General Knowledge Today

Banking & Finance-1: History, Structure & Types of Banking

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Kusidin, Presidency Banks, Imperial Bank of India, Hilton Young Commission, Nationalization of Banks and their impact, Scheduled Versus Non-scheduled banks, Old and New Private Sector Banks, RBI policy towards Foreign Banks, Regional Rural Banks, Different Rural Cooperatives, Unit Banking / Branch Banking, Mixed, Chain, Retail / Wholesale Banking, Social Banking, Narrow Banking, Shadow Banking.

Part-I : History of Banking

Earliest evidence of Banking in India is found from the period of Vedic Civilization. During those days, loan deeds called rnapatra or rnalekhya were prevalent. Interest rates as well as usury (*Sood Khori* in Hindi) was prevalent in Vedic India. The Vedic word Kusidin refers to an usurer (*Soodkhor* in Hindi) .This term is also found in Manusmriti. Various types of instruments were found in Buddhist, Mauryan and Mughal periods. The Arthashastra of Kautilya mentions presence of bankers during Maurya era. There were instruments in Maurya Era known as "Adesha" which are equivalent to Bill of exchange of current times.

Origin of Modern Banking Industry in India

Who were the indigenous bankers of India?

Since ancient times, businessmen called Shroffs, Seths, Sahukars, Mahajans, Chettis etc. had been carrying on the business of banking. These indigenous bankers included very small money lenders to shroffs with huge businesses, who carried on the large and specialized business even greater than the business of banks.

Which is the first bank of India?

The first bank of India is Bank of Hindustan established in 1770. This bank was established at Calcutta under European management. It was liquidated in 1830-32.

What were the three Presidency Banks? When they were established?

From 1612 onwards, British East India Company had set up various factories or trading posts in India with the permission of the local Mughal emperors. In this process, they had established three presidency towns viz. Madras in 1640, Bombay in 1687 and Bengal Presidency in 1690. East India Company's headquarters moved from Surat to Bombay (Mumbai) in 1687. Three Presidency banks were set up under charters from the British East India Company- Bank of Calcutta, Bank of Bombay and the Bank of Madras. The dates of their establishment were as follows:

- **2 June 1806:** Bank of Calcutta was established in 1806; it was renamed in 1809 as Bank of Bengal
- **15 April 1840:** Bank of Bombay established
- **1 July 1843:** Bank of Madras established

These worked as quasi central banks in India for many years. Since Calcutta was the most active trading port in India, mainly due to the trade of the British Empire; it became a banking center.

What happened with Presidency banks later on?

In 1921, the presidency banks viz. Bank of Bengal, Bank of Bombay and Bank of Madras were amalgamated to form Imperial Bank of India. It was a private entity till that time. In 1955, this Imperial Bank of India was nationalized and renamed as **State Bank of India**. Thus, State bank of

India is oldest Bank of India among the banks that exist today.

Which is the oldest joint stock bank of India?

A bank that has multiple shareholders is called joint-stock bank. Oldest Joint Stock bank of India was Bank of Upper India that was established in 1863. But this bank failed in 1913. India's Oldest Joint Stock Bank which is still working is Allahabad Bank. It is also known as India's oldest public sector bank. It was established in 1865.

Which were the first banks owned / managed by Indians?

The first Bank with Limited Liability to be managed by Indian Board was Oudh Commercial Bank. It was established in 1881 at Faizabad. This bank failed in 1958. The first bank purely managed by Indians was Punjab National Bank, established in Lahore in 1895. The Punjab national Bank has not only survived till date but also is one of the largest banks in India. However, the first Indian commercial bank which was wholly owned and managed by Indians was Central Bank of India which was established in 1911. So, Central Bank of India is called India's First Truly Swadeshi bank. Its founder was Sir Sorabji Pochkhanawala and its first chairman was Sir Pherozeshah Mehta.

Which was the first bank to open a branch at foreign soil?

Bank of India was the first Indian bank to open a branch outside India in London in 1946 and the first to open a branch in continental Europe at Paris in 1974. Bank of India was founded in September 1906 as a private entity and was nationalized in July 1969. Since the logo of this Bank is a star, its head office in Mumbai is located in Star House, Bandra East, Mumbai.

Origin of Reserve Bank of India

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India . RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1955.

RBI did not start as a Government owned bank but as a privately held bank without major government ownership. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned bank.

What was Hilton Young Commission?

Hilton-Young Commission was the Royal Commission on Indian Currency and Finance set up by British Government of India in 1920s. In 1926, this commission had recommended to the government to create a central bank in the country. On the basis of mainly this commission, the RBI act was passed.

Where were the original headquarters of RBI?

Original headquarters of RBI were in Kolkata, but in 1937, it was shifted to Shahid Bhagat Singh Marg, Mumbai.

In which year, Banking Regulation Act was passed ?

Immediately after the independence, the Government of India came up with the Banking Companies Act 1949. This act was later changed to Banking Regulation (Amendment) Act 1949. Further, the Banking Regulation (Amendment) Act of 1965 gave extensive powers to the Reserve Bank of India as India's central banking authority.

