2. Offers easy and timely credit to those are in need of it

3. Acting as financial super market by offering variety of services

4. Channelizing funds for productive purposes

5. Providing housing finance

6. These institutions, particularly, investment companies, render expert advice in investment of funds.

**DISCOUNT HOUSES**

Discount houses are meant for discounting bill of exchange on behalf of others. A discount house is a firm that operates in buying, selling, discounting and/or negotiating bills of exchange or promissory notes. This is usually performed on a large scale, and some of its transactions include dealing with government bonds and treasury bills.

In India, Discount and Finance House of India (DFHI) was established for this purpose. DFHI was set up in March 1988 by Reserve Bank of India jointly with public sector banks and all India Financial Institutions to develop the money market and to provide liquidity to money market instruments as a sequel to Vaghul Working Group recommendations. With the introduction of new money market instruments such as Certificates of Deposits and Commercial Paper, DFHI began dealing in these instruments as well. With effect from 1992-93, DFHI was authorised to deal in dated Government Securities. After DFHI was accredited as a Primary Dealer in February 1996, its operations significantly increased particularly in Treasury Bills and dated Government Securities. During these years, DFHI opened its branches at Ahmedabad, Bangalore, Calcutta, Chennai, New Delhi and at Hyderabad with a view to catering to the requirements of the small and medium sized institutions operating at these centres and at the same time integrating the markets at these regional centres with main money market at Mumbai.
Objectives of DHFI

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

ii. To promote secondary market in short term money market instruments i.e. to be an active trader in money market instruments rather than a mere repository, and thereby, impart improved liquidity to short term money market instruments.

iii. To integrate markets at regional centres with the main market at Mumbai, through its network.

iv. Provide safe and risk-free short-term investment avenues to institutions; DFHI being an institution promoted by the public sector banks/financial institutions and RBI, enjoys excellent credit rating in the market.

v. Provide greater liquidity to money market instruments.

vi. Facilitate money market transactions for small and medium sized institutions who are not regular participants in the market.

vii. DFHI provides the 'Constituent SGL' Account facility which enables even those entities which otherwise do not have an SGL Account facility with the RBI to reap the full benefits of investing in government securities.

DFHI deals in the following instruments/products:

i. Treasury Bills

ii. Dated Government Securities

iii. Certificates of Deposit

iv. Commercial Papers

v. Call (overnight) Money

vi. Notice Money

vii. Term Money

viii. Derivative Usance Promissory Notes of Commercial Banks

ix. Interest Rate Swaps/Forward Rate Agreements

ACCEPTANCE HOUSES

Acceptance houses are another constituent of money market. They work in bill market. They function as an intermediary between lenders and borrowers, exporters and importers in the
short term. They accept the bills of buyers whose position is unknown to sellers and thus facilitates transaction between them, for a reward of commission.

In India commercial banks are also acting as Acceptance Houses.

References

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Financial System

Financial system is a system that allows the transfer of money between savers and borrowers. It is a set of institutions, instruments and markets which encourage savings and channelise them for productive purposes. It consist of specialised and non specialised financial institutions, organised and unorganised financial markets, financial services and instruments which facilitate transfer of financial surplus of the economy.

Constituents of a Financial System

Components of a formal financial system include financial institutions, financial markets, financial instruments, financial services and regulators.

- Financial assets/Instruments – A financial asset is an intangible asset that derives value because of a contractual claim. It consist of Cash, Marketable securities, bank deposits, mutual fund units, insurance policies etc

- Financial Institutions - Financial Institution is an institution (public or private) that collects funds (from the public or other institutions) and invests them in financial assets. It include Banking and Non-banking institutions, Term finance institutions, Specialised finance institutions, investment institutions etc

- Financial services – Financial services are the economic services provided by the financial institutions. These may be either Fund based services such as underwriting, leasing, hire purchase, insurance etc. or Fee based services such as merchant banking, issue management, credit rating, stock broking etc.

- Financial Markets – A financial market is a market in which people and entities can trade financial assets such as securities, bonds, derivatives, currencies etc. The main financial markets are Money market, Capital market, Derivative market etc.

