

FINANCIAL INSTITUTIONS AND MARKETS

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UNIT-II: FINANCIAL INSTITUTIONS: Commercial Banking: Types – Functions – Lending by Commercial Banks – Recent Developments – Merchant Banking-functions— Venture Capital—objectives--Private Equity– role in start-ups—Hire purchase and leasing— Non-banking Finance Companies: Types – Functions.

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UNIT-I

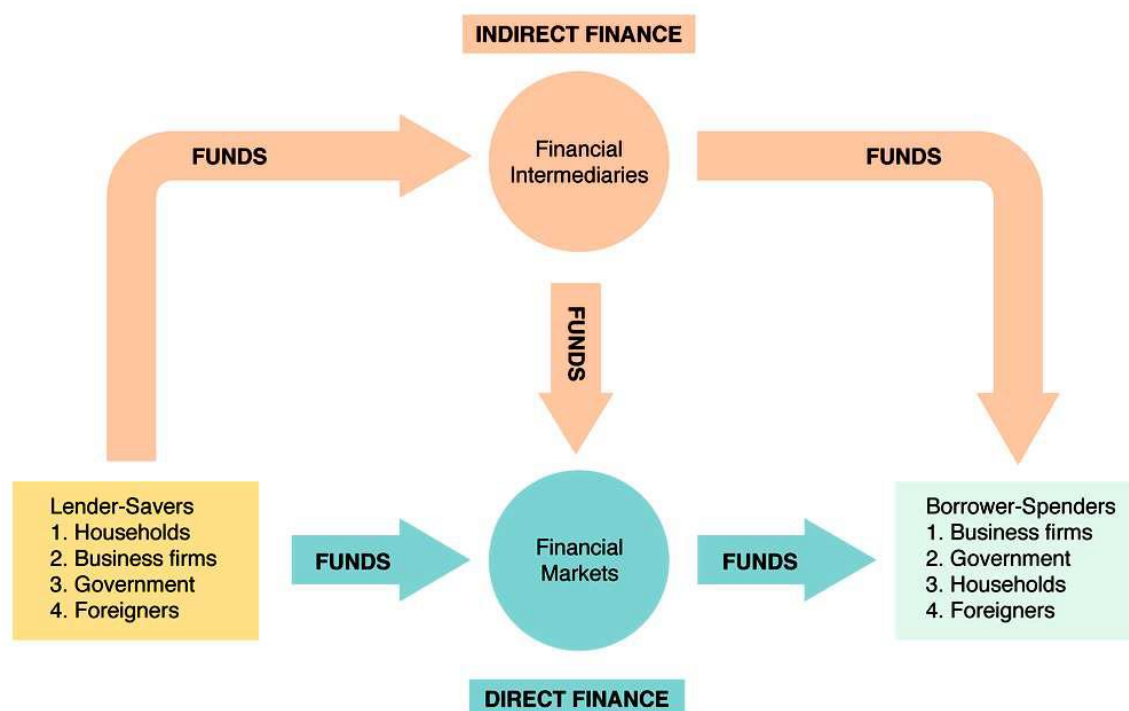
INDIAN FINANCIAL SYSTEM

Introduction:

Economic growth and development of any country depends upon a well-knit financial system. Financial system comprises a set of sub-systems of financial institutions financial markets, financial instruments and services which help in the formation of capital. Thus a financial system provides a mechanism by which savings are transformed into investments and it can be said that financial system play an significant role in economic growth of the country by mobilizing surplus funds and utilizing them effectively for productive purpose.

The financial system is characterized by the presence of integrated, organized and regulated financial markets, and institutions that meet the short term and long term financial needs of both the household and corporate sector. Both financial markets and financial institutions play an important role in the financial system by rendering various financial services to the community. They operate in close combination with each other.

Flow of funds in the financial systems



Financial System;

The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation

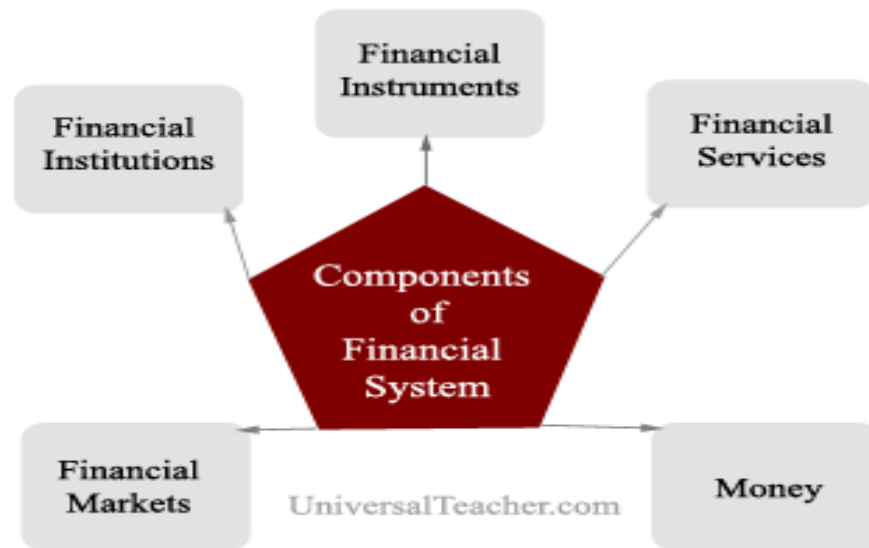
Role/ Functions of Financial System: A financial system performs the following functions:

1. It serves as a link between savers and investors. It helps in utilizing the mobilized savings of scattered savers in more efficient and effective manner. It channelizes flow of saving into productive investment.
2. It assists in the selection of the projects to be financed and also reviews the performance of such projects periodically.
3. It provides payment mechanism for exchange of goods and services.
4. It provides a mechanism for the transfer of resources across geographic boundaries.
5. It provides a mechanism for managing and controlling the risk involved in mobilizing savings and allocating credit.
6. It promotes the process of capital formation by bringing together the supply of saving and the demand for investible funds.
7. It helps in lowering the cost of transaction and increase returns. Reduce cost motives people to save more.
8. It provides you detailed information to the operators/ players in the market such as individuals, business houses, Governments etc.

Components/ Constituents of Indian Financial system:

The following are the four main components of Indian Financial system

1. Financial institutions / Intermediaries
2. Financial Markets
3. Financial Instruments/Assets/Securities
4. Financial Services.
5. Money



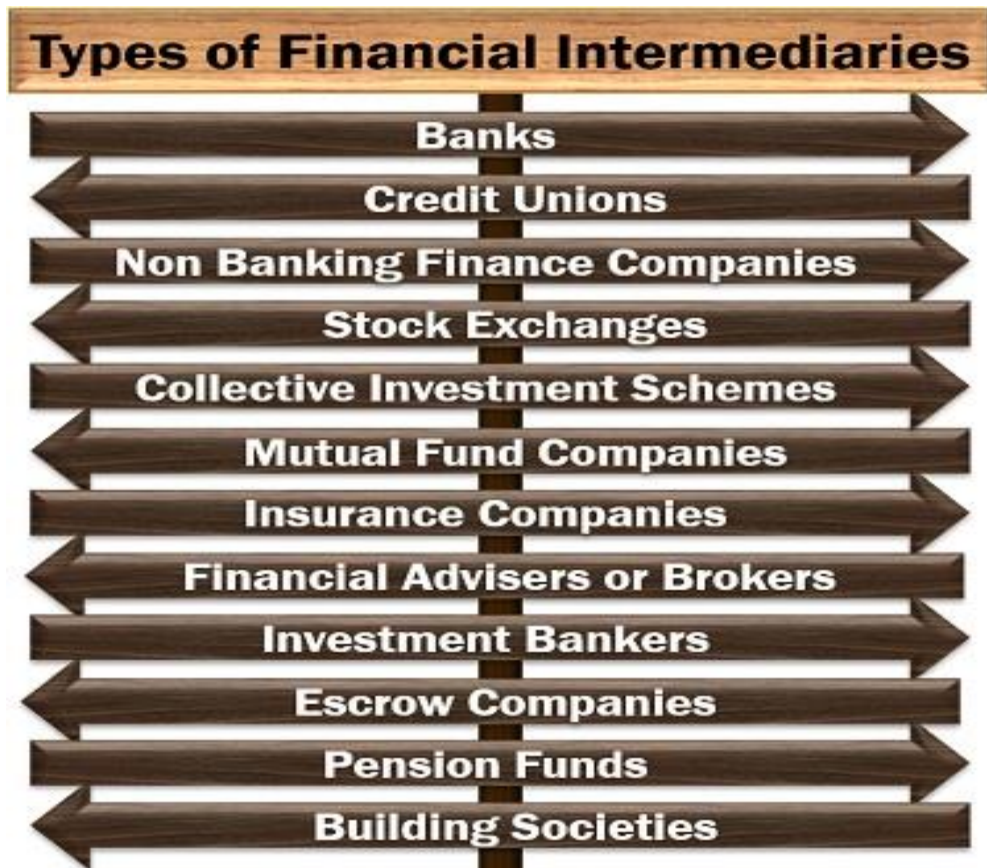
1. Financial institutions: Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities seeking advice on various issues ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets elsewhere. Financial institutions act as **financial intermediaries** because they act as middlemen between savers and borrowers. Were these financial institutions may be of Banking or Non-Banking

They could be categorized into Regulatory, Intermediaries, Non-intermediaries and Others. They offer services to organizations looking for advises on different problems including restructuring to diversification strategies. They offer complete array of services to the organizations who want to raise funds from the markets and take care of financial assets for example deposits, securities, loans, etc

Types of Financial Intermediaries

- **Banks:** The central and commercial banks are the most well known financial intermediaries simplifying the lending and borrowing process along with providing various other services to its customers on a large scale.
- **Credit Unions:** These are the cooperative financial units which facilitate lending and borrowing of funds to provide financial assistance to its members.
- **Non-Banking Finance Companies:** A NBFC is a financial company engaged in activities such as advancing loans to its clients at a very high rate of interest.

- **Stock Exchanges:** The stock exchange facilitate the trading of securities and stocks, and in every trading activity it charges the brokerage from each party which is its profit.
- **Mutual Fund Companies:** The [mutual fund](#) organizations clubs the amount collected from various investors who have the same investment objective and risk-taking ability, to invest in the securities, bonds and other investment options to ensure a capital gain in the long run.
- **Insurance Companies:** These companies provide insurance policies to the individuals and [business](#) entities to secure them against accident, death, risk, uncertainties and default. For this purpose, they accept deposits in the form of premium which is pooled into profitable investments to gain returns. The insured person can claim the money in case of any mishap as per the agreement.
- **Financial Advisers or Brokers:** The investment brokers also collect the funds from various investors to invest it in the securities, bonds, equities, etc. The financial advisers even provide guidance and expert opinions to the investors.
- **Investment Bankers:** These banks specialize in services initial public offerings (IPO), other equity offerings, proving for mergers and acquisitions, institutional client's broker services, underwriting debts, etc. while mediating between the investor or public and the companies issuing securities.
- **Escrow Companies:** It is a third party acting as an intermediary and responsible for getting all the conditions fulfilled at the time of loan provided by one party to the other for the real estate mortgage.
- **Pension Funds:** The government entities initiates a pension fund where a certain amount is deducted from the salary of the employees each month to be returned with interest after their retirement. This collected sum is then invested in different schemes to gain profits.
- **Building Societies:** These financial intermediaries are similar to the credit unions, owned and facilitating mortgage loans and demand deposits to its members.
- **Collective Investment Schemes:** Under this scheme, the various investors with common investment objective come together to pool their funds and collectively invest this amount into a profitable investment option. Later they distribute the interest among themselves as per the agreement.



2. **Financial Markets:** Finance is a prerequisite for modern business and financial institutions play a vital role in economic system. It's through financial markets the financial system of an economy works.

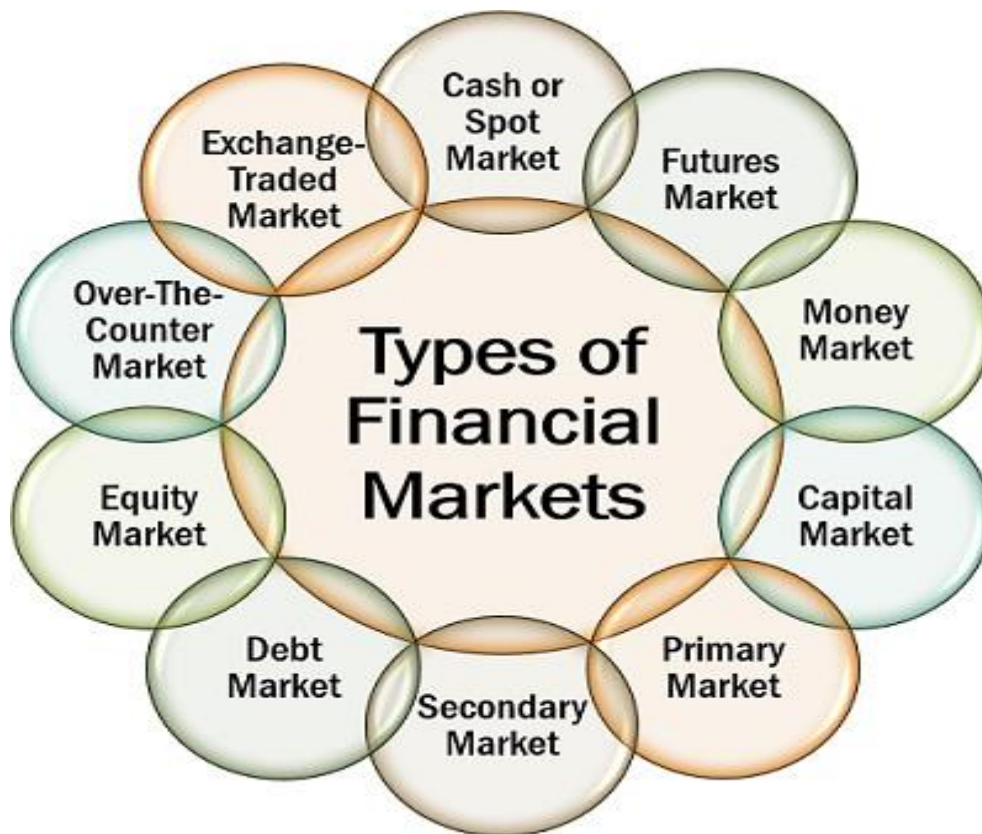
The main functions of financial markets are:

1. to facilitate creation and allocation of credit and liquidity;
2. to serve as intermediaries for mobilization of savings;
3. to assist process of balanced economic growth;
4. to provide financial convenience

Definition: A financial market is a marketplace where trading or exchange of various financial instruments and assets takes place, and the price of these assets is dependant on its demand and supply in the respective market. All the financial and economic activities in a country are dependent upon these markets

Example : The most common financial market is the **Real Estate Investment Trusts (REITs)** which initiates investments from small investors who intend to own real estate but lack the sufficient funds for the purpose. These trusts pool in the funds collected from such investors into profitable real estate projects.