Beginning of Banking Reforms and Nationalization of the Banks

The banking sector reforms started immediately after the independence. These reforms were basically aimed at improving the confidence level of the public because in those days, most banks were not trusted by the majority of the people. Instead, the deposits with the Postal department were considered rather safe. Banking sector and Financial sector reforms are not static events but continuous processes happening even today and will keep continuing. Nationalization of Banks, consolidation, diversification and liberalization of the banking industry in the 1980s and 1990s were part of this ongoing process. A few recent events as part of banking sector reforms include:

- Deregulation of interest rates
- Payment banks
- Increased autonomy to banks
- Basel III compatibility of banks
- Regulation of Non-banking Finance Companies etc.

The first major step was Nationalization of the **Imperial Bank of India** in 1955 via **State Bank of India Act.** State Bank of India was made to act as the principal agent of RBI and handle banking transactions of the Union and State Governments.

After that, in a major process of nationalization, seven subsidiaries of the State Bank of India were nationalized via the State Bank of India (Subsidiary Banks) Act, 1959. In 1969, fourteen major private commercial banks were nationalized. These 14 banks Nationalized in 1969 are shown in the below table.

List of 14 Banks Nationalized in 1969	
1.	Central Bank of India
2.	Bank of Maharashtra
3.	Dena Bank
4.	Punjab National Bank
5.	Syndicate Bank
6.	Canara Bank
7.	Indian Bank
8.	Indian Overseas Bank
9.	Bank of Baroda
10.	Union Bank
11.	Allahabad Bank
12.	United Bank of India
13.	UCO Bank
14.	Bank of India

The above was followed by a second phase of nationalization in 1980, when Government of India acquired the ownership of 6 more banks, thus bringing the total number of Nationalized Banks to 20. The private banks at that time were allowed to function side by side with nationalized banks and the foreign banks were allowed to work under strict regulation.

What was the impact of Nationalization of Banks?

Nationalization of the Banks brought the public confidence in the banking system of India. After the two major phases of nationalization in India, the 80% of the banking sector came under the public sector / government ownership. After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800 per cent in deposits, and advances took a huge jump by 11,000 per cent. Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.

What are financial sector reforms ? Why they are needed?

The financial sector reforms are one of the most important policy agenda of the authorities around the world. There are several reasons for the same.

- Firstly, the reforms are needed to increase the efficiency of financial resource mobilizations and generate higher levels of growth.
- Secondly, financial sector reforms are utmost necessary for the macro-economic stability. India saw its worst economic crisis in the decade of 1980s.

In 1991, India embarked into an era of Economic Reforms which led to liberalization, privatization and globalization of the Indian Economy. The financial sector reforms were an integral part to these reforms.

The financial sector reforms got momentum with the recommendations of various committees such as Chakravarty Committee (1985), Vaghul Committee (1987) and most notably by Narasimham Committee (1991), which is also known as first Narasimham Committee.

What is the importance of year 1991 in banking of India?

Prior to 1991, India was more or less an isolated economy, loosely integrated with the economy of rest of the world. The public sector was born out of a planned economy model, which was underpinned by a Nehruvian-Fabian socialist philosophy.

In 1991, India embarked on the path of liberalization, privatization and globalization. This injected new energy into the slow growing Indian Economy. With reference to Banking sector, it was in this year that the **first Narasimham Committee** gave a blueprint of banking sector reforms. On the basis of these recommendations, the government launched a comprehensive financial sector liberalization programme which included interest rates liberalization, reduction of reserved rations, reduced government control in banking operations and establishment of a market regulatory framework. Another outcome of liberalization was the dismantling of prohibitions against foreign direct investment.

Some more outcomes of reforms that impacted the banking sector were:-

- Steps were taken to move to a market determined exchange rate system, and a unified exchange rate was achieved in the 1990s itself
- The government also released a slew of norms pertaining to asset classification, income recognitions, capital adequacy etc which the banks had to comply with
- Current account convertibility was allowed for the Rupee in accordance with IMF conditions
- Nationalized banks were allowed to raise funds from the capital markets to strengthen their capital base
- The lending rates for commercial banks was deregulated, thereby freeing them to lend more or as they saw fit

- Also, banks were allowed to fix their own interest rates on domestic term deposits that matures within two years
- Customers were encouraged to move away from physical cash, as RBI issued guidelines to the banks pertaining to the issuance of debit cards and smart cards
- The process of introducing computerization in all branches of banks began in 1993 in line with the Committee on Computerization in Banks' recommendations, which had been submitted in 1989
- FII (Foreign Institutional Investors) were allowed to invest in dated Government Securities
- The Foreign Exchange Management Act (FEMA) was enacted in 1999 and effectively repudiated the Foreign Exchange Regulation Act (FERA) of 1973. FEMA enabled the development and maintenance of the Indian foreign exchange markets and facilitated external trade and payments
- The NSE (National Stock Exchange) began its operations in 1994
- RBI began the practice of auctioning Treasury Bills spanning 14 days and 28 days

Capital index bonds were introduced in India for the first time. The newly adopted policy of liberalization led the RBI to provide licenses to conduct banking operations to some private banks such as ICICI Bank, HDFC Bank etc. The growth of industries and expansion of economic operations also revitalized banking operations, which had to keep up with the demand for various banking operations by the flourishing and even nascent enterprises.

Bankers also responded to the renewed demand from the industrial sector and regular customers. New technology and customer-friendly measures were adopted by bankers to attract and retain customers. The Banking Ombudsman was established, so that consumers could have a forum to address their grievances against banks and the services they provided.