- Regulators - These are bodies which regulate and controls various constituents of financial system. Examples are Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), Reserve Bank of India (RBI), Forward Market Commission (FMC) etc.
Capital Market

Meaning

Capital market refers to the institutional arrangements for facilitating borrowing and lending of long term funds. It is the organised mechanism for effective and efficient transfer of money capital from individuals and institutional savers to entrepreneurs engaged in industry of commerce in both private sector and public sector. Modern capital markets are almost invariably hosted on computer-based electronic trading systems.

For a long time, the Indian capital market was considered too small to warrant much attention. However, this view has changed rapidly as vast amounts of international investment have poured into our markets over the last decade. The Indian market is no longer viewed as a static universe but as a constantly evolving market providing attractive opportunities to the global investing community.

Role / Functions of Capital Market:

Capital market plays an important role in mobilising resources, and diverting them in productive channels. In this way, it facilitates and promotes the process of economic growth in the country. It ensures better coordination between the flow of savings and the flow of investment that leads to capital formation and directs the flow of savings into most profitable channels.

In addition to resource allocation, capital markets also provide a medium for risk management by allowing the diversification of risk in the economy. A well-functioning capital market tends to improve information quality as it plays a major role in encouraging the adoption of stronger corporate governance principles, thus supporting a trading environment, which is founded on integrity.

Following are the main role or functions of capital market.

1. Link between Savers and Investors:

The capital market acts as a link between savers and investors. It plays an important role in mobilising the idle savings of people and diverting them in productive and profitable investment. In this way, capital market plays a vital role in transferring the financial resources from surplus and wasteful areas to deficit and productive areas, thus increasing the productivity and prosperity of the country.

2. Encouragement to Saving:

With the development of capital market, the banking and non-banking institutions provide facilities to invest money in stock market, which encourage people to save more. In the less-developed countries, in the absence of a capital market, there are very little savings and those who save often invest their savings in unproductive and wasteful areas such as rela estate, gold etc.
3. Capital Formation:

The capital market facilitates lending to the businessmen and the government and thus encourages investment. It helps to mobilise the huge capital required for business. It is an important and efficient means to channel and mobilize funds to enterprises, and provide an effective source of investment in the economy.

4. Promotes Economic Growth:

The capital market not only reflects the general condition of the economy, but also smoothenes and accelerates the process of economic growth. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country. It plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country's long-term growth prospects, and thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena.

5. Stability in Security Prices:

The capital market tends to stabilise the values of stocks and securities and reduce the fluctuations in the prices to the minimum. The process of stabilisation is facilitated by providing capital to the borrowers at a lower interest rate and reducing the speculative and unproductive activities.

6. Assists to Government:

Capital market assists the Government to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital.

7. Benefits to Investors:

Capital market is beneficial to the investors in many ways:

a) Liquidity of Investment: Shares and bonds are easily transferable at low transaction cost as compared to other assets such as real estate. Therefore an investor can buy and sell at considerable convenience.

b) Hedge against inflation: Securities prices over the long term tend to outperform inflation, therefore investment in securities can be a reliable hedge against inflation in the long term.

c) Higher Return: Capital market provides comparatively higher return in the long run than other invest avenues such as real estate, gold, and bank deposits.

d) Collateral: Securities represent stocks of wealth, and can be used as collateral to secure financing such as loans from lending institutions.

e) Flexibility: Shares and bonds are traded in units and lots that are affordable by investors of different income levels. As such, investment in securities can be customized to the specific incomes of investors.
f) **Tax advantage:** The government offers many tax advantages to the long term investment in equity market.

**Components of Capital Market:**

Capital market can be classified into two;

1. Primary market
2. Secondary market.

Primary market is the market where the securities are issued for the first time. It is the primary market in which the companies issue their securities. Secondary market is the market for already issued (second hand) securities. Secondary market enables the further buying and selling of issued securities.

**Important Financial Instruments in Capital Market:**

1. **Shares:**

   According to the Companies Act 1956, ‘a share is the share in the share capital of a company’. It is a portion of capital which is divided among number of people. It is a unit of ownership interest in a corporation and offered for sale. Shares are of two types, Preference shares and Equity shares.

   (i) **Preference shares:**

   Preference shares are those shares which have a preferential right for the payment dividend during the life time of the company and for the return of capital at the time of winding up. Preference shares carry fixed rate of dividend that are paid to shareholders before equity stock dividends are paid out.