Types of Financial Markets



1. **Cash or Spot Market:** It is a spot or real-time market where all the trading and transactions are executed or take place immediately.
2. **Forward or Futures Market:** Unlike cash market, in future and forward markets, the execution of the transaction takes place on a future date when the price of securities or transaction value is decided at present to minimize the loss to either party.
3. **Money Market:** The financial market which provides very short-term loans or advances having a maturity period within a year of issue is termed as a money market.
4. **Capital Market:** This market exists for the trading of medium and long-term financial instruments between the individuals and financial institutions.
5. **Primary Market:** In a financial market, when the listed companies issue new securities, or new companies take entry with new stocks, it is called as a primary market.
6. **Secondary Market:** It is commonly known as the stock market. It is a financial market where the individuals, brokers, companies, banks and various other parties are involved in trading of existing (already issued previously) securities.

7. **Debt Market:** The financial market which facilitates the trading of debt instruments or instrument with fixed interest such as bonds, fixed deposits, debentures is called debt market.
8. **Equity Market:** This market deals in financial instruments or securities whose value keeps on fluctuating and the claimant receives the amount which persists on the date of redemption.
9. **Exchange-Traded Market:** The market where trading of call, put and futures options take place on an organized futures exchange in a systematic manner is called an exchange-traded market.
10. **Over-The-Counter Market:** Unlike an exchange, in this unregulated market, trading of various securities such as exotic options and derivatives, swaps, credit derivatives, forward contracts take place directly between the two parties without any involvement of the intermediaries.

3. Financial Instruments: Another important constituent of financial system is financial instruments. They represent a claim against the future income and wealth of others. It will be a claim against a person or an institution, for the payment of the some of the money at a specified future date. The products which are traded in a financial market are financial assets, securities or other type of financial instruments. There is a wide range of securities in the markets since the needs of investors and credit seekers are different. They indicate a claim on the settlement of principal down the road or payment of a regular amount by means of interest or dividend. Equity shares, debentures, bonds, etc are some examples.

1. **Primary Securities:** Securities issued by the non-financial economic units.
 - a. **Equity Shares:** An equity share is the ownership securities. They bear the risk and enjoy the rewards of ownership.
 - b. **Preference Shares:** Holders enjoy preferential right as to: (a) payment of dividend at a fixed rate during the lifetime of the Company; and (b) the return of capital on winding up of the Company.
 - c. **Debentures:** An creditor ship security. Holders are entitled to predetermined interest and claim on the assets of the company.
 - d. **Innovative Debt instruments:** A variety of debt innovative instruments emerges with the growth of financial system to make them more attractive.
 - e. **Participative Debentures:** participate in the excess profits of the company after the payment of dividend.

f. Convertible debentures with options:

- ☐ **Third party convertible debentures:** entitle the holder to subscribe to the equity of another firm at a preferential price.
- ☐ **Convertible debenture redeemable at premium:** issued at face value with option to sell at premium.
- ☐ **Debt equity swap:** offers to swap debentures for equity.
- ☐ **Zero coupon convertible notes:** convertible in to shares and all the accrued / unpaid interest is forgone.

2. Indirect Securities:

- Issued by financial intermediaries.
- Such as units of mutual funds, policies of insurance companies, deposits of banks, etc.
- Better suited to small investors
- Benefits of pooling of funds by intermediaries.
- Convenience, lower risk and expert management.

3. Derivatives

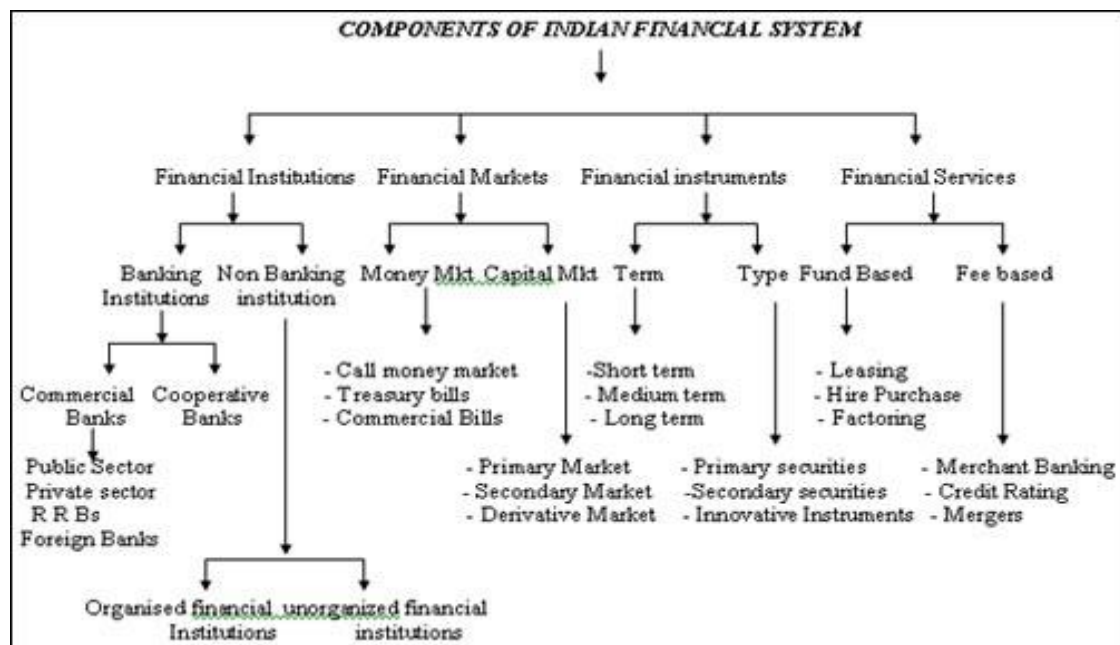
- Derivative is a product whose value is derived from the value of one or more basic variables called base, in a contractual manner. The underlying asset can be equity/forex or any other assets.
- The Securities Contracts (Regulation) Act, 1956 (SCIA) defined derivative to include-
 1. A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
 2. A contract which derives its value from the prices, or index of prices, of underlying securities.

4. Financial Services: Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as "activities, benefits and satisfaction connected with sale of money, that offers to users and customers, financial related value". Financial services consist of services provided by Asset Management and Liability Management Companies. They help to get the necessary funds and also make sure that they are efficiently deployed.

They assist to determine the financing combination and extend their professional services upto the stage of servicing of lenders. They help with borrowing, selling and purchasing securities, lending and investing, making and allowing payments and settlements and taking care of risk exposures in financial markets. These range from the leasing companies, mutual fund houses, merchant bankers, portfolio managers, bill discounting and acceptance houses.

The financial services sector offers a number of professional services like credit rating, venture capital financing, mutual funds, merchant banking, depository services, book building, etc. Financial institutions and financial markets help in the working of the financial system by means of financial instruments. To be able to carry out the jobs given, they need several services of financial nature. Therefore, financial services are considered as the *4th major component of the financial system*.

5. Money: Money is understood to be anything that is accepted for payment of products and services or for the repayment of debt. It is a medium of exchange and acts as a store of value.



RECENT DEVELOPMENTS IN INDIAN FINANCIAL SYSTEM

1. **The constitutional validity of the aadhaar scheme upheld by Supreme Court:** From now onwards, Aadhaar will not be mandatory for opening bank accounts, getting a phone connection or school admissions as per the constitutional validity of the Aadhaar scheme upheld by Supreme Court. Also, Aadhaar holder's data will not be disclosed on the grounds of national security.

2. **RBI To Form Regulatory Sandbox For Fintech And To Setp Up Data Science Lab:** The Reserve Bank of India (RBI) has decided to form a regulatory sandbox for financial technology (fintech) and setting up of data science labs in order to keep pace with innovation in the digital lending space.

3. **IRDAI to Migrate To Risk-Based Capital Regime Apex Insurance Regulator:** IRDAI has decided to move towards the risk-based capital (RBC) regime in order to improve protection for policyholders. This shift in regime was done because of the reason that current Solvency Based Rules were not helpful in assessing whether the capital held is adequate enough for the risks inherent in the insurance business. But, if risk-based capital system is there, then additional capital will not remain idle.

4. **Liquidity Boost:** RBI increased SLR under the base-iii calculations RBI has increased the amount of statutory liquidity ratio (SLR) with a further 2 per cent increase in the treasury holdings of banks as high-quality liquid assets (HQLAs) under the Basel-III calculations, potentially releasing up to Rs 2 lakh crore. Now, banks can consider as HQLAs to 15 per cent of their total deposits from 13 per cent earlier. Also, Banks have to mandatorily invest 19.5 per cent of their total deposits in government securities. It is important to note that, under the Basel-III rules, banks have to invest a part of their funds into liquid securities which make up a liquidity coverage ratio (LCR). Earlier in June 2018, RBI had allowed banks to consider 13 per cent of total deposits as HQLAs, up from 11 per cent.

5. **Government To Set Up Independent Payments Regulatory Board (PRB) IN RBI:** Finance Minister has proposed to create a six-member independent Payments Regulatory Board (PRB) in the RBI, in order to bring about structural reforms in the payment and settlement system.

For the purpose, necessary amendments have been proposed in the Finance Bill 2017 to create a Payments Regulatory Board in the Reserve Bank of India by replacing the existing Board for Regulation and Supervision of Payment and Settlement Systems (BPSS). As per the Finance Bill, the Reserve Bank of India will be the designated authority for the regulation and supervision of payment systems. Also, The RBI Governor will be the Chairperson, ex officio.

6. 20 Lakh People Join Modified Jandhan Scheme, Totalling Account Holders To 32.61

Crores As per the latest data released by the Finance Ministry, 20 lakh people have joined the modified Pradhan Mantri Jan Dhan Yojna (PMJDY), taking the total number of account holders in this flagship financial inclusion programme to 32.61 crore. The government earlier this month relaunched PMJDY as an open-ended scheme with higher insurance cover and doubles the overdraft (OD) facility. Under the revamped scheme, accidental insurance cover for new RuPay card holders has been revised and raised from Rs 1 lakh to Rs 2 lakh. Also, the existing Overdraft limit of Rs 5,000 has been increased to Rs 10,000 where no conditions will be attached for overdraft up to Rs 2,000. PMJDY was launched in August 2014, the first phase of which focused on opening basic bank accounts and RuPay debit card with in-built accident insurance cover of Rs 1 lakh. Phase II begins in August 15, 2018 to provide micro-insurance to the people and pension schemes to unorganised sector workers through Business Correspondents. It is important to note that about 53 per cent of PMJDY account holders are women, while 83 per cent of the total accounts are seeded with Aadhaar.

7. NPCI: Economic Times Awards 2018 for Change Agent of the Year: National Payment Corporation of India has been honored with Economic Times Awards 2018 for Change agent of the year. Ranging from creating the National Financial Switch for all ATM transactions and a centralized cheque clearance mechanism to the IMPS instant bank-to-bank fund transfer and Smartphone-based Unified Payments Interface (UPI), NPCI is an umbrella organization to cater to the varied payment needs of the Indian public. Dilip Asbe is the current CEO of NPCI.

8. PM Launched The India Post Payments Bank (IPPB): In New Delhi Prime Minister Narendra Modi has launched the long awaited India Post Payments Bank (IPPB) in order to ensure financial inclusion for the masses. The event was held at Talkatora Stadium in New Delhi.

IPPBs will have 650 branches in the country to provide an accessible, affordable and trusted bank for the common man. The Government owns 100 per cent equity in IPPBs and also all the 1.55 lakh post offices in the country will be linked to the IPPB system by December 31, 2018. IPPB will offer a wide variety of products including savings and current accounts, money transfer, direct benefit transfers, bill and utility payments, and enterprise and merchant payments. Also, Cabinet has approved the 80 per cent increase in spending for IPPB to compete aggressively with existing players like Airtel Payments Bank and Paytm Payments Bank.

9. **India To Become One Of World's Block chain Leaders By 2023:** With the right amount of industry and government participation, India could be in leadership ranks in adoption of block chain technology in the next five years, a survey by global consultancy firm PwC. A block chain is an open distributed ledger technology that stores information across multiple systems securely to enable peer-to-peer transactions by creating a trustworthy source. Banks and other financial institutions are investing in block chain technology as it cuts down their costs and makes their operations faster and more transparent.

10. **RBI To Conduct OMO To Infuse Liquidity** Based on the assessment of prevailing liquidity conditions in the economy, the Reserve Bank has decided to conduct purchase of government securities under Open Market Operations for an aggregate amount of Rs 100 billion (Rs 10,000 crore). Open Market Operation is a monetary policy tool used by central bank to either inject or drain liquidity from the economy. If there is excess liquidity, the RBI resorts to sale securities and sucks out the rupee liquidity. Similarly, when the liquidity conditions are tight, it starts purchasing securities from the market, thereby releasing money into the market.

11. **Government Develops National Logistics Portal:** Union Ministry of Commerce and Industry has developed National Logistics Portal to ensure ease of trading in international and domestic markets. It will be implemented in phases with the objective to fulfil Central Government's commitment to enhance trade competitiveness, create jobs, boost India's performance. Also, In 2018-19 budget speech, Union Finance Minister had announced that Department of Commerce will create portal which will be single window online market place for trade.