Important Dates in Banking History of India

Timeline of Banking in India	
1770	First bank was established at Cacutta under European Management.
1786	General Bank of India was set up.
2 June 1806	Bank of Calcutta was established in 1806; it was renamed in 1809 as Bank of Bengal
15 April 1840	Bank of Bombay established
1 July 1843	Bank of Madras established
1861	Paper Currency Act was enacted by British Government of India

Timeline of Banking in India	
1863	Oldest Joint Stock bank of India named Bank of Upper India was established.
1865	Allahabad Bank was established.
1881	Oudh Commercial Bank, the first Bank of India with Limited Liability to be managed by Indian Board was established at Faizabad
1895	Punjab National Bank was established. It was first bank purely managed by Indians.
1911	Central Bank of India, first Indian commercial bank which was wholly owned and managed by Indians, was established. It was called First Truly Swadeshi bank
1921	Three presidency banks viz. Bank of Calcutta, Bank of Bombay and Bank of Madras amalgamated to form Imperial Bank of India
1935	Creation of Reserve bank of India
1949 (January)	Nationalization of Reserve Bank of India
1949 (March)	Enactment of Banking Regulation Act
1955	Nationalization of Imperial Bank of India, which now became State Bank of India
1959	Nationalization of SBI Subsidiaries
1969	Nationalization of 14 major Banks
1971	Creation of Credit Guarantee Corporation
1975	Creation of Regional Rural Banks
1980	Nationalization of 7 more banks with deposits over Rs. 200 Crore

Dates of Establishment of various Banks

Year / Date	Bank
1786	General Bank of India (First bank established in India)
1790	Bank Of Hindustan which lasted until. 1832.
1839	Union Bank
02 June 1806	Bank of Calcutta

Year / Date	Bank
15th April 1840	Bank of Bombay
01st July 1843	Bank of Madras
1863	Bank of Upper India
1865	Allahabad Bank
1881	Oudh Commercial Bank
19th May 1894	Punjab National Bank
1895	Punjab National Bank In Lahore
1904	City Union Bank
1906	Bank of India
12-Mar-06	Corporation Bank
15th August 1907	Indian Bank
1908	Bank of Baroda
01st July 1906	Canara Hindu Permanent Fund (Renamed as Canara Bank in 1910)
21st December 1911	Central Bank of India
1916	Karur Vysya Bank
11-Nov-19	Union Bank of India
26th November 1920	Catholic Syrian Bank
1921	Imperial Bank of India by merger of three presidency banks.
11th May 1921	Tamilnad Mercantile Bank Limited
1923	Andhra Bank
1924	Karnataka Bank Limited
1925	Syndicate Bank

Year / Date	Bank
1926	Lakshmi Vilas Bank Limited
1927	Dhanlaxmi Bank Ltd
1929	South Indian Bank Limited
23rd October, 1931	Vijaya Bank
1934	Reserve Bank of India
16th Sept 1935	Bank of Maharashtra
1937	Indian Overseas Bank
1938	Jammu & Kashmir Bank
26th May 1938	Dena Bank
19th February 1943	Oriental Bank of Commerce
1943	UCO Bank
1943	United Bank of India
1945	Federal Bank Limited
1954	Nainital Bank Limited
1955	State Bank of India (Imperial Bank of India renamed as SBI)
1985	Kotak Mahindra Bank
1994	UTI Bank (Now Axis Bank)
Aug-94	HDFC Bank
1996	ICICI Bank
2003	Yes Bank
2013	Bhartiya Mahila Bank

Key Landmarks in the journey of RBI

- In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.
- In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.
- In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- In 1934, the Bill was passed and received the Governor General's assent
- In 1935, Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crore.
- In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- In 1947, Reserve Bank stopped acting as banker to the Government of Burma.
- In 1948, Reserve Bank stopped rendering central banking services to Pakistan.
- In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
- In 1949, Banking Regulation Act was enacted.
- In 1951, India embarked in the Planning Era.
- In 1966, the Cooperative Banks came within the regulations of the RBI.
- In 1966, Rupee was devaluated for the first time.
- In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking.
- In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.
- In 1974, the Priority Sector Advance Targets started getting fixed.
- In 1975, Regional Rural Banks started
- In 1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.
- In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated.
- In 1991-92, Economic Reforms started in India.
- In 1993, Exchange Rate became Market determined.
- In 1994, Board for Financial Supervision was set up.
- In 1997, the regulation of the Non Banking Financial Companies (NBFC) got strengthened.
- In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time.

- In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.
- In 2002, The Clearing Corporation of India Ltd Started operation.
- In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.
- In 2004, Liquidity Adjustment Facility (LAF) started working fully.
- In 2004, Market Stabilization Scheme (MSS) was launched.
- In 2004 Real Time Gross Settlement (RTGS) started working.
- In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.
- In 2007, Reserve bank of India was empowered to regulate the Payment systems.

Part-II: Structure of Banking

All banks of India can be simply divided into 3 major groups viz. Central Bank (RBI), Scheduled Banks and Non-scheduled Banks. This implies that every bank other than RBI, is either a scheduled bank or a non-scheduled bank.

However, on the basis of functions, there are five broad categories of Banks in India viz. Central Bank (RBI), Commercial Banks, Development Banks (or Development Finance Institutions), Cooperative Banks and Specialized banks.