   Following are the major types of preference shares.

   **Cumulative Preference Shares:** When unpaid dividends on preference shares are treated as arrears and are carried forward to subsequent years, then such preference shares are known as cumulative preference shares.

   **Non-cumulative Preference Shares:** Non-cumulative preference shares are those type of preference shares, which have right to get fixed rate of dividend out of the profits of current year only. They do not carry the right to receive arrears of dividend.

   **Redeemable Preference Shares:** Those preference shares, which can be redeemed or repaid after the expiry of a fixed period are known as redeemable preference shares.

   **Non-redeemable Preference Shares:** Those preference shares, which cannot be redeemed during the life time of the company, are known as non-redeemable preference shares. The amount of such shares is paid at the time of liquidation of the company.

   **Participating Preference Shares:** Those preference shares, which have right to participate in any surplus profit of the company after paying the equity shareholders, in addition to the fixed rate of
their dividend, are called participating preference shares. **Non-participating Preference Shares**: Preference shares, which have no right to participate on the surplus profit of the company are called non-participating preference shares. **Convertible Preference Shares**: Those preference shares, which can be converted into equity shares at the option of the holders after a fixed period according to the terms and conditions of their issue, are known as convertible preference shares. **Non-convertible Preference Shares**: Preference shares, which are not convertible into equity shares, are called non-convertible preference shares.

**(ii) Equity shares (Ordinary shares or Common shares):**

Equity shares are the ordinary shares of a company which have no preferential rights. They are the shares representing the ownership interest. Equity shares give their holders the power to share the earnings in the company as well as a vote in the Annual General Meetings of the company. Such a shareholder has to share the profits and also bear the losses incurred by the company. Equity share holders are the real owners of the company.

2. Debenture / Bond:

A debenture is an acknowledgement of the debt of the Company. It is a long term debt instrument yielding a fixed rate of interest issued by a company. A debenture is like a certificate of loan or debt evidencing the fact that the company is liable to pay a specified amount with interest. Debenture is not secured by the physical asset of the company. Debenture holders are the creditors of the company and hence they have no voting right in the company.

Bonds are the debt instruments secured by the physical asset of the company. In some countries, the term denture is used interchangeably with ‘bond’.

**Primary Market**

It is also called New Issue Market. It is the market where securities are issued for the first time. These securities are never traded before elsewhere. Both new companies and existing companies approach primary market for raising capital. The main function of primary market is to facilitate transfer of funds from willing investors to the entrepreneurs setting up new business or diversification, expansion or modernisation of existing business.

A new issue market is of paramount importance for economic growth and industrial development as it supplies necessary long term capital. Though the functions of primary market are so different from that of secondary market, the sentiments in the secondary market do affect the primary market activities.

**Primary market Intermediaries**

A number of intermediaries play a critical role in the process of issue of new securities. They are
1. Merchant bankers/lead managers: it is an institution that extends a number of services in connection with issue of capital. Their services include management of security issues, portfolio management services, underwriting of capital issues, credit syndication, financial advice and project counselling etc. It has now made mandatory that all public issues should be made by merchant bankers acting as lead managers.

2. Underwriters: underwriter guarantee that the securities offered for the public will be subscribed if it is not subscribed by the public. It is an insurance to the issuing company against the failure of issue. In case, the public fails to subscribe, the underwriter will have to take them up and pay for them. They charge a commission called underwriting commission for their service. It should not exceed 5 percent in case of shares and 2.5 percent for debentures.

3. Bankers to an issue: Banker to an issue accepts applications and application money, refund application money after allotment and participate in the payment of dividend by companies. No banker can act as a banker to an issue unless it possesses a registration with SEBI. SEBI grants registration only when it is satisfied that the bank has enough infrastructure, communication and data processing facilities and requisite man power to discharge such duties. The banker is required to maintain documents and records relating to the issue for a period of 3 years. It is also required to furnish information to the SEBI regarding the number of applications received, number of issues for which it has acted as a banker to an issue, date on which applications from investors were forwarded to registrar of issue, date and amount of refund to investors etc.

4. Registrar to an issue: It is an intermediary who performs the function of collecting application from investors (through bankers), keeping record of applications, keeping record of money received from investors, assisting companies in allotment and helping despatch of allotment letters, refund orders etc.