12. **DBS BANK:** Best Bank In The World DBS Bank has won the prestigious Best Bank award by Global Finance in its World's Best Global Banks 2018 Awards. DBS bank is increasingly gaining international recognition and stature on the world stage, particularly for its leadership in digital transformation. Also, in July 2018, the bank was crowned World's Best Digital Bank by Euro money for the second time in three years. DBS is a leading financial services group in Asia that has 280 branches across the world with its Headquartered in Singapore. Also, the bank has also been named as the "Safest Bank in Asia" by Global Finance for nine consecutive years from 2009 to 2017.

13. **RBI Liberalizes External Commercial Borrowings (ECBS) To Check Rupee Depreciation:** The Reserve Bank of India (RBI) liberalizes some aspects of the external commercial borrowings (ECBs) policy including those related to rupee-denominated bonds to help check rupee depreciation. Presently, domestic banks can act as arranger and underwriter for rupee denominated bonds (RDBs), also known as masala bonds, issued overseas, and their holding cannot be more than five per cent of the issue size after six months of issue as an underwriter. Now Indian banks have been permitted to participate as arrangers/underwriters/market makers/traders in RDBs issued overseas subject to applicable prudential norms. Government also exempted tax on interest payable by Indian companies to non-residents, including foreign companies, on borrowings through off-shore rupee denominated bonds issued till March 31, 2019. Till now, interest payable on these bonds issued before July 1, were subject to a concessional rate of tax of five per cent.

14. **Reserve Bank Approves License For Pay U To Open NBFC Arm:** PayU India has received a licence from the Reserve Bank of India to operate its own non-banking financial company, a development that will provide a big boost to the fintech in growing its consumer credit business. Pay U India, which processes monthly payments of about Rs 8,000 crore, derives only about 2% of its overall revenue from its credit businesses currently. Also, Flipkart-owned PhonePe has also partnered with Pay U to get enlisted as a payment mode for all merchants using the payment gateway for online transactions.

15. **Finance Ministry Moves To Declutter DRTS To Ease Debt Recovery:** The government decided to double pecuniary limit to Rs 20 lakh for filing applications with Debt Recovery Tribunal (DRTs), following the amendment to rules of Recovery of Debts due to Banks and Financial Institutions Act, 1993.

As a result, any bank or financial cannot approach DRTs if the amount due is less than Rs 20 lakh. To make the tribunals more effective and to facilitate fast disposal of debt recovery cases, the government has made several amendments in different laws, including the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.

16. BOB, Vijaya And Dena Bank Merger: Proposal To Create Second Largest PSU Lender: Government has decided to merge the three PSBs namely, BoB, Vijaya and Dena Bank to pursue banking sector reforms. The government announced the merger of Bank of Baroda, Vijaya Bank and Dena Bank to create the country's second-largest public sector bank by assets and branches and the third largest lender in the country. As on April 2017, State Bank had merged with five of its subsidiary banks and took over Bharatiya Mahila Bank. It is important to note that after the merger of BoB, Vijaya Bank and Dena Bank, the number of public sector banks will come down to 19.

WEAKNESS OF INDIAN FINANCIAL SYSTEM

1. Lack of co-ordination among financial institutions
2. Dominance of development banks in industrial finance
3. Inactive and erratic capital market
4. Unhealthy financial practices
5. Monopolistic market structures

UNIT-III

MONEY MARKET INTRODUCTION

Money Market is a segment of Financial Market where borrowing and lending of short-term funds take place. The maturity of money market instruments is from one day to one year. In India, this market is regulated by both RBI and **SEBI**. The nature of transactions in this market is such that they are large in amount and high in volume. Thus we can say that the entire market is dominated by a small number of large players.

Definition of Money Market

Money market is the center of dealing in short term monetary assets like bill of exchange, short term govt. securities and other short term loans. The main dealers of money markets are the banks and financial institutions. They get and give loan or purchase and sell short terms bill in this market. This is not fix place but this system in which they deal with each other.

FUNCTIONS OF INDIAN MONEY MARKETS

The instruments of this market are liquid when we compare it with other financial instruments. We can convert these instruments into cash easily. Thus, they are able to address the need for the short-term surplus funds of the lenders and short-term fund requirements of the borrowers. The major functions of such market instrument are to cater to the short-term financial needs of the economy. Some other functions are as following:

1. It helps in effective implementation of the RBI's monetary policy.
2. This market helps to maintain demand and supply equilibrium with regard to short-term funds.
3. It also meets the need of short-term fund requirement of the government.
4. It helps in maintaining liquidity in the economy.

FEATURES OF MONEY MARKET

1. **A Central Bank:** A developed money market has central banks at the top which is the most powerful authority in monetary and banking matter. It controls, regulates and guides the entire money market. It provides liquidity to the money market, as it is the lender of the last resort to the various constituents of the money market.

2. **Organized Banking System:** An organized and integrated banking system is the second feature of a developed money market. In fact, it is the pivot around which the whole money market revolves. It is the commercial banks which supply short-term loans, and discount bills of exchange. They form an important link between the borrowers, brokers, discount houses and acceptance houses and the central bank in the money market.

3. **Existence of Large Near-Money Assets:** A developed money market has a large number of near-money assets of various types such as bills of exchange, promissory notes, treasury bills, securities, bonds, etc. The larger the number of near-money assets, the more developed is the money market.

4. **Integrated Interest-Rate Structure:** Another important characteristic of a developed money market is that it has an integrated interest rate structure. The interest rates prevailing in the various sub-markets are integrated to each other. A change in the bank rate leads to proportional changes in the interest rate prevailing in the submarkets.

5. **Miscellaneous Factors:** Besides the above noted features, a developed money market is highly influenced by such factors as restrictions on international transactions, crisis, boom, depression, war, political instability, etc.

6. It is a market purely for short-term funds or financial assets called near money.

7. It deals with financial assets having a maturity period less than one year only.

8. In Money Market transaction cannot take place formal like stock exchange, only through oral communication, relevant document and written communication transaction can be done. Transaction has to be conducted without the help of brokers.

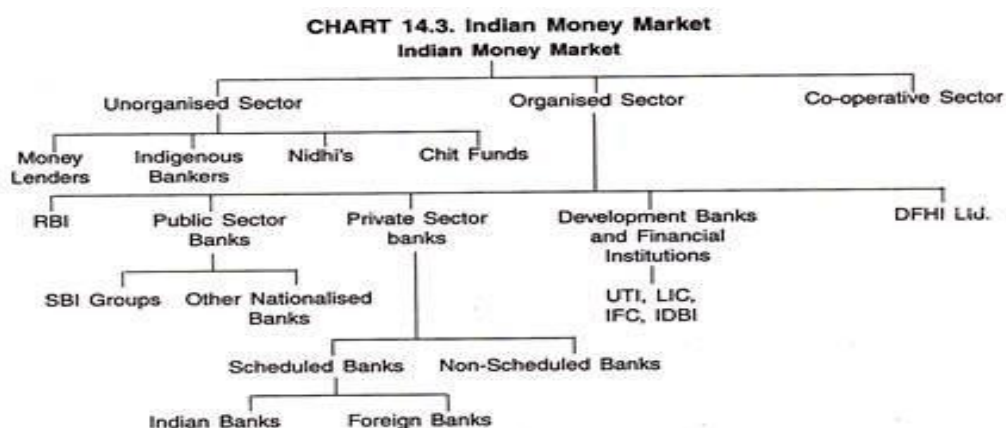
9. It is not a single homogeneous market, it comprises of several submarket like call money market, acceptance & bill market.

10. The component of Money Market are the commercial banks, acceptance houses & NBFC (Nonbanking financial companies).

OBJECTIVES OF MONEY MARKET

- To provide a reasonable access to users of short-term funds to meet their requirement quickly, adequately at reasonable cost.
- To provide a parking place to employ short term surplus funds.

ORGANIZATION OF MONEY MARKET



1. Unorganized Sector of Indian Money Market: Unorganized segment of the Indian money market is composed of unregulated non-bank financial intermediaries, indigenous bankers and money lenders which exist even in the small towns and big cities. Their lending activities are mostly restricted to small towns and villages. The persons who normally borrow from this unorganized sector include farmers, artisan's small traders and small scale producers who do not have any access to modern banks. The following are some of the constituents of unorganized money market in India.

(i) Indigenous Bankers: Indigenous bankers include those individuals and private firms which are engaged in receiving deposits and giving loans and thereby acting like a mini bank. Their activities are not at all regulated. During the ancient and medieval periods, these indigenous bankers were very active. But with the growth of modern banking, particularly after the advent of British, the business of the indigenous bankers received a setback. Moreover, with the growth of commercial banks and co-operative banks the area of operations of indigenous bankers has again contracted further. Even today, a few thousands of indigenous bankers are still operating in the western and southern parts of the country and engaging themselves in the traditional banking business. Indigenous bankers are classified into four main sub groups, i.e., Gujarati Shroffs, Multani-or Shikarpuri Shroffs, Chettiars and Marwari, Kayast. Gujarati Shroffs are mostly operating in Mumbai, Kolkata and in industrial and trading cities of Gujarat. The Multani or Shikarpuri Shroffs are operating mainly in Mumbai and Chennai. The indigenous bankers are mostly engaged in both banking and non-banking business which they do not want to separate. Their lending operations remain mostly unregulated and unsupervised. They charge high rate of interest and they are not influenced by bank rate policy of the Reserve Bank of India.

(ii) Unregulated Non-Bank Financial Intermediaries: There are different types of unregulated non-bank financial intermediaries in India. They are mostly constituted by loan or finance companies, chit funds and 'nidhis'. A good number of finance companies in India are engaged in collecting substantial amount of funds in the form of deposits, borrowings and other receipts. They normally give loans to wholesale traders, relailers, artisans, and different self-employed persons at a high rate of interest ranging between 36 to 48 per cent. There are various types of chit funds in India. They are doing business in almost all the states but the major portion of their business is concentrated in Tamil Nadu and Kerala. Moreover, there are 'nidhis' operating in South India which are a kind of mutual benefit funds restricted to its members.

(iii) Moneylenders: Moneylenders are advancing loans to small borrowers like marginal and small farmers, agricultural labourers, artisans, factory and mine workers, low paid staffs, small traders etc. at very high rates of interest and also adopt various malpractices for manipulating loan records of these poor borrowers. **There are broadly three types of moneylenders:**

- (i) Professional moneylenders dealing solely with money lending;
- (ii) Itinerant moneylenders such as Kabulis and Pathans and
- (iii) Non-professional moneylenders.

The area of operation of the moneylenders is very much localized and their methods of operation are also not uniform. The money lending operation of the moneylenders is totally unregulated and unsupervised which leads to worst exploitation of the small borrowers. Moneylenders have become a necessary evil in the absence of sufficient institutional sources of credit to the poorer sections of society. Although various measures have been introduced to control the activities of moneylenders but due to lack of political will, these are not enforced, leading to a exploitation of small borrowers.

2. Organized Sector of Indian Money Market: The organized segments of the Indian money market is composed of the Reserve Bank of India (RBI), the State Bank of India, Commercial banks, Co-operative banks, foreign banks, finance corporations and the Discount or Finance House of India Limited. The segment of Indian money market is quite integrated and well organized. Mumbai, Kolkata, Chennai, Delhi, Bangalore and Ahmadabad are the leading centers of the organized sectors of the Indian money market. The Mumbai money market is a well organized, having head offices of the RBI and different commercial banks, two leading well developed stock exchanges, the bullion exchange and fairly organized market for Government securities. All these have placed the Mumbai money market at par with New York money market of USA and London money market of England.

The main constituents of the organized sector of Indian money market include:

(i) Call Money Market: The call money market is a most common form of developed money market. It is a most sensitive segment of the financial system which reflects clearly any change in it. The call money market in India is very much centred at Mumbai, Chennai and Kolkata and out of which the Mumbai is the most important one. In such market, lending and borrowing operations are carried out for one day. The call money market is also termed as inter-bank call money market. Normally, scheduled commercial banks,

(ii) Treasury Bill Market: Treasury bill markets are markets for treasury bills. In India such treasury bills are short term liability of the Central Government which are of 91 day and 364 day duration. Normally, the treasury bills should be issued so as to meet temporary revenue deficit over expenditure of a Government at some point of time. But, in India, the treasury bills are, nowadays, considered as a permanent source of funds for the Central Government. In India, the RBI is the major holder of the treasury bills, which is around 90 per cent of the total. In India, ad-hoc treasury bills have now been replaced by ways and means Advances since April 1, 1997, so as to finance temporary deficits of the Central Government.

(iii) Commercial Bill Market: The Commercial bill market is a kind of sub-market which normally deals with trade bills or the commercial bills. It is a kind of bill which is normally drawn by one merchant firm on the other and they arise out of commercial transactions.

The purpose for issuing a commercial bill is simply to reimburse the seller as and when the buyer delays payment. But, in India, the commercial bill market is not so developed. This is mainly due to popularity of the cash credit system in bank lending and the unwillingness on the part of large buyer to bind himself to payment schedule related to the commercial bill and also the lack of uniform approach in drawing bills. Commercial bills are an instrument of credit which is very much useful to business firms and banks. In India, the outstanding amount of commercial bills rediscounted by the banks with different financial institutions at the end of March, 1996 was to the extent of only Rs 374 crore.

(iv) Certificate of Deposit (CD) Market: The certificate of Deposit (CD) was introduced in India by the RBI in March 1989 with the sole objective of widening the range of money market instruments and also to attain higher flexibility in the development of short term surplus funds for the investors. Initially the CDs are issued by scheduled commercial banks in multiples of Rs 25 lakh and also to the extent of a minimum of Rs 1 crore. Maturity period of CDs varied between three months and one year. In India, six financial institutions, viz., IDBI, ICICI, IFCI, IRBI, SIDBI and Export and Import Bank of India were permitted in 1993 to issue CDs for period varying between 1 to 3 years. Banks normally pay high rates of interest on CDs. In 1995-96, the stringent conditions in the money market induced the bankers to mobilise a good amount of resources through CDs. Accordingly in recent years, the outstanding amount of CDs issued by the commercial banks has almost been doubled from Rs 8,017 crore in March, 1995 to Rs 16,316 crore as on 29th March, 1996.

(v) Commercial Paper Market: In India, the Commercial Paper (CP) was introduced in the money market in January 1990. A listed company having working capital not less than Rs 5 crore can issue CP. Again the CP can be issued in multiples of Rs 25 lakhs subject to a minimum of Rs 1 crore for a maturity period varying between three to six months. CPs would be again freely transferable by endorsement and delivery.