Scheduled Versus Non-scheduled banks

A bank is called a scheduled bank in India, if it is listed in the second schedule of the RBI Act, 1934. In order to be included under this schedule of the RBI Act, banks have to fulfill certain statutory conditions such as:

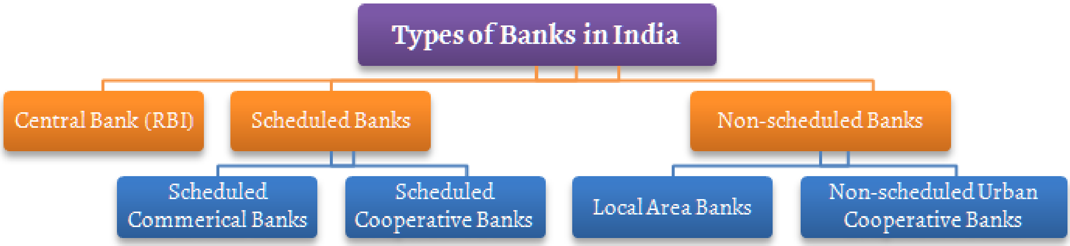
- These banks need to have paid up capital and reserves of at least Rs. 0.5 million (50 Lakh)
- They should satisfy the CRAR norms and other prudential norms of RBI
- They should satisfy the RBI that their business is not being conducted in a manner prejudicial to the interests of its depositors.

In our country all banks are scheduled banks except four Local Area Banks and some Non-scheduled Urban Cooperative Banks. As of February 2015, these four local area banks are:

1. Coastal Local Area Bank Ltd – Vijayawada (Andhra Pradesh)
2. Capital Local Area Bank Ltd – Phagwara (Punjab)
3. Krishna Bhima Samruddhi Local Area Bank Ltd, Mahbubnagar (Andhra Pradesh)
4. Subhadra Local Area Bank Ltd., Kolhapur (Maharashtra)

The scheduled banks are further classified into Scheduled Commercial Banks and Scheduled Cooperative Banks. The basic difference between scheduled commercial banks and scheduled cooperative banks is in their holding pattern. Scheduled cooperative banks are cooperative credit institutions that are registered under the Cooperative Societies Act. These banks work according to

the cooperative principles of mutual assistance.
Classification up to this point is displayed in the below graphics.



Different types of Scheduled Commercial Banks

The scheduled commercial banks are those banks which are included in the second schedule of RBI Act 1934 and which carry out the normal business of banking such as accepting deposits, giving out loans and other banking services.

Scheduled Commercial Banks can be further divided into four groups:

- Public Sector Banks: This includes:

  - SBI & Associates
  - Nationalized Banks
  - Other Public Sector Banks
- Private Banks
- Foreign Banks
- Regional Rural Banks

Number of Scheduled Commercial Banks (Public Sector Banks)

At present, there are 27 Public Sector Banks in India including SBI (and its 5 associates) and 19 nationalized banks. Further, there are two banks which have been categorized by RBI as "Other Public Sector Banks". IDBI and Bhartiya Mahila Bank come under this category. The 19 nationalized banks in India viz. Allahabad Bank, Andhra Bank, Bank of Baroda, Bank of India, Bank of Maharashtra, Canara Bank, Central Bank of India, Corporation Bank, Dena Bank, Indian Bank, Indian Overseas Bank, Oriental Bank of Commerce, Punjab & Sind Bank, Punjab National Bank, Syndicate Bank, UCO Bank, Union Bank of India, United Bank of India and Vijaya Bank.

Further, there are two scheduled commercial banks in India, which have been classified as "other Public Sector Banks". These are IDBI and Bhartiya Mahila Bank.

State Bank of India Group

State Bank of India with its around 17,000 branches and around 200 foreign offices, is India's largest banking and financial services company by assets. With over 2 lakh employees, SBI is banker to millions of Indians. This bank got birth in the British Era. Its first parents were three presidency banks viz. Bank of Calcutta (later Bank of Bengal), Bank of Bombay and the Bank of Madras. In 1921, these three presidency banks were merged in one entity called "Imperial Bank of India". The Imperial Bank of India was nationalized in 1955 and was renamed a State Bank of India. Thus, State bank of India is the oldest Bank of India.

In 1959, there were eight associates of SBI. The current five associate banks of SBI are:

- State Bank of Bikaner & Jaipur
- State Bank of Hyderabad
- State Bank of Mysore
- State Bank of Patiala
- State Bank of Travancore

Apart from the above, the SBI also has seven non-banking subsidiaries viz. SBI Capital Markets Ltd, SBI Funds Management Pvt Ltd, SBI Factors & Commercial Services Pvt Ltd, SBI Cards & Payments Services Pvt. Ltd. (SBICPSL), SBI DFHI Ltd, SBI Life Insurance Company Limited and SBI General Insurance.

Is SBI a nationalized bank?

SBI got birth in the British Era. Its first parents were three presidency banks viz. Bank of Calcutta (later Bank of Bengal), Bank of Bombay and the Bank of Madras. In 1921, these three presidency banks were merged in one entity called "Imperial Bank of India". The Imperial Bank of India was nationalized in 1955 and was renamed a State Bank of India. Thus, although SBI comes under the definition of nationalized banks; yet while classifying the commercial banks in India, RBI puts State Bank of India and its five associates under a separate category (SBI & Associates). Thus, Public Sector Scheduled Commercial Banks are of three categories in India viz. SBI & its five associates; 19 Nationalized Banks and two other Public Sector Banks viz. Bhartiya Mahila Bank and IDBI Bank.