5. Share transfer agents: They maintain the record of holders of securities on behalf of companies and deals with all activities connected with transfer or redemption of securities.

6. Debenture trustees: A debenture is an instrument of debt issued by the company acknowledging its obligation to repay the sum along with an interest. In the case of public issue of debentures, there would be a large number of debenture holders on the register of the company. As such it shall not be feasible to create charge in favour of each of the debenture holder. A common methodology generally adopted is to create Trust Deed conveying the property of the company. A Trust deed is an arrangement enabling the property to be held by a person or persons for the benefit of some other person known as beneficiary. It has been made mandatory for any company making a public/rights issue of debentures to appoint one or more debenture trustees before issuing the prospectus or letter of offer and to obtain their consent which shall be mentioned in the offer document.

7. Brokers to an issue: Brokers are the persons who procure subscriptions to issue from prospective investors spread over a larger area. A company can appoint as much number of brokers as it wants.

8. Portfolio managers: Portfolio construction, formulation of investment strategy, evaluation and regular monitoring of portfolio is an art that requires skill and high degree of expertise. Any person who
pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client [whether as a discretionary portfolio manager or otherwise(adviser)] the management or administration of a portfolio of securities or the funds of the client, as the case may be is a portfolio manager.

Different Kinds of Issue

Every Company needs funds for its business. Funds requirement can be for short term or for long term. To meet short term requirements, they may approach banks, lenders & may even accept fixed deposits from public/shareholders. To meet its long term requirements, funds can be raised either through loans from lenders, Banks, institutions or through issue of capital. Capital can be raised through private placement of shares, public issue, right issue etc.

1. Public Issue :

Public issue means raising funds from public. The main purpose of the public issue, amongst others, is to raise money through public and get its shares listed at any of the recognized stock exchanges in India.

Methods of Public Issue:

Public issue may be an Initial Public Offering (IPO) or Further/Follow on Public Offering (FPO). During the IPO or FPO, the company offers its shares to the public either at fixed price or offers a price range, so that the investors can decide on the right price. The method of offering shares at a fixed price is called Fixed Price Public Issue and the method of offering shares by providing a price range is called as book building method.

Initial Public Offering: It is the first time issue of securities to the public. The promoters of the companies after complying the with the guidelines of SEBI and the Companies Act ask the public at large to subscribe to their shares so that they can generate capital. It may be done through prospectus or Offer for Sale(Securities issued to a issue house and they sell securities to the public by issuing advertisement called OFS) Public issue through offer for sale is not popular in India.

• Further (Follow on) Public Offering: If an already listed company makes the issue of securities after IPO, it is called Follow on Public Offering. If an existing company again intends to raise capital from the general public after IPO, it can again make a public issue called FPO. It is a supplementary issue made by a company once it is listed and established on the stock exchange.

Book Building

Book building refers to the process of generating and recording investor demand for shares during an Initial Public Offering (IPO), or FPO during their issuance process, in order to support efficient price discovery. A price range (Price Band) is specified in the offer document with a floor price (Minimum price). Based on the demand and supply of the shares, the final price is fixed. The lowest price in the price range is known as the floor price and the highest price in the price range is known as cap price. The price at which the shares are allotted is known as cut off price. Usually, the issuer appoints a major investment bank
to act as a major securities underwriter or book-runner. Book-runner/Lead manager/Syndicate manager is the underwriter/investment bank who manage the book building process.

2. Right Issue:

It is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period. In a rights issue, the shares are generally offered at a discount to the current market price. Rights are often transferable, allowing the holder to sell them on the open market.

3. Bonus Issue (Gift shares):

It is an issue of additional shares to shareholders of a company instead of paying dividend. These are company's accumulated earnings which are not given out in the form of dividends, but are converted into free shares. Fully paid new shares are issued to shareholders in proportion to their holdings. For example, the company may give one bonus share for every five shares held.

4. Private Placement:

Issue of securities (by a listed company) to a selected group of investors not exceeding 49 is called Private Placement. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market. Following categories of issue can also be included in Private placement.

- Preferential Allotment: It is a type of Private placement by unlisted companies. Preferential Allotment is the process by which allotment of securities is done on a preferential basis to a select group of investors such as directors, existing shareholders etc.