(vi) Money Market Mutual Funds: In India, the RBI has introduced a scheme of Money Market Mutual Funds (MMMFs) in April 1992. The main objective of this scheme was to arrange an additional short term avenue for the individual investors. This scheme has failed to receive much response as the initial guidelines were not attractive. Thus, in November, 1995, the RBI introduced some relaxations in order to make the scheme more attractive and flexible.

As per the existing guidelines, the banks, public financial institutions and the private financial institutions are allowed to set up MMMFs. In the mean time, the limits of investment in individual instruments by MMMF have already been deregulated. Since April 1996, the RBI has allowed MMMFs to issue units to corporate enterprises and others at par with the mutual funds introduced earlier.

MONEY MARKET INSTRUMENTS

1) Treasury Bills: Treasury bills are considered the safest instruments since they are issued with a full guarantee by the United States government. They are issued by the U.S. Treasury regularly to refinance Treasury bills reaching maturity and to finance the federal government's deficits. They have a maturity of one, three, six, or twelve months. Treasury bills are sold at a discount to their face value, and the difference between the discounted purchases price and face value represents the interest rate. They are purchased by banks, broker-dealers, individual investors, pension funds, insurance companies, and other large institutions. Treasury bills, commonly referred to as T-Bills are issued by Government of Pakistan against their short term borrowing requirements. T-Bills are the most marketable money market security due to its simplicity. Their standard maturity periods are 4, 13, 26 or 52 weeks (1, 3, 6, 12 months) one of the money market instruments that are affordable to the individual investors. T-Bills are considered to be the safest investment. They are considered to be risk free as they are backed by the government.

2) Certificate of Deposit: A certificate of deposit (CD) is issued directly by a commercial bank, but it can be purchased through brokerage firms. It has a maturity date ranging from three months to five years and can be issued in any denomination. Most CDs have a fixed maturity date and interest rate, and they attract a penalty for withdrawing prior the time of maturity. Just like a bank's checking account, a certificate of deposit is insured by the Federal Deposit Insurance Corporation (FDIC). A Certificate of Deposit (CD) is a time deposit with bank. CDs are generally issued by commercial banks but the can be bought through brokerages. They bear a specific maturity date (from three months to five years, a specified interest rate and can be issued in any denomination. CDs offer a slightly higher yield than T-Bills because of the slightly higher default risk for bank

3) Commercial Paper: Commercial paper is an unsecured loan issued by large institutions or corporations to finance short-term cash flow needs such as inventory and accounts payables. It is issued at a discount, with the difference between the price and face value of the commercial paper being the profit to the investor. Only institutions with a high credit rating can issue commercial paper, and it is therefore considered a safe investment. Individual investors can invest in the commercial paper market indirectly through money market funds. Commercial paper has a maturity date between one month and nine months. Commercial paper is an unsecured, short term loan issued by a corporation, typically for financing Accounts Receivables and Inventories. Maturities on Commercial Papers are no longer than nine months, with maturities of between one and two months being the average. Commercial Paper is a very safe investment because the financial situation of a company can easily be predicted over a few months.

4) Banker's Acceptance: A banker's acceptance is a form of short-term debt that is issued by a firm but guaranteed by a bank. It is created by a drawer, providing the bearer the rights to the money indicated on its face at a specified date. It is often used in international trade because of the benefits to both the drawer and bearer. The holder of the acceptance may decide to sell it on a secondary market, and investors can profit from the short-term investment. The maturity date usually lies between one month and six months from the issuing date.

5) Repurchase Agreements: A repurchase agreement (repo) is a short-term form of borrowing that involves selling a security with an agreement to repurchase it at a higher price at a later date. It is commonly used by dealers in government securities who sell Treasury bills to a lender and agree to repurchase them at an agreed price at a later date. The Federal Reserve buys repurchase agreements as a way of regulating the money supply and bank reserves. Their date of maturity ranges from overnight to 30 days or more.

6) Commercial Bill: A commercial bill is essentially a bill of exchange. Bills of exchange are similar to checks and promissory notes. They can be drawn by individuals or banks and are generally transferable by endorsements. The difference between a promissory note and a bill of exchange is that this product is transferable and can bind one party to pay a third party that was not involved in its creation. If these bills are issued by a bank, they can be referred to as bank drafts. If they are issued by individuals, they can be referred to as trade drafts.

7) **Call Money:** Call Money is short term finance used for interbank transactions. It has a maturity period of one day to fifteen days. All the commercial banks are required to maintain cash balance which is known as Cash Reserve Ratio (CRR). The Reserve Bank of India keeps on changing this ratio from time to time thus affecting the availability of funds, for providing loans, with the banks. Call money is a facility under which banks borrow money from each other to maintain CRR at rate of interest known as Call Rate. This rate keeps on changing from day to day and sometimes from hour to hour. The relationship between call rates and other short term instruments such as commercial papers, certificates of deposit etc. is an inverse relationship. An increase in call money rates increases the demand for other short term instruments.

LIQUIDITY ADJUSTMENT FACILITY

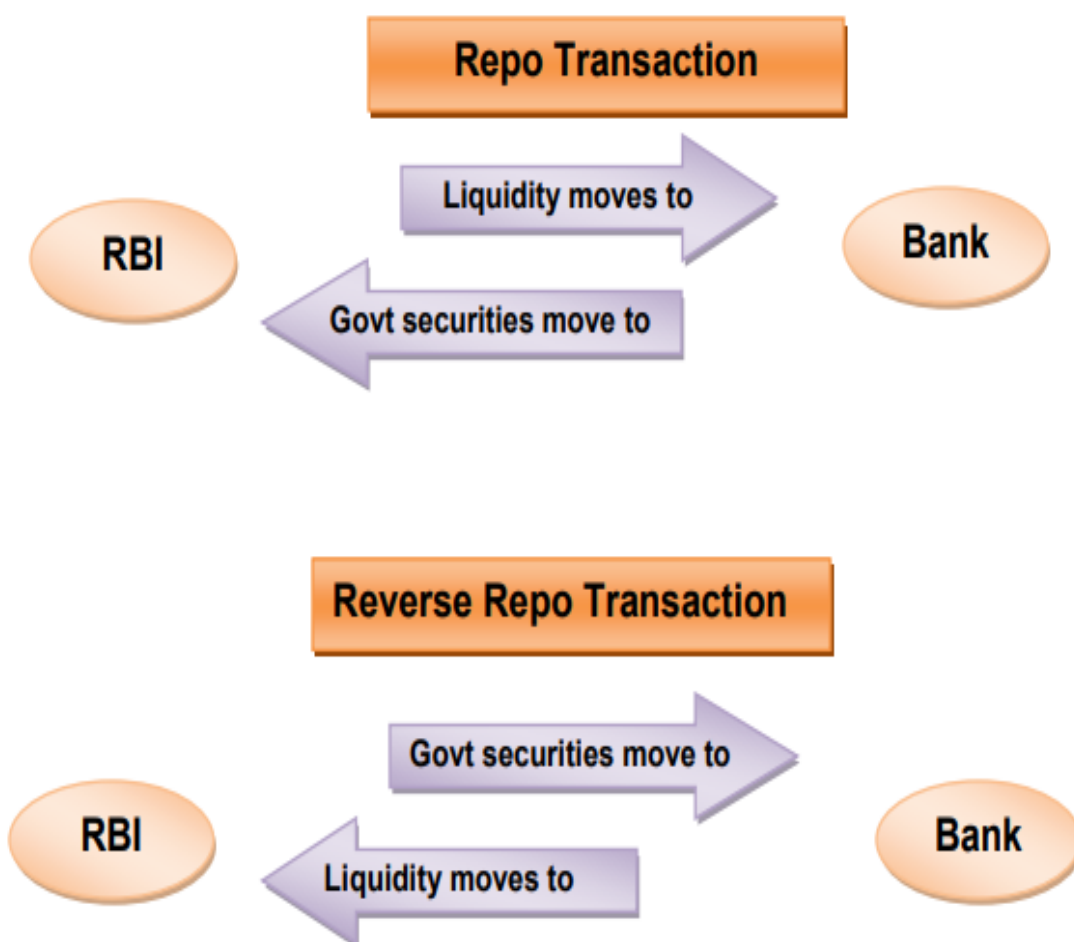
Liquidity Adjustment Facility is the mechanism by the RBI for managing the liquidity needs of the commercial banking system. The LAF is an important instrument of monetary policy. Various tools under the LAF including the popular repo and reverse repo are used by the RBI to manage liquidity in the financial system.

Components of LAF

The LAF works through various instruments devised by the RBI to inject liquidity into the banking system when the system/institutions need cash as well as to absorb liquidity when the banking system has excess money. Besides the usual repo and reverse repo, LAF includes auction-based repo and reverse repo (variable rate) tools for managing liquidity. Tools other than the repo and reverse repo were launched by the RBI later. Following are the components of LAF:

- Repo (Overnight fixed repo or the ‘popular’ repo)
- Reverse repo (Overnight fixed reverse repo or the ‘popular’ reverse repo)
- Term repo (auction)
- Overnight variable rate repo (auction)
- Overnight variable rate reverse repo (auction).
- Liquidity adjustment facility (LAF) is a monetary policy tool used by RBI to manage market liquidity and money supply targets. LAF was introduced in June 2000 and conducted daily on overnight basis.

- It helps banks to adjust their daily liquidity mismatches by pledging government securities over and above the SLR of 23% (Banks generally maintain SLR excess of 23% to borrow under LAF).
- LAF consist of Repo and Reverse Repo transactions. To meet liquidity shortage, banks can borrow from RBI through a repo transaction.
- In a Repo (Repurchase agreement) transaction banks make short term borrowing by selling government securities to RBI in agreement to buy back the same security at repo rate. Repo rate is the rate at which banks borrow from RBI.
- Repo transaction injects liquidity by RBI into the market through banks. Reverse repo transaction is opposite of a repo transaction. Since May 2011, RBI has linked reverse repo rate to repo rate. Reverse repo rate will be 100bps lower than repo rate.
- Chart below shows how a repo and reverse repo transaction takes place



When there is shortage of liquidity banks borrow from RBI at repo rate and when there is excess liquidity banks park their surplus liquidity with RBI at reverse repo rate.

MARGINAL STANDING FACILITY (MSF)

MSF was introduced by RBI in 2011, where banks can borrow from RBI when there is a considerable shortfall of liquidity. Under MSF, banks can borrow from RBI up to 1 % of NDTL and can pledge securities within the SLR unlike under LAF where has to be above the SLR. RBI recently restricted borrowing under LAF to 1 % of NDTL or approximately 75000cr. This implies that any additional borrowing required banks will have to go through other routes like call money market or marginal standing facility (MSF) which increases their cost of borrowing. The **Marginal Standing Facility (MSF)** is the rate at which the scheduled commercial banks borrow funds fortnight from the Reserve Bank of India against the government approved securities.

Why to use the MSF when banks can borrow funds through a Repo Rate?

The need for MSF arises, to meet the short-term emergency needs of the banks in case of a severe cash shortage or when the inter-bank liquidity dries up completely and to curb the volatility in the overnight interest rates.

Volatility refers to the variability of returns from the investments. It is directly proportional to the risk Viz. The higher the volatility, the higher is the risk of not getting the desired returns from the investments because of the fall in the market price, at the time it is to be en-cashed. Thus, to restrain from such volatility, RBI offered commercial banks the service to pledge their government securities and get more funds at a rate higher than the repo rate. In the case of borrowings, the commercial banks can borrow funds overnight up to a certain percentage of their net demand and time liabilities (NDTL).

The NDTL represents the aggregate bank's deposits along with the borrowings from others. The funds can be raised against all the government approved securities, including SLR (Statutory Liquidity Reserves- a reserve maintained by the commercial banks in the form of cash, gold, and other approved government securities – Bonds).

RBI uses Marginal standing facility to control and manage the money supply in the financial system. With the increase in the rate, the borrowing becomes expensive for the commercial banks and in return the loans become dearer for the individual or corporate borrowers, which will result in less flow of money in the market. Also, the MSF rate is often increased by RBI to curb the excessive availability of rupee and to avoid further rupee depreciation against a dollar.

MONETARY POLICY

- Monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the Act. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

MONETARY POLICY COMMITTEE (MPC)

- Monetary Policy Committee (MPC) is the body of the RBI, headed by the Governor, responsible for taking the important monetary policy decision about setting the repo rate. Repo rate is 'the policy instrument' in monetary policy that helps to realize the set inflation target by the RBI (at present 4%).
- The MPC replaces the previous arrangement of Technical Advisory Committee.
- The MPC was setup after a Memorandum of Understanding between the government and the RBI about the conduct of the new inflation targeting monetary policy framework in February 2015. First meeting of the MPC was held on October 4, 2016 after the Government made amendment of the RBI Act in June 27, 2016. Committee's meeting also marked the beginning of full-fledged implementation of the new inflation targeting monetary policy framework.

STRUCTURE OF THE MPC

- The Monetary Policy Committee (MPC) is formed under the RBI with six members. Three of the members are from the RBI while the other three members are appointed by the government. Members from the RBI are the Governor who is the chairman of the MPC, a Deputy Governor and one officer of the RBI. The government members are appointed by the Centre on the recommendations of a search-cum-selection committee which is to be headed by the Cabinet Secretary. The Committee is to meet at least four times a year and make public its decisions following each meeting. The quorum for the meeting of the MPC is four members. There will be no reappointment of the committee. Under MPC, the governor has a casting vote and doesn't enjoy veto power (there was veto power for him under TAC). Decisions will be taken on the basis of majority vote.

- The main responsibility of the MPC is to administer the inflation targeting monetary policy regime through determining the policy rate or repo rate to contain inflation.