Why SBI is put in different category?

This is mainly because SBI group is governed by a different set of laws viz. SBI Act, 1955 and SBI Subsidiary Banks Act, 1959.

Old private banks and new private banks

In private sector banks, most of the capital is in private hands. There are two types of scheduled commercial (private sector) banks in India viz. Old Private Sector Banks and New Private Sector Banks. There are 13 old private sector banks as follows:

1. Catholic Syrian Bank
2. City Union Bank
3. Dhanlaxmi Bank
4. Federal Bank

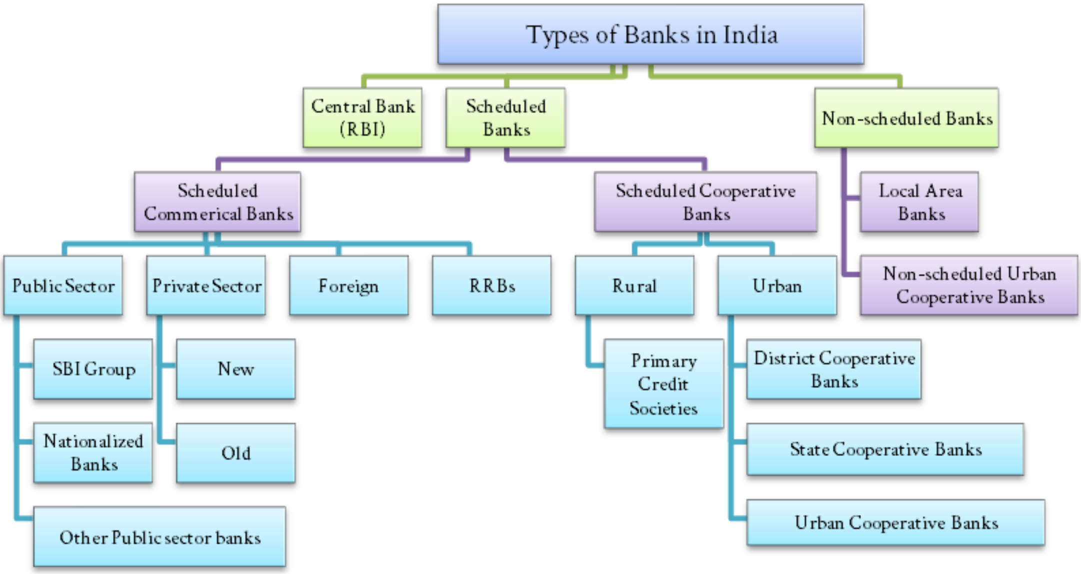
5. ING Vysya Bank
6. Jammu and Kashmir Bank
7. Karnataka Bank
8. Karur Vysya Bank
9. Lakshmi Vilas Bank
10. Nainital Bank
11. Ratnakar Bank
12. South Indian Bank
13. Tamilnad Mercantile Bank

Out of the above banks, the Nainital Bank is a subsidiary of the Bank of Baroda, which has 98.57% stake in it. Some other old generation private sector banks in India have merged with other banks. For example, Lord Krishna Bank merged with Centurion Bank of Punjab in 2007; Sangli Bank merged with ICICI Bank in 2006; Centurion Bank of Punjab merged with HDFC in 2008. All of these were doing business when RBI came up with its new guidelines on private Banks in 1993.

New Private Sector Banks

The new private sector banks were incorporated as per the revised guidelines issued by the RBI regarding the entry of private sector banks in 1993. At present, there are seven new private sector banks viz. Axis Bank, Development Credit Bank (DCB Bank Ltd), HDFC Bank, ICICI Bank, IndusInd Bank, Kotak Mahindra Bank, Yes Bank.

Apart from the above, there are two banks which are yet to commence operation. These have obtained 'in-principle' licenses from RBI. They are **IDFC** and **Bandhan Bank** of Bandhan Financial Services. Thus, the whole picture of banking classification is as follows:



Foreign Banks and their branches in India

As of December 2014, there are 43 foreign banks from 26 countries operating as branches in India and 46 banks from 22 countries operating as representative offices in India. Apart from that, few foreign banks have entered into India via the NBFC route. There are 334 foreign bank branches in India.

What is the share of foreign banks in the banking business in India?

Foreign Banks account for less than 1% of the total branch network in the country. However, they account for approximately 7% of the total banking sector assets and around 11% of the profits. Most of the foreign banks in India are niche players and their business is usually focused on trade finance, external commercial borrowings, wholesale lending, investment banking and treasury services. Some other banks are confined to private banking and wealth management.

What is the RBI policy towards Foreign Banks in India?

RBI policy towards presence of foreign banks in India is based upon two cardinal principles viz. reciprocity and single mode of presence.

By reciprocity, it means that overseas banks are given near national treatment in India only if their home country allowed Indian banks to open branches there without much restrictions. By single mode of presence, it means that RBI allows either of the branch mode or a wholly owned subsidiary (WOS) mode in India.

Some other policy guidelines of RBI towards foreign banks are as follows:

1. Banks have to adhere to mandated Capital Adequacy requirements as per Basel Standard.

2. They should have to meet minimum capital requirement of Rs. 5 billion.
3. They should need to maintain minimum CRAR at 10%
4. Priority sector targets for foreign banks in India is 40%.