- Qualified Institutions Placement (QIP): It is also part of private placement (by Listed companies). It is the issue of securities to Qualified institutional Buyers (QIB) in terms of the provisions of the Issue of Capital & Disclosure Requirements (ICDR) of SEBI.

- Employees Stock Option Scheme (ESOS): A stock option scheme granted to specified employees of a company is called Employee Stock Option Scheme. ESOS carry the right, but not the obligation, to buy a certain amount of shares in the company at a predetermined price.

Physical Shares and Demat shares:

Shares with share certificates printing on a paper is called Physical shares where as the shares in electronic format is called Demat (Dematerialised) shares. The process of converting the physical form of shares to dematerialised form is called Dematerialisation. The Depositories Act was passed by the parliament in 1995 and this paved the way for conversion of physical securities into electronic format. Depository and Depository participants are the organisations through which the physical shares can be converted into electronic form. If one wishes to get back his securities in physical form after dematerialisation, he can request his Depository participants for rematerialisation.
Depository:

A depository is an organisation which holds securities (like shares, debentures, bonds, government securities, mutual fund units etc.) of investors in electronic form at the request of the investors through a registered Depository Participant. It also provides services related to transactions in securities. At present two Depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) are registered with SEBI.

Depository Participants

A Depository Participant (DP) is an agent of the depository through which it interfaces with the investor and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations /clearing houses, NBFCs and Registrar to an Issue or Share Transfer Agent complying with the requirements prescribed by SEBI can be registered as DP. As on December 21, 2012, a total of 866 DPs (289 NSDL, 577 CDSL) are registered with SEBI.

Following services are provided by a depository to the beneficial owners through a depository participant:

- Opening a demat account;
- Dematerialization, i.e. converting physical securities into electronic form
- Rematerialization, i.e. converting electronic securities into physical form
- Maintaining record of securities held by the beneficial owners in the electronic form
- Settlement of trades by delivery or receipt of securities
- Settlement of off-market transactions
- Receiving electronic credit in respect of securities allotted by issuers under IPO or otherwise on behalf of demat account holders;

Secondary market/Stock market

Secondary Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. It is the organized mechanism for purchase and sale of existing securities. Investors in new issue market who do not want to hold the securities up to maturity can approach stock market to sell their securities. Similarly those who want to become an investor in an existing company which do not offer new issue of securities at present, approach stock market for purchasing securities.
Definition

Securities Contract & Regulation Act 1956 defines secondary market as ‘any body of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling of securities’.

Difference between Primary Market and Secondary Market

<table>
<thead>
<tr>
<th>Primary Market</th>
<th>Secondary Market</th>
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<tbody>
<tr>
<td>1. It is the market where securities are issued for the first time</td>
<td>1. It is the market for already issued (Second hand) securities</td>
</tr>
<tr>
<td>2. It deals with issuing of securities</td>
<td>2. It deals with buying and selling of securities.</td>
</tr>
<tr>
<td>3. Primary market for a security opens for a limited period</td>
<td>3. Secondary market for a security is always open</td>
</tr>
<tr>
<td>4. Company is directly involved in transaction</td>
<td>4. Company is not directly involved. Transactions occur between investors through Stock exchanges</td>
</tr>
<tr>
<td>5. Primary market is a source of fund to the company</td>
<td>5. It is not a direct source of fund to the company</td>
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Stock Exchange

Stock exchange is an organized market for buying and selling corporate and other securities. In Stock exchange, securities are purchased and sold out as per certain well-defined rules and regulations. It provides a convenient and secured mechanism or platform for transactions in different securities. Stock exchanges are indispensable for the smooth and orderly functioning of corporate sector in a free market economy. A stock exchange need not be treated as a place for speculation or a gambling. It acts as a place for safe and profitable investment.

Characteristics of a Stock Exchange

1. It is the place where securities are purchased or sold
2. It is an Association of Person whether incorporated or not
3. Trading is regulated by rules & regulations prescribed by SEBI and itself.
4. Both genuine investors and speculators buy and sell shares
5. Securities or corporations, trusts, governments, semi govt. bodies etc. are allowed to be dealt at stock exchanges.

**Investors and Speculators:**

Stock market participants consist of Investors and Speculators. Investor is a person or institution who makes investment in securities with the intention of getting a fair return from the investment. But the Speculator make investment in risky securities in an attempt to profit from short and medium term fluctuations in the market value of shares.