FUNCTION OF THE MPC

- The main responsibility of the MPC will be to keep the inflation targets set by the RBI. The MPC decides the changes to be made to the policy rate (repo rate) to contain inflation within the target (based on CPI) level set under India's inflation targeting regime. Members of the MPC can suggest reasons for their support or opposition for a policy rate change.
- This will be published in the minutes of the MPC and the minutes should be published after 14 days of MPC meeting. The minutes should contain the reasons for each member proposing or opposing the monetary policy decision taken by the MPC.
- In case the inflation target is failed to achieve (2% higher or lower than the set target of 4% for continuous three quarters), the RBI has to give an explanation to the government about the reasons, the remedial actions and the estimated time for realizing the target. Another responsibility for the RBI is to publish a Monetary Policy Report every six months, elaborating inflation forecasts and inflation sources for the next six to eighteen months.

PRESENT MEMBERS OF THE MPC

- As mentioned, there are six members in the MPC. Three each from the RBI and the government. Members from the RBI are: Governor Shaktikanta Das, Michael Patra (officer recommended by the Central Board) and Viral Acharya (Deputy Governor in charge of Monetary Policy Department).
- Government representatives are Chetan Ghate, Professor at Indian Statistical Institute, Pami Dua, Director at Delhi School of Economics and Ravindra Dholakia, Professor of IIM Ahmedabad. The MPC members are appointed for a period of four years.

RBI FUNCTIONS & ORGANIZATION STRUCTURE

Establishment

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the **Reserve Bank of India Act, 1934**. 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. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

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; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of growth."

Main Functions

Monetary Authority:

- Formulates implements and monitors the monetary policy.
- Objective: maintaining price stability while keeping in mind the objective of growth.

Regulator and supervisor of the financial system:

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- Objective: maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

Manager of Foreign Exchange

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

Issuer of currency:

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Objective: to give the public adequate quantity of supplies of currency notes and coins and in good quality.

Developmental role

- Performs a wide range of promotional functions to support national objectives.

Related Functions

- 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.

ORGANIZATION STRUCTURE



ROLE OF RBI IN MONEY MARKET:

- Firstly the central bank (RBI) could do this by setting a necessary reserve ratio, which would restrict the ability of the commercial banks to increase the money supply by loaning out money. If this condition were above the ratio the commercial banks would have wished to have then the banks will have to create fewer deposits and make fewer loans than they could otherwise have profitably done. If the central bank imposed this requirement in order to reduce the money supply, the commercial banks will probably be unable to borrow from the central bank in order to increase their cash reserves if they wished to make further loans. They might try to attract further deposits from customers by raising their interest rates but the central bank may retaliate by increasing the necessary reserve ratio.
- The central bank (RBI) can influence the supply of money through special deposits. These are deposits at the central bank which the banking sector is required to lodge. These are then frozen, thus preventing the sector from accessing them even though interest is paid at the average Treasury bill rate. Making these special deposits reduces the level of the 'commercial banks' operational deposits which forces them to cut back on lending.
- The supply of money can also be prohibited by the central bank (RBI) by adjusting its interest rate which it charges when the commercial banks wish to borrow money (the discount rate). Banks generally have a ratio of cash to deposits which they consider to be the minimum safe level. If demand for cash is such that their reserves fall below this level they will be able to borrow money from the central bank at its discount rate. If market rates were 8% and the discount rate were also 8%, then the banks might decrease their cash reserves to their minimum ratio knowing that if demand exceeds supply they will be able to borrow at 8%. The central bank, even if, may raise its discount rate to a value above the market level, in order to encourage banks not to reduce their cash reserves to the minimum during excess loans. By raising the discount value to such a level, the commercial banks are given an incentive to hold more reserves thus reducing the money multiplier and the money supply.
- Another way the money supply can be affected by the central bank is through its operation of the interest rate. By raising or lowering interest rates the demand for money is respectively reduced or increased. If it sets them at a certain level it can clear the market at level by supplying sufficient money to match the demand. Alternatively it could fix the money supply at a convinced rate and let the market clear the interest rates at the balance. Trying to fix the money supply is not easy so central banks regularly set the interest rate and provide the amount of money the market demands.

- The central bank (RBI) may also involve the money supply through operating on the open market. This allows it to influence the money supply through the financial base. It may choose to either buy or sell securities in the marketplace which will either inject or remove money respectively. Thus the monetary base will be affected causing the money supply to modify.

PRIMARY DEALERS

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

The PDs are thus created to promote transactions in government securities market. A facilitating arrangement is essential for selling of government securities as government is the single largest borrower in the market who borrows through the issue of its securities – treasury bills and bonds. RBI instructs PDs to have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation etc to ensure that they are active in supporting the trade in government securities. PDs are active in the stock market also for enhancing the trading of government securities.

Eligibility Conditions for PDs

- a. Subsidiary of scheduled commercial bank/s and All India Financial Institutions
- b. Subsidiaries/ joint ventures set up in India by entities incorporated abroad.
- c. Company incorporated under the Companies Act, 1956 and does not fall under (a) or (b).

The applicant for PD should register as an NBFC for at least one year prior to the submission of application. Other conditions like net owned fund etc are mentioned by the RBI.

The decision to authorize PDs will be taken by RBI based on its perception of market needs, suitability of the applicant and the likely value addition to the system. Some other functions besides trading in government securities are also assigned to them.

Role and Functions of Primary Dealers

The role of Primary Dealers is to:

- (i) Commit participation as Principals in Government of India issues through bidding in auctions
- (ii) Provide underwriting services
- (iii) Offer firm buy – sell / bid ask quotes for T-Bills & dated securities
- (v) Development of Secondary Debt Market

PDs are performing an exceptional role in giving marketability to government securities. the RBI has elaborated the role of PDs in the following words “PDs are expected to play an active role in the G-Sec market, both in its primary and secondary market segments through various obligations like participating in Primary auction, market making in G-Sec, predominance of investment in G-Sec, achieving minimum secondary market turnover ratio, maintaining efficient internal control system for fair conduct of business etc. A PD is required to have a standing arrangement with RBI based on the execution of an undertaking and the authorization letter issued by RBI every three years. Undertaking will be based on passing of a fresh Board resolution by the PD every three years.”

As on January 2015, there was 21 Primary Dealers in the country. Most of the PDs are started by scheduled commercial banks and are registered as NBFCs. Operations of the PDs are subject to prudential and regulatory guidelines issued by RBI from time to time.

Unit-IV

INTRODUCTION OF DEBIT MARKET

Debt market is where investors buy and sell debt securities, mostly in the form of bonds. Debt market in India is one of largest in Asia. Like all other countries, Indian debt market is also considered a useful substitute to banking channels for finance. The debt market in India consists of mainly two categories: The government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market. The debt market is any market situation where trading debt instruments take place. Examples of debt instruments include mortgages, promissory notes, bonds, and Certificates of Deposit. A debt market establishes a structured environment where these types of debt can be traded with ease between interested parties. The debt market often goes by other names, based on the types of debt instruments that are traded. In the event that the market deals mainly with the trading of corporate bond issues, the debt market may be known as a bond market. If mortgages and notes are the main focus of the trading, the debt market may be known as a credit market. When fixed rates are connected with the debt instruments, the market may be known as a fixed income market.

CLASSIFICATION OF INDIAN DEBT MARKET

Government Securities Market (G-Sec Market): It consists of central and state government securities. It means that, loans are being taken by the central and state government. It is also the most dominant category in the India debt market. **Bond Market:** It consists of Financial Institutions bonds, Corporate bonds and debentures and Public Sector Units bonds. These bonds are issued to meet financial requirements at a fixed cost and hence remove uncertainty in financial costs.

BRIEF ABOUT THE DEBIT MARKET IN INDIA

The Indian debt market is a market meant for trading (i.e. buying or selling) fixed income instruments. Fixed income instruments could be securities issued by Central and State Governments, Municipal Corporations, Govt. Bodies or by private entities like financial institutions, banks, corporate, etc. Simply put, a bond/debt can be defined as a loan in which an investor is the lender. The Indian debt market offers a variety of debt instruments, offered by the Government and non-Government entities. The factors that are propelling the growth of the market are:

- introduction of new instruments, increased liquidity
- deregulation of interest rates, improved settlement systems

HISTORY OF THE INDIAN DEBT MARKET

- The debt is one of the most critical components in the financial system of any economy and acts as the fulcrum of a modern financial system. The debt market in most developed countries is many times bigger than the other financial markets including the equity market. The US bond market is more than \$13.5 trillion in size with a turnover exceeding \$500 billion daily representing the largest securities market in the world. The size of the world bond markets is close to US \$31.4 trillion which is nearly equivalent to the total GDP of all countries in the world. The total size of the Indian debt market is currently estimated to be in the range of US \$92 billion to US \$100 billion. India's debt market accounts for approximately 30 percent of its GDP. The Indian bond market measured by the estimated value of bonds outstanding is next only to the Japanese and Korean bond markets in Asia. The Indian debt market, in terms of volume, is larger than the equity market.
- In the post reforms era, a fairly well segmented debt market has emerged comprising:
 - ✓ Private corporate debt market
 - ✓ Public sector undertaking bond market and
 - ✓ Government securities market
- The government securities market accounts for more than 90 percent of the turnover in the debt market. It constitutes the principal segment of the debt market. The Indian debt market has traditionally been a wholesale market with participation restricted to few institutional players – mainly banks. The banks were the major participants in the government securities market due to statutory requirements. The turnover in the debt market too was quite low a few hundred crores till the early 1990s. The debt market was fairly underdeveloped due to the administrated interest rate regime and the availability of investment avenues which gave a higher rate of return to investors.
- In the early 1990s, the government needed a large amount of money for investment in development and infrastructure projects. The government realized the need of a vibrant, efficient and healthy debt market and undertook reform measures. The Reserve Bank put in substantial efforts to develop the government securities market but its two segments, the private corporate debt market and public sector undertaking bond market, have not yet fully developed in terms of volume and liquidity. It is debt market which can provide returns commensurate to the risk, a variety of instruments to match the risk and liquidity preferences of investors, greater safety and lower volatility. Hence the debt market has a lot of potential for growth in the future. The debt market is critical to the development of a developing countries like india.

Regulation of Debt Market:

- The Reserve Bank of India regulates the government securities market and money market while the corporate debt market comes under the purview of the Securities Exchange and Board of India (SEBI). In order to promote an orderly development of the market, the government issued a notification on March 2, 2000 delineating the areas of responsibility between the Reserve Bank and SEBI. The contracts for sale and purchase of government securities, gold related securities, Money market securities and securities derived from these securities and ready forward contracts in debt securities shall be regulated by the Reserve Bank. Such contracts, if executed on the stock exchanges shall, however, be regulated by SEBI in manner that is consistent with the guidelines issued by the Reserve Bank.

Link between Money Market and Debt Market:

The money market is market dealing in short term debt instruments (up to one year) while the debt market is a market for long term instruments (more than one year) The money market supports the long term debt market by increasing the liquidity of securities. A developed money market is a prerequisite of the development of a debt market.

MAJOR PLAYERS OF DEBIT MARKET

- **State governments and Central government.** The largest segment of the Indian Debt market consists of the Government of India securities where the daily trading volume is in excess of Rs.2000 crore, with instrument tenors ranging from short dated Treasury Bills to long dated securities extending upto 30 years.(source: www.dbie.rbi.org.in)
- **Non-government entities** like Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, Corporate entities.

INSTRUMENTS OF DEBIT MARKET

There are a variety of instruments offered in the debt market like:

- **MIBOR linked bonds.** MIBOR (Mumbai Inter Bank Offered Rate) bonds are closely modeled on the LIBOR (London Inter Bank Offered Rate) bonds. Currently, Reuters and the National Stock Exchange (NSE), are the two calculating agents for the benchmark. The NSE MIBOR benchmark is the more popular of the two and is based on rates polled by NSE from a representative panel of 31 banks/institutions/primary dealers.
- **Commercial Papers(CPs).** These are short term unsecured promissory notes, generally issued by corporate entities.
- **Certificate of Deposits (CDs).** These are issued by banks.

- **Treasury Bills.** These are issued by Reserve Bank of India (RBI).
- **Medium- to long-term bonds.** These are issued by corporate entities/financial institutions. They can feature fixed or floating rates.
- **Call money market.** This represents overnight and term money between banks and institutions.
- **Repo transactions.** These represent temporary sale with an agreement to buy back the securities at a future date at a specified price.
- **Collateralized Borrowing And Lending Obligation (CBLO).** CBLOs were developed by the Clearing Corporation of India (CCIL) and Reserve Bank of India (RBI). It is a money market instrument that represents an obligation between a borrower and a lender as to the terms and conditions of the loan. The details of the CBLO include an obligation for the borrower to repay the debt at a specified future date and an expectation of the lender to receive the money on that future date, and they have a charge on the security that is held by the CCIL. CBLOs are used by those who are heavily restricted or have been phased out of the interbank call money market.

The other instruments that are prevalent in the debt market are Debentures, Secured premium notes, Deep Discount Bonds, PSU Bonds / Tax-Free Bonds, Floating Rate Bonds, State Government Securities, STRIPS and Interest Rate Derivative products.

Primary Dealer

A primary dealer is a firm that buys government securities directly from a government. The intention is to resell the securities to others. Act as a market maker of government securities. The government may regulate the behavior and numbers of its primary dealers and impose conditions of entry. Some governments sell their securities only to primary dealers. Governments that use primary dealers include Canada, France, Italy, Spain, the United Kingdom, and the United States

History

The current system of primary dealers was set up in 1960 with 18 dealers. The number of primary dealers grew to 46 in 1988, declined to 21 by 2007 and stands at 21 in October 2011. The most recent additions to the list of primary dealers were Bank of Nova Scotia, New York Agency and BMO Capital Markets Corp., both named on October 4, 2011.

List of Primary Dealers in Government Securities Market (As on December 10, 2013)

STANDALONE PRIMARY DEALERS

Deutsche Securities (India) Pvt. Ltd □ ICICI Securities Primary Dealership Nomura Fixed
□ Income Securities Pvt. Ltd. PNB Gilts Ltd. □ SBI DFHI Ltd □ Limited Morgan Stanley
India Primary Dealer Pvt. Ltd. □ STCI Primary Dealer Limited.