Further, the foreign banks have to follow other norms as set by Reserve Bank of India.

Regional Rural Banks

Each RRB is owned by three entities with their respective shares as follows:

- Central Government → 50%
- State government → 15%
- Sponsor bank → 35%

They are different from other commercial banks on the basis of their:

- **Ownership:** as mentioned above, they are owned by three different entities
- **Regulation:** They are regulated by NABARD; which is a subsidiary of RBI. Other banks are regulated by RBI directly.
- **Statutory Background:** RRBs have a separate law behind them viz. Regional Rural Banks Act, 1976.
- **Statutory pre-emptions:** RRBs don't need to maintain CRR and SLR like other banks.

What were the reasons for establishing the Regional Rural Banks?

Regional Rural Banks were started due to the fact that even after nationalization, there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers. So, basic idea was that such banks will work in rural perspectives and they would bring more and more farmers under the financial inclusion. A separate act was passed to provide them a statutory background.

What were various problems of Regional Rural Banks?

RRBs were conceived as low cost institutions having a rural ethos, local feel and pro poor focus. Every bank was to be sponsored by a "Public Sector Bank", however, they were planned as the self sustaining credit institution which were able to refinance their internal resources in themselves and were excepted from the statutory pre-emptions. However, soon the RRBs were marred by several problems. There was a need to consolidate and recapitalize them. In 1990, there were 196 RRBs in India. This number currently stands at 57 (March 2014) after mergers and amalgamations.

What is the current government's policy on Regional Rural Banks?

The Modi Government has put hold on further amalgamation of the Regional Rural Banks. The focus of the new government is to improve their performance and exploring new avenues of investments in the same. Currently, there is a bill pending to amend the RRB Act which aims at increasing the pool of investors to tap capital for RRBs.

Cooperative Banking

A cooperative is jointly owned enterprise in which same people are its customers who are also its owners. Thus, basic difference between scheduled commercial banks and scheduled cooperative banks is in their holding pattern. Scheduled cooperative banks are cooperative credit institutions that are registered under the Cooperative Societies Act. These banks work according to the cooperative principles of mutual assistance.

Indian cooperative structures are one of the largest such networks in the world with more than 200 million members. It has about 67% penetration in villages and fund 46% of the total rural credit. It also stands for 36% of the total distribution of rural fertilizers and 28% of rural fair price shops.

What is history of Cooperative Banking in India?

The idea of cooperatives was first given by Hermann Schulze (1808-83) and Friedrich Wilhelm Raiffeisen (1818-88). In India, the history of Cooperatives begins from 1904 when the Cooperative Credit Societies Act, 1904 led to the formation of Cooperative Credit Societies in both rural and urban areas. The act was based on recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901). The Cooperative Societies Act of 1912, further gave recognition to the formation of non-credit societies and the central cooperative organizations. In independent India, with the onset of planning, the cooperative organizations gained more leverage and role with the continued governmental support.

What is the extent of Urban Cooperative Banking in India?

The structure of cooperative network in India can be divided into two broad segments viz. Urban Cooperative Banks and Rural Cooperatives. Urban Cooperatives can be further divided into scheduled and non-scheduled. Both the categories are further divided into multi-state and single-state. Majority of these banks fall in the non-scheduled and single-state category. Banking activities of Urban Cooperative Banks are monitored by RBI. However, registration and management activities are managed by Registrar of Cooperative Societies (RCS). These RCS operate in single-state and Central RCS (CRCS) operate in multiple state.

Different Rural Cooperatives

The rural cooperatives are further divided into short-term and long-term structures. The short-term cooperative banks are three tiered operating in different states. These are-

- State Cooperative Banks- They operate at the apex level in states
- District Central Cooperative Banks-They operate at the district levels
- Primary Agricultural Credit Societies-They operate at the village or grass-root level.

Likewise, the long-term structures are further divided into –

- State Cooperative Agriculture and Rural Development Banks (SCARDS)- These operate at state-level.

- Primary Cooperative Agriculture and Rural Development Banks (PCARDBS)-They operate at district/block level.

The rural banking cooperatives have a complex monitoring structure as they have a dual control which has led to many problems. A Forum called State Level Task Force on Cooperative Urban Banks (TAFCUB) has been set-up to look into issues related to duality in control.

- All banking activities are regulated by a shared arrangement between RBI and NABARD.
- All management and registration activities are managed by RCS.

Key features of Cooperative banking in India

A cooperative bank is an institution which is owned by its members. They are the culmination of efforts of people of same professional or other community which have common and shared interests, problems and aspirations. They cater to a services like loans, banking, deposits etc. like commercial banks but widely differ in their values and governance structures. They are usually democratic set-ups where the board of members are democratically elected with each member entitled to one vote each. In India, they are supervised and controlled by the official banking authorities and thus have to abide by the banking regulations prevalent in the country. The basic rules, regulations and values may differ amongst nations but they have certain common features:

- Customer-owned
- Democratic structures
- Profits are mainly pooled to form reserves while some amount is distributed to members
- Involved in community development
- Foster financial inclusion by bringing banking to the doorstep of the lowest segment of society

These banks are small financial institutions which are governed by regulations like Banking Regulations Act, 1949 and Banking Laws Cooperative Societies Act, 1965. They operate both in urban and rural areas under different structural organizations. Their functions are decided by the level at which they operate and the type of people they cater to. They greatly differ from the commercial banking entities.