**Types of Speculators in Stock market:**

**Bull (Tejiwala):** Bull is a speculator who is hopeful of price rise in the near future. He makes purchases of securities with the intention of selling them at a higher price in future.

**Bear (Mundiwal):** Bear is a speculator who expect fall in prices. He sell securities with the intention of buying them at a lower price in future.

**Lame Duck:** When the bear fails to meet his obligations, he is called Lame Luck. Generally a bear agrees to dispose off certain shares on specific date. But sometimes he fails to deliver due to non availability of shares in the market.

**Stag:** Stag is a speculator who purchases shares to sell them above par value to earn premium. He rapidly buy and sell stocks in quick succession.

**Jobber:** Jobber is a professional speculator who has a complete information regarding the particular shares he deals. He conducts the securities in his own name. He is the member of the stock exchange and he deals only with the members.

**Role of stock exchange in economic development**

The liquidity that an exchange provides affords investors the ability to quickly and easily sell securities. This is an attractive feature of investing in stocks, compared to other less liquid investments such as real estate.

History has shown that the price of shares and other assets is an important part of the dynamics of economic activity, and can influence or be an indicator of social mood. Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions.

Exchanges also act as the clearinghouse for each transaction, meaning that they collect and deliver the shares, and guarantee payment to the seller of a security. This eliminates the risk to an individual buyer or seller that the counterparty could default on the transaction.
The smooth functioning of all these activities facilitates economic growth in that lower costs and enterprise risks promote the production of goods and services as well as employment. In this way the financial system contributes to increased prosperity.

**Functions / services of stock exchange**

1. Liquidity & marketability of securities: ensures ready and continuous market where buyers and sellers are continuously available. Securities can be easily converted to cash without time delay in two days.

2. Safety of fund: Exchanges are working under strict rules & regulations which are meant to ensure safety of funds.

3. Supply of long term funds: Securities traded in stock market are negotiable or transferable in character. One investor is substituted for another. Company is assured of long term availability of funds.

4. Flow of capital to profitable ventures: Profitability and popularity of companies are reflected in stock prices.

5. Motivation for improved performance: prices are visible to the public. This public exposure makes a company conscious of its status in the market.

6. Promotion of investment through capital formation

7. Reflection of business cycles. Central bank can make suitable monetary policies based on the behaviour of stock market.

8. Marketing of new issues: If new issues are listed in exchange, they are readily acceptable to the public.

**Stock Exchanges in India**

There are twenty two stock exchanges in India (2013) out of which seven are permanent. Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are the main stock exchanges in India.

**Bombay Stock Exchange (BSE):**

It was established in 1875 as "The Native Share & Stock Brokers' Association". BSE Ltd (formerly known as Bombay Stock Exchange Ltd.) is Asia’s first Stock Exchange and one of India’s leading exchange groups located in Dalal Street, Mumbai.. BSE is a corporatized and demutualised entity, with a broad shareholder-base which includes two leading global exchanges, Deutsche Bourse and Singapore Exchange as strategic partners. BSE provides an efficient and transparent market for trading in equity, debt instruments, derivatives, mutual funds. More than 5000 companies are listed on BSE. The companies listed on BSE Ltd command a total market
capitalization of USD 1.32 Trillion as of January 2013. BSE’s popular equity index - the S&P BSE SENSEX is India's widely tracked stock market benchmark index.

**National Stock Exchange (NSE)**

The National Stock Exchange of India Ltd. (NSE) is one of the country’s leading stock exchange located in Mumbai. National Stock Exchange (NSE) was established in the mid 1990s as a demutualised electronic exchange. NSE has a market capitalisation of more than US$989 billion and 1,635 companies listed as on July 2013. NSE's flagship index, the S&P CNX Nifty, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

**Stock Index**

An Index is basically an indicator of stock prices. It gives us a general idea about whether the prices of stocks have gone up or gone down. The Dow Jones Industrial Average (DJIA), Standard & Poor's 500 (S&P 500), Wilshire 5000, Nasdaq Composite Index etc are the examples of world’s top stock market indices. BSE-Senex and NSE-Nifty are the main stock Indices in India.