BANK PRIMARY DEALERS

Bank of America □ Bank Of Baroda □ Canara Bank □ Citibank N.A □ Corporation Bank □
HDFC Bank Ltd. □ Hongkong and Shanghai Banking Corpn. Ltd.(HSBC) □ J P Morgan
Chase Bank N.A, Mumbai Branch □ Standard Chartered Bank □ Axis Bank Ltd. □ IDBI
Bank Limited □ Kotak Mahindra Bank Ltd. □

Roles and Obligations of PDs

- PDs are required to support the primary markets like support auctions for issue of Government dated securities and Treasury Bills as per the minimum norms for underwriting commitment, bidding commitment and success ratio as prescribed by RBI from time to time. PDs should offer two-way prices in Government □ securities, through the Negotiated Dealing System Order Matching (NDS-OM), over-the-counter market and recognized Stock Exchanges in India and take principal positions in the secondary market for Government securities.
- PDs should maintain adequate physical infrastructure and skilled manpower for efficient participation in primary issues, trading in the secondary market, and to advise and educate investors. A Primary Dealer shall have an efficient internal control system for fair conduct of business, settlement of trades and maintenance of accounts.
- A Primary Dealer will provide access to RBI to all records, books, information and documents as and when required. PDs' investment in Government Securities and Treasury Bills on a daily basis should be at least equal to its net call/notice/repo (including CBLO) borrowing plus net RBI borrowing (through LAF/ Intra-Day Liquidity/ Liquidity Support) plus the minimum prescribed NOF.

- PDs should annually achieve a minimum turnover ratio of 5 times for Government dated securities and 10 times for Treasury Bills of the average month-end stocks. The turnover ratio in respect of outright transactions should not be less than 3 times in government dated securities and 6 times in Treasury Bills (Turnover ratio is computed as the ratio of total purchase and sales during the year in the secondary market to average month-end stocks). A PD should submit periodic returns as prescribed by RBI from time to time. PDs' operations are subject to prudential and regulatory guidelines issued by RBI from time to time.

BOND

Introduction

- A bond is a debt instrument issued by governments, corporations and other entities for raise funds.

Definition

- A bond is a (written and signed promise) debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate (Coupon Rate).
- A bond is written and signed promise to pay a certain sum of money on a certain date.
- A bond is a (written and signed promise) debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate (Coupon Rate).

History of Bond

- Bonds have been around for thousands of years, dating back to as far as 2400 BC. Throughout the centuries, the use of bonds has grown exponentially, with both governments and companies using these securities for crucial funding.

Feature of Bond

- Principal/Nominal/Par/Face-value
- Maturity • Coupon/Interest • Credit Quality • Embodied Options

Classification of Bonds

- Secure and Unsecure • Term bond, Serial Bond and Callable Bond • Convertible and Non-Convertible • Registered and Un-Registered or Bearer Bond • Commodity Backed (Bond is not backed by cash)

Parties Involved in Bond

- Issuer • Investment Bank? Underwriter • Investor

Major Types of Bonds

1. Government Bond: It is also known as Treasury bond. It is issued by a national government, generally with a promise to pay periodic interest payment and to repay the face value on the maturity date. • They are usually denominated in the country's own currency. It is safest bond with the lowest interest rate. The first ever bond issued by a national government was issued by the Bank of England in 1694 to raise money to fund a war against France.

2. Municipal Bond: A bond issued by state or local government or any of their agencies. Interest from these bonds is generally tax-free to residents but in some cases, interest is federally taxable. It is generally used to finance Public Project such as roads, schools, airports and seaports and infrastructure related. It is secured by specific revenue the interest receives holder of municipal bond is often exclude from income tax. Early days (1800s), Officially the first recorded municipal bond was a general obligation bond issued by the City of New York for a canal in 1812. • The debt was used to finance both urban improvements and a growing system of free public education. Potential Issuers are • States/Counties • Cities • Development Agencies (Capital Development Authority CDA) (Karachi Development Authority KDA) • Other Govt: Agencies WAPDA

3. Corporate Bond: A bond which is issued by a corporation in order to raise financing for a verity of reasons, such as to ongoing operations or to expend business. • The term is usually applied to longer term debt instrument, with maturity of least one year. Corporate debt instrument with maturity shorter than one year are referred as a commercial paper. Trading corporate bonds trade in decentralized, dealer based, over the counter markets. • Corporate bonds sometimes listed on stock exchanges those bonds are called Listed bonds. • Vast majority of trading volume happens O.T.C. Risk Analysis Compared to government bonds, corporate bonds generally have a higher risk. Corporate bond holders are stated for this risk by receiving a higher yield than government bond.

4. Zero-Coupon Bond: It is also known as an “accrual bond” is a debt security that doesn't pay interest (coupon) but is traded at a discount, rendering profit at maturity when the bond is redeemed for its full face value. • The maturity dates on zero coupon bonds are usually long term, with many having initial maturities of at least 10 years. • It doesn't make regular interest payments or so-called coupons, hence term zero-coupon bond.

Other Types of Bond

1. Personal Bond: It is a written contract in which a person who has been arrested agrees to appear at all required court dates and promises to abstain from breaking the law while the personal bond is in force. Once the contract is signed, payment of bail is waived, and the arrested person is released from jail.

2. High Yield Bond: A junk bond refers to high-yield or noninvestment grade bonds. Junk bonds are fixed-income instruments that carry a credit rating. • Junk bonds are so called because of their higher default risk in relation to investment grade bonds. • These bonds have a higher risk and higher yield which attracts to investor.

3. Convertible Bond: It is type of bond that the holder can convert into a specified number of shares of common stock in the issuing company or cash of equal value. • It has the maturity of greater than 10 years. • It is a Hybrid security with debt and equity-like features. • A convertible bond has a coupon rate lower than that of similar non-convertible debt.

4. Perpetual Bond: It is a bond with no maturity date. Therefore, it may be treated as equity, not as debt . • Issue pay coupons on the perpetual bonds forever and they do not have to redeem the principal. • Perpetual bond cash flows are, therefore, those of perpetuity.

5. Bearer Bond (unregistered Bond): It is an certificate issued without a name of its holder. In other words, the person who has the paper certificate can claim the value of the bond. • They are traded like cash. • Bearer bonds are very risky because they can be lost or stolen. • Bearer bond in the event of its lost, theft, or destruction. • Relief is possible in the case of US public debt.

6. Registered Bond: It is a bond whose ownership is recorded by the issuer, or by a transfer agent. • Interest payments, and the principal upon maturity are sent to registered owner. • It is alternative to a bearer bond. • Interest is pay only registered person.

7. War Bond: It is bond issued by government to fund military operations during war time. This type of bond has low return rate. • War bond are often accompanied by appeals to patriotism and conscience.

8. Serial Bond: It is a bond that matures in installments over a period of time. • Serial bonds (or installment bonds) describes a bond issue that matures in portions over several different dates. Instead of facing a large lump-sum principal repayment at maturity, an issuer can opt to spread the principal repayment over several periods. • Example: Rs. 100,000, 5-years serial bond would mature in a Rs. 20,000 annuity over a 5-year interval. • Bond issues consisting of a series of blocks of securities maturing in sequence the coupon rate can be different.

9. Revenue Bond: Revenue bond is issued by a (local) government. • It is a special type of municipal bond distinguish by its guarantee of repayment. • Revenue bonds are typically non-recourse, meaning that in the event of default, the bond holder has no alternative to other governmental asset or revenues.

10. Prize Bond: It is also known as a Lottery Bond. • Funds raised are used to offset government borrowing and are refundable to the bond owner on demand. • Interest is returned to bond owners via prizes which are distributed by means of random selection of bonds.

11. Development Impact Bond (DIPs)

12. Climate Bond

13 Covered Bond

14. Insurance Bond

Unit-v

Definition of Stock Exchange:

The securities regulation act of 1956 defined stock exchange as “an association, organization, or a individual which is established for the purpose of assisting, regulating, and controlling business in buying, selling and dealing in securities.”

Meaning:

This comes under treasury sector, which provides service to stock brokers & traders to trade stocks, bonds and securities. Stock exchanges help the companies to raise their fund. Therefore the companies needs to list themselves in the Stock Exchange and the shares will be issued which is known as equity or a ordinary share and these shareholders are the real owners of the company the Board of Directors of the Company are elected out of these Equity Shareholders only.

FEATURES OF STOCK EXCHANGE

- It is an organized market
- It is a securities market
- It is an important constituent of capital market i.e., market for long-term finance
- It is a voluntary association of persons desirous of dealing in securities
- Stock exchange is a voluntary association, its membership is not open to everybody
- In a stock exchange, only the members can deal in i.e., buy & sell securities
- The members of a stock exchange can buy and sell securities either as brokers for & on behalf of their clients
- The dealings in a stock exchange are under certain accepted code of conduct i.e., rules and regulations

IMPORTANT FUNCTION OF STOCK EXCHANGE

- Provide central and convenient meeting places for sellers and buyer of securities
- Increase the marketability and liquidity of securities
- Contribute to stability of prices of securities
- Equalization of price of securities & Smoothen price movement
- Help the investors to know the worth of their holdings
- Promote the habit of saving and investment
- Helps in capital formation
- Helps companies and government to raise funds from the investors

HISTORY OF STOCK EXCHANGE

The stock exchange was established by “East India company” in 18th century . In India it was established in 1850 with 22 stock brokers opposite to town hall Bombay .This stock exchange is known as oldest stock exchange of Asia.

BROKER AND JOBBER

BROKER: He is one act as a intermediary on behalf of others. A broker in a stock exchange is a commission agent who transacts business in securities on behalf of non members.

JOBBER: He is not allowed to deal with the public directly .He deals with brokers who are engaged with the investors. Thus, the securities is bought by the jobber from members and sells to members who are operating on the stock exchange as broker

SPECULATION AND SPECULATOR

SPECULATION: It is the transaction of members to buy or sell securities on stock exchange with a view to make profits to anticipated raise or fall in price of securities.

SPECULATOR: The dealer in stock exchange who indulge in speculation are called speculator. They do not take delivery of securities purchased or sold by them, but only pay or rescue the difference between the purchase price and sale price. The different types of speculators are BULL, BEAR, STAG & LAME DUCK

LARGEST STOCK EXCHANGES IN THE WORLD

- London Stock Exchange
- New York Stock Exchange
- Australia Stock Exchange
- Tokyo Stock Exchange
- Hong Kong Stock Exchange
- Toronto Stock Exchange

LARGEST STOCK EXCHANGES IN INDIA

- National Stock Exchange
- Bombay Stock Exchange
- Calcutta Stock Exchange
- Cochin Stock Exchange
- Pune Stock Exchange

BOMBAY STOCK EXCHANGE (BSE)

BSE Ltd, the first ever stock exchange in Asia established in 1875 and the first in the country to be granted permanent recognition under the Securities Contract Regulation Act, 1956, has had an interesting rise to prominence over the past 143 years.

It is oldest and first stock exchange of India established in the year 1875. First it was started under banyan tree opposite to town hall of Bombay over 22 stock brokers. The top gainer in BSE is 100 companies in that GMR infra is first.

It is Asia's first & the Fastest Stock Exchange in world with the speed of 6 micro seconds and one of India's leading exchange groups. Over the past 143 years, BSE has facilitated the growth of the Indian corporate sector by providing it an efficient capital-raising platform. Popularly known as BSE, the bourse was established as 'The Native Share & Stock Brokers' Association' in 1875. In 2017 BSE become the 1st listed stock exchange of India.

Today BSE provides an efficient and transparent market for trading in equity, currencies, debt instruments, derivatives, mutual funds. BSE SME is India's largest SME platform which has listed over 250 companies and continues to grow at a steady pace. BSE StAR MF is India's largest online mutual fund platform which process over 27 lakh transactions per month and adds almost 2 lakh new SIPs ever month. BSE Bond, the transparent and efficient electronic book mechanism process for private placement of debt securities, is the market leader with more than Rs 2.09 lakh crore of fund raising from 530 issuances. (F.Y. 2017-2018).

Keeping in line with the vision of Shri Narendra Modi, Hon'ble Prime Minister of India, BSE has launched India INX, India's 1st international exchange, located at GIFT CITY IFSC in Ahmadabad.

Indian Clearing Corporation Limited, a wholly owned subsidiary of BSE, acts as the central counterparty to all trades executed on the BSE trading platform and provides full novation, guaranteeing the settlement of all bonafide trades executed.

BSE Institute Ltd, another fully owned subsidiary of BSE runs one of the most respected capital market educational institutes in the country. BSE has also launched BSE Sammaan, the CSR exchange, is a 1st of its kind initiative which aims to connect corporate with verified NGOs. BSE's popular equity index - the S&P BSE SENSEX - is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa)

Vision

"Emerge as the premier Indian stock exchange with best-in-class global practice in technology, products innovation and customer service."

NATIONAL STOCK EXCHANGE (NSE)

The NSE of India is the leading stock exchange of India, covering 370 cities and towns in the country. It was established in 1994 as a TAX company. It was established by 21 leading financial institutions and banks like the IDBI, ICICI, IFCI, LIC, SBI, etc.

The National Stock Exchange of India Ltd. (NSE) is the leading stock exchange in India and the second largest in the world by nos. of trades in equity shares from January to June 2018, according to World Federation of Exchanges (WFE) report. NSE launched electronic screen-based trading in 1994, derivatives trading (in the form of index futures) and internet trading in 2000, which were each the first of its kind in India. NSE has a fully-integrated business model comprising our exchange listings, trading services, clearing and settlement services, indices, market data feeds, technology solutions and financial education offerings. NSE also oversees compliance by trading and clearing members and listed companies with the rules and regulations of the exchange.

NSE is a pioneer in technology and ensures the reliability and performance of its systems through a culture of innovation and investment in technology. NSE believes that the scale and breadth of its products and services, sustained leadership positions across multiple asset classes in India and globally enable it to be highly reactive to market demands and changes and deliver innovation in both trading and non-trading businesses to provide high-quality data and services to market participants and clients.

Mr. Vikram Limaye is the Managing Director and CEO of NSE.

NSE's identity crafted in the nineties has for the last 25 years, stood for reliability, expertise, innovation and trust. In the last 25 years, the Indian economy and technology landscape has changed dramatically. So has NSE. NSE's new identity reflect its multi-dimensional nature: multiple asset classes, multiple customer segments, and its multiple roles including, exchange, regulator, index provider, data and analytics, IT services, educator and market developer.