- These are established under specific acts of cooperative societies operating in different states unlike mainstream commercial banks which are mainly joint-stock companies.
- They have a tiered network with a bank at each level of state, district and rural. The state-level bank forms the apex authority.
- Not all sections of banking regulation act are applicable to cooperative banks
- The ultimate motive is community participation, benefit and growth as against profit-

maximization for commercial banks.

Major problems of the functioning of the Cooperative Banks in India

- The duality in control by RCS of a state as 'Cooperation' is a state subject. However financial regulatory control by RBI has led to many troubles as there is ambiguity in power structure as there is no clear demarcation.
- Patchy growth of cooperative societies across the map of India. It is said these have grown maximally in states of Gujarat, Maharashtra, Tamil Nadu whereas the other parts of India don't have a heightened presence.
- The state partnership has led to excessive state control and interference. This has eroded the autonomous characters of many of these.
- Dormant membership has made them moribund as there is a lack of active members and lack of professional attitude.
- Their main focus being credit so they have reduced to borrower-driven entities and majority of members are nominal and don't enjoy voting rights.
- Credit recovery is weak especially in rural areas and it has sustainability crisis in some pockets.

- There is a lack of risk management systems and lack of basic standardised banking models.
- There is a widening gap between the level of skills and the increasing computerization of banks.

The government needs to have a serious look into the issues as they did not show an impressive growth in the last 100 years.

Part-III: Types of Banking

What is Branch Banking?

Branch banking involves business of banking via branches. The branches are set up under Section 23 of Banking Regulations Act, 1949. A branch should cater to all banking services and include a specialized branch, a satellite office, an extension counter, an ATM, administrative office, service branch and a credit card centre for the purpose of branch authorization policy. The advantage of branch banking is that it helps in better management, more inclusion and risk diversification. The disadvantage of branch banking is that it might encourage outside local influences.

What is Unit Banking?

Unit banking is a system of banking which originated in US. It is a limited way of banking where banks operate only from a single branch (or a few branches in the same area) taking care of local community. In comparison to branch banking, the size of unit banks is very small. Due to small size and due to unit structure; the decision making in unit banks is very fast. The management in unit banks enjoy more autonomy and more discretionary powers. However, due to single units, the risk is not distributed or diversified.

What is Mixed Banking?

Mixed Banking is the system in which banks undertake activities of commercial and investment banking together. These banks give short-term and long-term loans to industrial concerns. The banks appoint experts which give valuable advice on various financial issues and also help gauge the financial health of companies. Industries don't have to run to different places for differential financial needs. They thus promote rapid industrialization. They may however pose a grave threat to liquidity of a bank and lead to bad debts.

What is Chain Banking?

Chain banking system refers to the type of banking when a group of persons come together to own and control three or more independently chartered banks. Each of these banks could maintain their independent existence despite common control and ownership. The banks in the chains were assigned specific functions so there was no loss of profits and overlapping of interests.

What is retail banking?

Retail banking means banking where transactions are held directly with customers and there are no transactions with other banks or corporations. The banks provide all kinds of personal banking services to customers like saving accounts, transactional accounts, mortgages, personal loans, debit and credit cards etc.

It has provided immense benefits to customers who ultimately become loyal customers due to benefits like wide interest spreads, diversified credit risks and stability. However, due to increasing use of new technology, the operational costs for banks have gone up considerably.

What is wholesale banking?

Wholesale banking involves banking services for high net-worth clients like corporate, commercial banks, mid-size companies etc. India has a suitable investment climate and is seen as a favoured investment destination so it has a huge potential for the growth of this vertical of banking. It provides an ease of access to the complete financial portfolio of a client who can easily browse through the same and make suitable allocations, transfers etc.

It can be equally risky for a firm if all the funds are parked in one place only and there is no diversification of risks.

What is relationship banking?

Relationship banking is a banking system in which banks make deliberate efforts to understand customer needs and offer him products accordingly.

- It helps banks to gather critical soft information about the borrowers, which helps them to determine creditworthiness of such clients.

- Clients too often become responsible and avoid moral hazard behavior.
- However, the banks may discourage borrowers to invest in high risk projects.
- Clients can often renegotiate their loan terms and hence result in inefficient investments for banks.

What is Correspondent Banking?

Correspondent banking prevalent in over 200 countries is a profitable way of doing business by banks in foreign countries in which they don't have physical presence or limited operational permissions. Correspondent banks thus act as banking agent for a home bank and provides various banking services to customers where otherwise the home bank does not operate.

- It helps customers to perform banking operations at ease even in places where their banks don't have physical presence.
- Customers stay loyal to such banks as they get excellent customer service even in foreign lands.

What is universal Banking?

Universal banking is a system of banking under which big banks undertake a variety of banking services like commercial banking, investment banking, mutual funds, merchant banking, insurance

etc. It involves providing all these services under one roof by financial experts who can handle multiple financial products easily.

This helps to boost investor confidence and also makes the operations more cost-effective. However, different policy regulations for different financial products makes the operations cumbersome and are a big drawback for banks. Also, if such banks fail, it will lead to a big dip in customer confidence.

What is Social Banking?