**BSE-SENSEX**

The S&P BSE SENSEX is a stock market index of 30 well established and financially sound companies listed in Bombay Stock exchange. These 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since 1 January 1986, the BSE SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the BSE SENSEX is taken as 100 on 1 April 1979, and its base year as 1978–79. Other popular indices of BSE are S&P BSE 100, S&P BSE 200, S&P BSE MIDCAP, S&P BSE SMALLCAP etc.

**NSE-NIFTY**

The CNX NIFTY, also called the NIFTY 50 or simply the NIFTY, is National Stock Exchange of India's benchmark index for Indian equity market. It is a stock market Index of 50 companies of 22 sectors of the Indian economy. NIFTY, is used extensively by investors in India and around the world to take exposure to the Indian equities market. The base period for the CNX NIFTY is November 3, 1995 and base value of the index has been set at 1000. Besides CNX NIFTY there are many other stock market Indices for NSE such as CNX NIFTY JUNIOR, LIX 15, CNX MIDCAP, INDIA VIX, CNX SMALLCAP etc.

**Listing of securities**

Listing of securities means the enrolment of a name of company in an official list of the Stock exchange. Listing means admitting for trading on a recognized stock exchange. It facilitates buying and selling of securities in the exchange. Listing provides an exclusive privilege to securities in the stock exchange. Only listed shares are quoted on the stock exchange. Stock
exchange facilitates transparency in transactions of listed securities in perfect equality and competitive conditions. Listing is beneficial to the company, to the investor, and to the public at large.

A company, desirous of listing its securities on the Exchange, shall be required to file an application, in the prescribed form, with the Exchange before issue of Prospectus by the company, where the securities are issued by way of a prospectus or before issue of ‘Offer for Sale’, where the securities are issued by way of an offer for sale. The company shall be responsible to follow all the requirements specified in the Companies Act, the listing norms issued by SEBI from time to time and such other conditions, requirements and norms that may be in force from time to time.

Advantages / Importance of Listing

- **Fund Raising:** Listing provides an opportunity to the corporates / entrepreneurs to raise capital to fund new projects/undertake expansions/diversifications and for acquisitions.

- **Liquidity and Ready Marketability of Security:** Listing brings in liquidity and ready marketability of securities on a continuous basis adding prestige and importance to listed companies.

- **Ability to raise further capital:** An initial listing increases a company's ability to raise further capital through various routes like preferential issue, rights issue, Qualified Institutional Placements and ADRs/GDRs.

- **Supervision and Control of Trading in Securities:** The transactions in listed securities are required to be carried uniformly as per the rules and bye-laws of the exchange. All transactions in securities are monitored by the regulatory mechanisms of the stock exchange, preventing unfair trade practices. It improves the confidence of small investors and protects them.

- **Fair Price for the Securities:** The prices are publicly arrived at on the basis of demand and supply; the stock exchange quotations are generally reflective of the real value of the security. Thus listing helps generate an independent valuation of the company by the market.

- **Tax advantage:** The listed companies are treated as widely held companies under the income tax act and all the tax advantages available to a widely held company is available for listed companies.

- **Protect the Interest of Investors:** The listing agreement signed with the exchange provides for timely disclosure of information relating to their assets, dividend, bonus and right issues, facilities for transfer, other company related information etc by the company. Thus providing more transparency and building investor confidence.

- **Collateral Value of Securities:** Listed securities are acceptable to lenders as collateral for credit facilities. A listed company can also borrow from financial institutions easily as it is
rated favorably by lenders of capital. The company can also raise additional funds from the public through the new issue market with a greater degree of assurance.

- **Better Corporate Practice:** Since the violation of the listing agreement entails the delisting/suspension of securities from the rings of the exchange, the listed companies are expected to follow fair practices to the advantage of investors and public.

- **Benefits to the Public:** The data daily culled out by the stock exchange in the form of price quotations provide valuable information to the public which can be used for project and research studies. The stock exchange prices can be an index of the state of the economy. Financial institutions, NRI, individual investor’s etc. can take wise decisions before making investments.

**Procedure for dealing in stock exchange**

1. **Selection of a broker:** Individual investors are not permitted to transact securities through an exchange without a broker. The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. So the first thing to be done is to select a broker.