The new identity depicts growth with a modern representation of a blooming flower. The multiple colours capture the multi-faceted nature of the business. The red denotes NSE's strong foundation, the yellow and orange are inspired by the flower for prosperity and auspicious ventures the marigold, and the blue triangle is a compass, always future-oriented and helping us find our true North.

The sharp edges indicate technology, precision and efficiency. The shape also amplifies NSE's tradition of collaboration. The internal vectors depict NSE's DNA of continuously pushing boundaries.

Purpose: Committed to improve the financial well-being of people.

Vision: To continue to be a leader, establish global presence, facilitate the financial well-being of people.

Values: NSE is committed to the following core values:

RECENT DEVELOPMENTS OF INDIAN STOCK EXCHANGES

Well-developed securities markets are the backbone of any financial system. Apart from providing the medium for channelizing funds for investment purposes, they aid in pricing of assets and serve as a barometer of the financial health of the economy. Over a period, the Indian securities market has undergone□ remarkable changes and grown exponentially, particularly in terms of resource mobilization, intermediaries, the number of listed stocks, market capitalization, and turnover and investor population. The Recent Trends and Development in Indian Securities Market Since 1992 are as following:

1. **Corporate Securities Market:** With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package to develop the securities market was introduced. The issuers complying with the eligibility criteria were allowed freedom to issue the securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen based trading. Trades enjoyed counter-party guarantee. The trading cycle shortened to a day and trades are settled within 2 working days, while all deferral products were banned. Physical security certificates almost disappeared. A variety of derivative products were permitted.
2. **SEBI Act, 1992:** It created a regulator (SEBI), empowered it adequately and assigned it with the responsibility for (a) Protecting the interests of investors in securities, (b) Promoting the development of the securities market, and (c) Regulating the securities market. Enactment of SEBI Act is the first attempt towards integrated regulation of the securities market.
3. **Creation of Market Regulator:** Securities and Exchange Board of India (SEBI), the securities market regulator in India, was established under SEBI Act 1992, with the main objective and responsibility for Protecting the interests of investors in securities, Promoting the development of the securities market, and Regulating the securities market.
4. **Screen Based Trading:** Prior to setting up of NSE, the trading on stock exchanges in India was based on an open outcry system. The system was inefficient and time consuming because of its inability to provide immediate matching or recording of trades. In order to provide efficiency, liquidity and transparency, NSE introduced a nation-wide on-line fully automated screen based trading system (SBTS) on the CM segment on November 3, 1994.
5. **Reduction of Trading Cycle:** Earlier, the trading cycle for stocks, based on type of securities, used to vary between 14 days to 30 days and the settlement involved another fortnight. The Exchanges, however, continued to have different weekly trading cycles, which enabled shifting of positions from one Exchange to another. It was made mandatory for all Exchanges to follow a uniform weekly trading cycle in respect of scrips not under rolling settlement.

In December 2001, all scrips were moved to rolling settlement and the settlement period was reduced progressively from T+5 to T+3 days. From April 2003 onwards, T+2 days settlement cycle is being followed.

6. **Equity Derivatives Trading**: In order to assist market participants in managing risks better through hedging, speculation and arbitrage, SC(R) A was amended in 1995 to lift the ban on options in securities. Trading in derivatives, however, took off in 2000 with index futures after suitable legal and regulatory framework was put in place. The market presently offers index futures, index options, single stock futures and single stock options.

6. **Risk Management**: Market integrity is the essence of any financial market. To pre-empt market failures and protect investors, the regulator/exchanges have developed a comprehensive risk management system, which is constantly monitored and upgraded. It encompasses capital adequacy of members, adequate margin requirements, limits on exposure and turnover, indemnity insurance, on-line position monitoring and automatic disablement, etc. They also administer an efficient market surveillance system to curb excessive volatility, detect and prevent price manipulations. The anonymous electronic order book ushered in by the NSE did not permit members to assess credit risk of the counter-party necessitated some innovation in this area. To effectively address this issue, NSE introduced the concept of a novation, and set up the first clearing corporation, viz. National Securities Clearing Corporation Ltd. (NSCCL), which commenced operations in April 1996.

The NSCCL assures the counterparty risk of each member and guarantees financial settlement. Counterparty risk is guaranteed through a fine tuned risk management system and an innovative method of on-line position monitoring and automatic disablement. NSCCL established a Settlement Guarantee Fund (SGF). The SGF provides a cushion for any residual risk and operates like a self-insurance mechanism wherein the members contribute to the fund. In the event of failure of a trading member to meet his obligations, the fund is utilized to the extent required for successful completion of the settlement. This has eliminated counterparty risk of trading on the Exchange

8. Short Selling: Short selling is defined as selling a stock which the seller does not own at the time of trade. Pursuant to the recommendations of the Secondary Market Advisory Committee (SMAC) of SEBI and the decision of the SEBI Board, it was decided to permit all classes of investors to short sell. It increases liquidity in the market, and makes price discovery more efficient. Besides, it curbs manipulation of stocks as informed investors are able to go short on stocks they feel are higher than fair value. This facility was available to non-institutional investors. Vide a circular in February 2008; SEBI permitted all classes of investors, viz., retail and institutional investors to short sell. It, however, does not permit naked short sales and accordingly, requires participants to mandatorily honor their obligation of delivering the securities at the time of settlement.

9. Cross Margining: Many trading members undertake transactions on both the cash and derivative segments of an Exchange. They keep separate deposits with the exchange for taking positions in two different segments. In order to improve the efficiency of the use of the margin capital by market participants and as an initial step towards cross margining across cash and derivatives markets SEBI allowed Cross Margining benefit in May 2008. For Cross margining the stock positions of the institutions in capital market segment after confirmation by the custodian on T+1 day shall be compared with the stock futures position of the same institution in derivative segment based on the CP code of the institution at the end of the day. The position shall be considered for cross margining only if the position in the capital market segment offsets the position in the derivative segment.

10. Market Infrastructure: As part of the ongoing efforts to build debt market infrastructure, two new systems, the Negotiated Dealing System (NDS) and the Clearing Corporation of India Limited (CCIL) commenced operations on February 15, 2002. NDS facilitates screen based negotiated dealing for secondary market transactions in government securities and money market instruments, online reporting of transactions in the instruments available on the NDS and dissemination of trade information to the market. Government Securities (including T-bills), call money, notice/term money, repos in eligible securities, Commercial Papers and Certificate of Deposits are available for negotiated dealing through NDS among the members. CCIL facilitates settlement of transactions in government securities (both outright and repo) on Delivery versus Payment (DVP-II) basis which provides for settlement of securities on gross basis and settlement of funds on net basis simultaneously.

11. Research in Securities Market: In order to deepen the understanding and knowledge about Indian capital market, and to assist in policy-making, SEBI has been promoting high quality research in capital market. It has set up an in-house research department, which brings out working papers on a regular basis. In collaboration with NCAER, SEBI brought out a 'Survey of Indian Investors', which estimates investor population in India and their investment preferences. SEBI has also tied up with reputed national and international academic and research institutions for conducting research studies/projects on various issues related to the capital market. The objective of this initiative is to foster research, which can support and facilitate- (a) stock exchanges to better design market micro-structure, (b) participants to frame their strategies in the market place, (c) regulators to frame regulations, (d) policy makers to formulate policies, and (e) expand the horizon of knowledge. The Initiative has received tremendous response.

12. Testing and Certification: A testing and certification mechanism that has become extremely popular and is sought after by the candidates as well as employers is unique on-line testing and certification programme called National Stock Exchange's Certification in Financial Markets (NCFM). It is an on-line fully automated nation-wide testing and certification system where the entire process from generation of question paper, testing, assessing, scores reporting and certifying is fully automated - there is absolutely no scope for human intervention. It allows tremendous flexibility in terms of testing centers, dates and timing and provides easy accessibility and convenience to candidates as he can be tested at any time and from any location. It tests practical knowledge and skills, that are required to operate in financial markets, in a very secure and unbiased manner, and certifies personnel who have a proper understanding of the market and business and skills to service different constituents of the market.

13. Demutualization: Historically, stock exchanges were owned, controlled and managed by the brokers. In case of disputes, integrity of the stock exchange suffered. NSE, however, was set up with a pure demutualised governance structure, having ownership, management and trading with three different sets of people. Currently, all the stock exchanges in India have a demutualised set up.

14. Dematerialization: As discussed before, the old settlement system was inefficient due to (i) the time lag for settlement and (ii) the physical movement of paper-based securities. To obviate these problems, the Depositories Act, 1996 was passed to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed and accuracy. There are two depositories in India, viz. NSDL and CDSL. They have been set up to provide instantaneous electronic transfer of securities. .

15. Clearing Corporation: The anonymous electronic order book ushered in by the NSE did not permit members to assess credit risk of the counter-party and thus necessitated some innovation in this area. To address this concern, NSE had set up the first clearing corporation, viz. National Securities Clearing Corporation Ltd. (NSCCL), which commenced its operations in April 1996.

16. Investor Protection: In order to protect the interest of the investors and promote awareness, the Central Government (Ministry of Corporate Affairs 1) established the Investor Education and Protection Fund (IEPF) in October 2001. With the similar objectives, the Exchanges and SEBI also maintain investor protection funds to take care of investor claims. SEBI and the stock exchanges have also set up investor grievance / service cells for redress of investor grievance. All these agencies and investor associations also organize investor education and awareness programmes.

17. Globalization: Indian companies have been permitted to raise resources overseas through issue of ADRs, GDRs, FCCBs and ECBs. Further, FIIs have been permitted to invest in all types of securities, including government securities and tap the domestic market. The investments by FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment route up to 24% of the paid up capital of the company. The Indian stock exchanges have been permitted to set up trading terminals abroad. The trading platform of Indian exchanges is now accessible through the Internet from anywhere in the world. RBI permitted two-way fungibility for ADRs / GDRs, which means that the investors (foreign institutional or domestic) who hold ADRs / GDRs can cancel them with the depository and sell the underlying shares in the market.

18. Launch of India VIX 2: Volatility index is a measure of market's expectation of volatility over the near term. It measures the amount by which an underlying Index is expected to fluctuate in the near term, based on the order book of the underlying index options. India's first volatility index, India VIX (based on the Nifty 50 Index Option prices) was launched by NSE in April 2008.

19. Direct Market Access: In April 2008, SEBI allowed the direct market access (DMA) facility to the institutional investors. DMA allows brokers to offer their respective clients, direct access to the Exchange trading system through the broker's infrastructure without manual intervention by the broker.

20. Launch of Securities Lending & Borrowing Scheme: In April 2008, the Securities Lending & Borrowing mechanism was allowed. It allows market participants to take short positions effectively with less cost.

21. Launch of Currency Futures: On August 29, 2008, NSE launched trading in currency future contracts in the USD-INR pair for the first time in India. Trading in other currency pairs like Euro – INR, Pound Sterling – INR and Japanese Yen was further made available for trading in March 2010.

22. Launch of Interest Rate Futures: On August 31, 2009, futures on interest rate were launched on the National Stock Exchange.

23. ASBA: Application Supported by Blocked Amount (ASBA) is a major primary market reform. It enables investors to apply for IPOs / FPOs and rights issues without making a payment. Instead, the amount is blocked in investors' own account and only an amount proportionate to the shares allotted goes out when allotment is finalized.

24. Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009: In August 2009, the SEBI issued Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009, replacing the Disclosure and Investor Protection (DIP) Guidelines 2000. ICDR Regulations 2009 would govern all disclosure norms regarding issue of securities.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Introduction

- The Securities and Exchange Board of India was established as an interim administrative body on 12 April 1988 by the Government of India. Its main objective was to promote orderly and healthy growth of securities and to provide protection to the investors. The Ministry of Finance of the Government of India has overall administrative control over its functions. On 30th January 1992, it was given a statutory status through an ordinance, which later on was replaced by Act of Parliament known as Securities and Exchange Board of India Act, 1992. SEBI is considered as watchdog of the securities market.

Reasons for the Establishment of SEBI:

- During 1980s, there was tremendous growth in the capital market due to increasing participation of public. This led to many malpractices like Rigging of prices, unofficial premium on new issues, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. by the brokers, merchant bankers, companies, investment consultants and others involved in the securities market. This resulted in many investor grievances. Because of lack of proper penal provision and legislation, the government and the stock exchanges were not able to redress these grievances of the investors. This necessitated a need for a separate regulatory body, and hence Securities and Exchange Board of India was established.

Purpose and Role of SEBI:

- The main objective is to create such an environment which facilitates efficient mobilization and allocation of resources through the securities market. This environment consists of rules and regulations, policy framework, practices and infrastructures to meet the needs of three groups which mainly constitute the market i.e. issuers of securities (companies), the investors and the market intermediaries.
 - (i) **To the Issuers:** SEBI aims to provide a market place to the issuers where they can confidently look forward to raise the required amount of funds in an easy and efficient manner.
 - (ii) **To the Investors:** SEBI aims to protect the right and interest of the investors by providing adequate, accurate and authentic information on a regular basis.
 - (iii) **To the Intermediaries:** In order to enable the intermediaries to provide better service to the investors and the issuers, SEBI provides a competitive, professionalized and expanding market to them having adequate and efficient infrastructure.

Objectives of SEBI:

Following are the main objectives of SEBI:

- 1. Protection:** To guide, educate, and to protect the rights and interests of the investors.
- 2. Competitive and Professional:** To make the intermediaries like merchant bankers, brokers etc. competitive and professional by regulating their activities and developing a code of conduct.
- 3. Prevention of Malpractices:** To prevent trading malpractices.
- 4. Balancing:** To establish a balance between statutory regulation and self regulation by the securities industry.
- 5. Orderly Functioning:** To promote orderly functioning of stock exchange and securities industry by regulating them.

FUNCTIONS OF SEBI

The functions of SEBI can be divided into three parts viz:

- (1) Regulatory function
- (2) Development Function &
- (3) Protective function.

1. Regulatory Functions: Regulatory functions of SEBI are as follows:

- (a) Registration of Brokers and Agents:** It registers brokers, sub-brokers, transfer agents, merchant banks etc.
- (b) Notifications of Rules and Regulations:** It notifies rules and regulations for the smooth functioning of all intermediaries in the securities' market.
- (c) Levying of Fees:** It levies fees, penalties and other charges for contravening its directions and orders.
- (d) Regulator of Investment Schemes:** It registers and regulates collective investment schemes and mutual funds.
- (e) Prohibits Unfair Trade Practices:** SEBI prohibits fraudulent and unfair trade practices.
- (f) Inspection and Enquiries:** It undertakes inspection and conducts enquiries & audit of stock exchange
- (g) Performing and Exercising Powers:** It performs & exercises such powers under Securities Contracts (Regulation) Act 1956, as have been delegated to it by the Government of India.