2. **Opening Demat account with Depository Participant:** Demat (Dematerialized) account refers to an account which an Indian citizen must open with the Depository participant (DP) to trade in listed securities in electronic form. Hence, the second step in trading procedure is to open a Demat account.

3. **Placing an order:** Next step is to place an order for purchase or sale of securities. Broker helps in selection of securities and proper time for it. Investor must place the order very clearly specifying the range of price at which the securities can be bought and sold.

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

5. **Settlement:** This means actual transfer of securities. This is the last stage in the trading of securities done by the broker on behalf of their clients. The selling broker hands over the transfer form and share certificates to the buying broker after receiving the price. Complete settlement is made in 2–7 days of the transaction. Settlement of securities is done by the clearing corporation of the exchange.

**Domestic Institutional Investors (DII) and Foreign Institutional Investors (FII)**

Institutional investors are organizations which pool large sums of money and invest those sums in securities, real property and other investment assets. They can also include operating companies which decide to invest their profits to some degree in these types of assets. Typical
investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds.

Domestic institutional investors (DII) are those institutional investors established or incorporated in India which undertake investment in the financial markets of India. These are institutions or organizations such as banks, insurance companies, mutual funds etc. An institutional investor that has met certain qualifications to invest in securities outside its home country is called Qualified Domestic Institutional Investor (QDII).

An investor or investment fund that is established or registered in a foreign country and investing in the financial markets of India is called Foreign Institutional Investor (FII). International institutional investors must register with the Securities and Exchange Board of India to participate in the market. FIIs are investing huge amounts in the Indian stock exchanges and it reflects their high confidence and a healthy investor sentiment for our markets. However, the ceiling for overall investment for FIIs is 24 per cent of the paid up capital of the Indian company and 10 per cent for NRIs/PIOs. The limit is 20 per cent of the paid up capital in the case of public sector banks. The ceiling of 24 per cent for FII investment can be raised up to sectoral cap/statutory ceiling, subject to the approval of the board and the general body of the company passing a special resolution to that effect. In December 2013, there are more than 1700 Foreign Institutional Investors registered with SEBI.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) is the regulatory authority for the securities market in India. It was established in the year 1988 under a resolution of the Government of India and given statutory powers on 12 April 1992 through the SEBI Act, 1992. Its headquarters is located at Mumbai. It has four regional offices in New Delhi, Kolkata, Chennai and Ahamedabad. Controller of Capital Issues derived from the Capital Issues (Control) Act, 1947 was the regulatory authority in capital market before SEBI came into existence.

The SEBI is managed by a chairman and eight members. The chairman is nominated by Union Government of India. Two members are selected from the officers of the Union Finance Ministry and one member from The Reserve Bank of India. The remaining 5 members are nominated by Union Government of India, out of them at least 3 shall be whole-time members.

Functions of SEBI

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as "...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto". SEBI adopts the following measures to protect the interest of investors and to regulate and promote the securities market in India.

(a) Regulating the business in stock exchanges and any other securities markets
(b) Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner

(c) Registering and regulating the working of the depositories, Depository Participants (DP) custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries.

(d) Registering and regulating the working of venture capital funds and collective investment schemes including mutual funds.

(e) Promoting and regulating self-regulatory organisations.

(f) Prohibiting fraudulent and unfair trade practices relating to securities markets.

(g) Promoting investors’ education and training of intermediaries of securities markets.

(h) Prohibiting insider trading in securities.

(i) Regulating substantial acquisition of shares and take-over of companies.

(j) Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other intermediaries and self regulatory organisations associated with the securities market.

(k) performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 as may be delegated to it by the Central Government;

(l) Levying fees or other charges for carrying out the purposes of the Act.

(m) Conducting research for the above purposes

(n) performing such other functions as may be prescribed.

**Powers of SEBI**

For the discharge of its functions efficiently, SEBI has been vested with the following powers:

1. Power to regulate the matters relating to the issue of capital, transfer of securities etc

2. Power to issue directions to the parties and intermediaries associated with securities market.

3. Approve by−laws of stock exchanges.

4. Inspect the books of accounts and call for periodical returns from recognized stock exchanges.
5. Power to investigate the affairs of intermediaries or persons associated with securities market.

6. Inspect the books of accounts of financial intermediaries.

7. Compel certain companies to list their shares in one or more stock exchanges.

8. Registration of intermediaries

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