2. Development Functions: Development functions of SEBI are as under:

(a) Training to intermediaries: It promotes training of intermediaries of the securities.

(b) Promotion of fair trade: It promotes fair trade practices by making underwriting optional.

(c) Research: It publishes information useful to all market participants for conducting research.

3. Protective Functions: Protective Functions of SEBI are as under:

(a) Prevents Insider Trading: It does so by prohibiting insiders such as directors, promoters etc. to make profit through trading of securities using confidential price sensitive information.

(b) Prohibits Fraudulent and Unfair Trade Practices: It prohibits fraudulent and unfair trade practices in the security market, such as price rigging and sale or purchase of securities through misleading statements.

(c) Promotes Fair Practices: It promotes fair practices and code of conduct in the securities market e.g. it looks after the interests of the debenture holders in terms of any mid-term revision of interest rates etc.

(d) Educates Investors: It educates the investors through campaigns.

STOCK MARKET INDEX

- A stock market index is a method of measuring a section of the stock market. Many indices are cited by news or financial services firms and are used as benchmarks, to measure the performance of portfolios such as mutual funds. Alternatively, an index may also be considered as an instrument (after all it can be traded) which derives its value from other instruments or indices. The index may be weighted to reflect the market capitalization of its components, or may be a simple index which merely represents the net change in the prices of the underlying instruments. Most publicly quoted stock market indices are weighted.

STOCK MARKET INDICES

- Stock market indices are useful in understanding the level of prices and the trend of price movements of the market. A stock market index is created by selecting a group of stocks that are capable of representing the whole market or a specified sector or segment of the market. The change in the prices of this basket of securities is measured with reference to a base period. There is usually a provision for giving proper weights to different stocks on the basis of their importance in the economy. A stock market index act as the indicator of the performance of the economy or a sector of the economy. Stock market indices are the barometer of the stock market. BSE SENSEX, NSE-50 etc are some of the market indices.

• USEFULNESS OF STOCK MARKET INDICES

- Indices help to recognize broad trends in the market.
- The investor can use the indices to allocate the funds rationally among the stocks.
- Technical analysts use these indices to predict the future market.
- Indices function as a status report on the general economy.
- To earn returns on par with the market returns, he can choose the stocks that reflect the market movement.
- Index can be used as a bench mark for evaluating the investor's portfolio.
- Indices help to recognize the broad trends in the market.

Examples of BSE INDICES

BSE 100, BSE 200, BSE IPO, BSE Mid Cap and BSE Small Cap

Examples of NSE INDICES

S and P CNX Nifty, CNX Nifty Junior, S and P CNX 500, CNX Midcap 200, S and P CNX Defty

Initial Public Offering (IPO) & Follow-on Public Offering (FPO)

All business entities need funds to finance their day to day operation. There are two ways of raising funds for the business i.e. in the form of equity which mean the owned capital of the company or debt which represents the borrowed capital of the company.

When funds are raised as equity, the company approaches various individuals to sell its shares at a fixed price. When this offering is done by the company for the first time, it is known as IPO or initial public offering.

As against this, when the shares offered for sale, for the second, third or fourth time is called follow-on public offering, (FPO).

Nowadays, the public offering is very common, and if you are also thinking to invest your hard earned money in any company, it would be beneficial to have a basic knowledge of words, abbreviations and jargon, which are often used in the stock market.

Comparison Chart

BASIS FOR COMPARISON	IPO	FPO
Meaning	Initial Public Offering (IPO) refers to an offer of securities made to the public for subscription, by the company.	Follow-on Public Offering (FPO) means an offer of securities for subscription to public, by a publicly traded enterprise.
What is it?	First public issue	Second or third public issue
Issuer	Unlisted Company	Listed Company
Objective	Raising capital through public investment.	Subsequent public investment.
Risk	High	Comparatively low

Definition of IPO

Initial Public Offering, shortly known as IPO is the first public offering of equity shares of a company going to be listed on the stock exchange and publicly traded. It is the main source of acquiring money from the general public to finance its projects and the company allots shares to the investors in return. It is the turning point in the lifecycle of the company; that transforms from a small closely held company, which seek to expand their business or large privately owned firms to a publicly listed one.

There are two ways in which IPO can be done, firstly when the fresh issue of shares takes place, resulting in injection of fresh capital to the company. Secondly, when existing shares are offered for sale, wherein no infusion of capital takes place because the amount received as proceeds from the issue of shares go to shareholders who offer their shares for sale.

Certain eligibility conditions are required to be fulfilled by the company so as to make an IPO. Guidelines specified by the Securities and Exchange Board of India (SEBI) and Company Act need to be complied by the promoters of the enterprise.

Below are the steps a company must undertake to go public via an IPO process:

1. Select a bank
2. Due diligence and filings
3. Pricing
4. Stabilization
5. Transition

Step 1: Select an investment bank: The first step in the IPO process is for the issuing company to choose an investment bank to advise the company on its IPO and to provide underwriting services. The investment bank is selected according to the following criteria:

- Reputation
- The quality of research
- Industry expertise
- Distribution i.e. if the investment bank can provide the issued securities to more institutional investors or to more individual investors.
- Prior relationship with the investment bank

Step 2: Due diligence and regulatory filings: Underwriting is the process through which an investment bank (the underwriter) acts a broker between the issuing company and the investing public to help the issuing company sell its initial set of shares. The following underwriting arrangements are available to the issuing company:

- **Firm Commitment:** Under such an agreement, the underwriter purchases the whole offer and resells the shares to the investing public. The firm commitment is the most common underwriting arrangement because it guarantees the issuing company that a particular sum of money will be raised.
- **Best Efforts Agreement:** Under such an agreement, the underwriter does not guarantee the amount that they will raise for the issuing company. It only sells the securities on the behalf of the company.
- **Syndicate of Underwriters:** Public offerings can be managed by one underwriter (sole managed) or by multiple managers. When there are multiple managers, one investment bank is selected as the lead or book-running manager. An underwriter must draft the following documents:
 - ✓ **Engagement Letter, Letter of Intent, Underwriting Agreement, Registration Statement** which has two parts: **The Prospectus** – this is provided to every investor who buys the issued security & **Private filings** – this comprises information which is provided to the SEC for inspection but is not necessarily made available to the public
 - Red herring document:** In the cooling off period, the underwriter creates an initial prospectus which consists of the details of the issuing company, save the effective date and offer price. Once the red herring document has been created, the issuing company and the underwriters market the shares to public investors. Often, underwriters go on road shows (called the dog and pony shows – lasting for 3 to 4 weeks) to market the shares to institutional investors and evaluate the demand for the shares.

Step 3: Pricing: After the IPO is approved by the SEC, the effective date is decided. On the day before the effective date, the issuing company and the underwriter decide the offer price (i.e. the price at which the shares will be sold by the issuing company) and the precise number of shares to be sold. Deciding the offer price is important because it is the price at which the issuing company raises capital for itself. However, after the stock starts trading on the secondary market, money raised through the sale of shares the company, not the underwriter. The following factors affect the offering price:

- the success/failure of the road shows (as recorded in the order books)
- the company's goal
- condition of the market economy

Step 4: Stabilization: After the issue has been brought to the market, the underwriter has to provide analyst recommendations, after-market stabilization and create a market for the stock issued. The underwriter carries out after-market stabilization in the event of order imbalances by purchasing shares at the offering price or below it. Stabilization activities can only be carried out for a short period of time – however, during this period of time, the underwriter has the freedom to trade and influence the price of the issue as prohibitions against price manipulation are suspended.

Step 5: Transition to Market Competition: The final stage of the IPO process, the transition to market competition, starts 25 days after the initial public offering, once the “quiet period” mandated by the SEC ends. During this period, investors transition from relying on the mandated disclosures and prospectus to relying on the market forces for information regarding their shares. After the 25-day period lapses, underwriters can provide estimates regarding the earning and valuation of the issuing company. Thus, the underwriter assumes the roles of advisor and evaluator once the issue has been made.

Definition of FPO

FPO, an acronym for Follow-on Public Offering, as the name suggests it is the public issue of shares to investors at large, by a publicly listed company. The process is after an IPO; wherein the company goes for a further issue of shares to the general public with a view to

diversifying their equity base. The shares are offered for sale by the company through an offer document called prospectus. There is two type of Follow-on Public Offering:

- Dilutive offering
- Non-Dilutive offering

RED-HERRING PROSPECTUS

Meaning

Means a prospectus, which does not have complete particulars on the price of the securities offered and quantum of securities offered

Definition

A preliminary registration statement that must be filed with the Securities and Exchange Commission (SEC) describing a new issue of stock and the prospects of the issuing company.

Reason for Preparing

- First thing to attract people without disclosing much information about the deal.
- The “red herring” is a reference to a legal disclosure, printed in red.
- Informing to readers that the SEC has not yet reviewed and approved the document.
- Securities may not be sold or may offers to buy be accepted prior to the time the Registration Statement becomes effective.
- Investors can get an idea of upcoming offerings.
- How much they can get away with before the SEC registration.

Issuers of Red-Herring Prospectus

1. Apollo health street limited.
2. Power finance corporation ltd.
3. Engineers India limited.
4. Tata steel limited.

SWEAT EQUITY

According to the Companies Act, sweat equity are equity shares that a company issues to an individual in consideration of his/her services, knowhow or any other value addition that the company has benefited from. . In other words, it is the equity given to a company's executives to reflect the value the executives have added and will continue to add to the company

For instance, if a person works for creating patents for a company, then the company can issue equity (shares) to him, instead of paying cash. It could be issued for many other things too such as the person providing technical know-how, brand rights or similar value additions to the company.

All the limitations, restrictions and provisions relating to equity shares are applicable to such sweat equity shares. These equity shares can be issued free of monetary consideration or at a concession to their prevailing value.

A company may issue sweat equity shares if the following conditions are fulfilled: (a) the issue of sweat equity shares is authorized by a special resolution passed by the company (b) the resolution specifies the number of shares, current market price, monetary consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued c) not less than one year has, at the date of the issue, elapsed since the date on which the company was entitled to commence business (d) the sweat equity shares of a company whose equity shares are listed on a recognized stock exchange are issued in accordance with the regulations made by the Securities and Exchange Board of India (SEBI) in this behalf.

In a broader sense, sweat equity can be issued to anyone who has rendered services to the company. Sweat equity can be issued to an employee, consultant or a vendor. That is the reason start-up companies use sweat equity as currency to pay for services that they cannot pay for in “hard” cash. However, in India, as per SEBI regulations, sweat equity shares can be issued only to employees or directors.

In a nutshell, sweat equity shares are typically used to encourage entrepreneurs to form startup ventures. However, there are specific regulations in India which must be followed regarding the issuance of sweat equity shares. It seems that these guidelines were not adhered to while awarding the rights of ownership to certain franchisees.

RIGHT ISSUE

It is an issue of capital to the existing share holders of the company through a letter of offer made in the first instance to the existing shareholders on a prorate basis. (Under Section 81 of The Companies Act, 1956)

A rights issue is a way by which a listed company can raise additional capital. However, instead of going to the public, the company gives its existing shareholders the right to subscribe to newly issued shares in proportion to their existing holdings.

For example, 1:4 rights issue means an existing investor can buy one extra share for every four shares already held by him/her. Usually the price at which the new shares are issued by way of rights issue is less than the prevailing market price of the stock, i.e. the shares are offered at a discount.

Characteristics

- Number of rights that a shareholder gets is according to no. of shares held by him.
- Rights are negotiable
- Rights can be exercised during a fixed period (usually 30 days)
- Subscription price- price per share of additional equity

Procedure

Company sends a letter of offer with 4 applications (FORM A, FORM B, FORM C, and FORM D)

FORM A- Acceptance of rights & application for additional shares

FORM B- Renouncing the rights in favor of someone

FORM C- Application by the renounce in whose favor the rights have been renounced by the original allotted through form b.

FORM D- requires for split forms.

Conditions

- Only those shareholders who have applied for full rights can apply for additional shares
- Who renounce their rights, wholly or partially, are not eligible for additional shares
- Shares available due to non exercise of rights by some shareholders are allotted to shareholders who have demanded additional capital
- Any balance share left after providing additional shares are disposed of at the ruling market price or issue price whichever is higher

Consequences

- Value of A Share
$$\frac{NP_0 + S}{N+1}$$

N- no. of existing shares required for a right share

P₀ – right market price per share, S- Subscription price of right shares

Value of a Right

Difference b/w market price of a share after the right issue and subscription price

$$\frac{P_0 - S}{N+1}$$

N- no. of existing shares required for a right share

P₀ – right market price per share, S- Subscription price of right shares

Why does a company go for it?

The basic idea is to raise fresh capital. A rights issue is not a common practice that a corporate organization resorts to. Ideally, such an issue occurs when a company needs funds for corporate expansion or a large takeover. At the same time, however, companies also use rights issue to prevent themselves from being conked out. Since a rights issue results in higher equity base for the organization, it also provides it with better leveraging opportunities. The company becomes more comfortable when it comes to raising debt in the future as its debt-to-equity ratio reduces.

What should an investor be careful about in case of a rights issue?

An investor should be able to look beyond the discount offered. Rights issues are different from bonus issue as one is paying money to get additional shares and hence one should subscribe to it only if he/she is completely sure of the company's performance. Also, one must not take up the rights if the share price has fallen below the subscription price as it may be cheaper to buy the shares in the open market.

What is the effect on the company and what if a shareholder does not exercise his right?

A rights issue affects two important elements of a company equity capital and market capitalization. In case of a rights issue, since additional equity is raised, the issuing company's equity base rises to the extent of the issue. The effect on m-cap depends on the perception of the market. In theory, every new issue has some kind of diluting effect and hence as a result of a fall in the market price in proportion to an increase in the number of shares, the market capitalization remains unaffected. Alternatively, investors can just let the rights issue lapse.