Social banking is a concept where banking services are oriented towards mass welfare and financial inclusion of the poor and vulnerable segments of society. RBI has taken some commendable initiatives to make financial inclusion a reality for the remotest segments of Indian population. Some of these are:

- Availability of ICT based Business Correspondent Model for delivery of banking services at the doorstep of every household in remote villages.
- 3 year Financial Inclusion Plans for banks. This has been implemented since 2010.
- To cover all villages with a population of over 2000 has been successfully completed by 2012.
- It is mandatory for banks to open 25% of new branches in rural areas which don't have access to formal banking.
- Basic Savings Bank Deposit Account has been introduced for all.
- KYC documentations have been considerably relaxed and simplified for small accounts.

Indian government has thus made the Financial Inclusion as one its topmost priority and has taken many policies and schemes to achieve the same. It has to work on implementation line to make the policies a great success.

What is Virtual Banking?

Virtual banking is performing all banking operations online. This has served as a great revolution in banking market as banks have to continuously struggle for perfection to live up to competition and stay ahead of it. As banks don't have physical offices, they find the options very cost-effective. The banks thus pass these benefits to customers in form of waiving of account fee or higher rates of interest. The trend is catching in Indian markets but some typical fears still grip an average Indian who still places more trust in bank staff with whom they can personally go and talk, rather than relying on machines.

What is Narrow Banking?

The Narrow Banking is very much an antonym to the Universal Banking. Narrow Banking means Narrow in the sense of engagement of funds and not in activity. So, simply, Narrow Banking involves mobilizing the large part of the deposits in Risk Free assets such as Government Securities.

What is Islamic Banking?

Islamic banking is banking or banking activity that is consistent with the principles of sharia and its practical application through the development of Islamic economics.

What is Shadow Banking?

Shadow banking refers to all the non-bank financial intermediaries that provide services similar to those of traditional commercial banks. They generally carry out traditional banking functions, but do so outside the traditional system of regulated depository institutions. Some of these activities include:

- Credit intermediation – Any kind of lending activity including at least one intermediary between the saver and the borrower
- Liquidity transformation – Usage of short-term debts like deposits or cash-like liabilities to finance long-term investments like loans.
- Maturity transformation – Using short-term liabilities to fund investment in long-term assets

In the Indian financial arena, shadow banks term can be used for Non-Banking Finance Companies (NBFCs). However, NBFCs in India have been regulated by the RBI (Reserve Bank of India) since 1963. Other examples are investment bankers, Money market mutual funds, mortgage companies etc.

General Knowledge Today

Banking & Finance-2: RBI, Monetary Policy

Target 2016: Integrated IAS General Studies

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Functions of RBI, Strucutre of RBI, Board for Financial Supervision, Board for Payment and Settlement Systems (BPSS), Objectives of Monetary policy, Open Market Operations, Liquidity Adjustment Facility (Repo and Reverse Repo), Marginal Standing Facility, SLR, CRR, Bank Rate, Credit Ceiling, Para – banking Activities, Proportional Reserve System and Minimum Reserve System, Ways and means advances (WMA), Statuary Reserves, Lender of the Last Resort (LORL), LERMS.

History & Genesis of RBI

Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India . RBI started its operations from April 1, 1935. It was established via the RBI act 1934, so it is also known as a statutory body. Similarly, SBI is also a statutory body deriving its legality from SBI Act 1935.

RBI did not start as a Government owned bank but as a privately held bank without major government ownership. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.

After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalization of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned bank.

Hilton Young Commission

Hilton-Young Commission was the Royal Commission on Indian Currency and Finance set up by British Government of India in 1920s. In 1926, this commission had recommended to the government to create a central bank in the country. On the basis of mainly this commission, the RBI act was passed.

Original headquarters of RBI

Original headquarters of RBI were in Kolkata, but in 1937, it was shifted to Shahid Bhagat Singh Marg, Mumbai.

Structure & Functions of RBI

The core structure of RBI includes one Central Board of Directors, two Assistive bodies (BFS and BPSS), four local boards, 33 departments, 19 regional offices and 9 sub-offices.

Main functions of RBI

- To work as monetary authority and implement its Monetary Policy
- To serve as issuer of bank notes
- Serve as banker to central and state governments
- Serve as debt manager to central and state governments
- Provide ways and means advances to the state governments
- Serve as banker to the banks and lender of last resort (LORL) for them
- Work as supervisor and regulator of the banking & financial system
- Management of Foreign Exchange Reserves of the country

- Support the government in development of the country

Structure and functions of Central Board of Directors in RBI

Central Board of Directors is the top decision making body in the RBI. It is made of official directors and Non-official directors.

The Governor and Deputy Governors are the official directors. There is on Governor and maximum 4 Deputy Governors; so maximum number of Official Directors in RBI's Central Board of Directors is five. Governor and Deputy governors are appointed by Central Government. The tenure of service is maximum of 5 years or till the age of 62 whichever is earlier.

Further, there are 16 non-official directors in RBI. Out of them, there are four represent the local Boards located in Delhi, Chennai, Kolkata and Mumbai, thus representing 4 regions of India. Rest 12 are nominated by the Reserve Bank of India. These 12 personalities have expertise in various segments of Indian Economy.

The Central Board of Directors holds minimum 6 meetings every year. Out of which, at least 1 meeting every quarter is held. Though, typically the committee of the central board meets every week (Wednesday).

Assistive bodies in RBI

There are two assistive bodies for Central Board of Directors viz. Board of Financial Supervision (BFS) and Board for Payment and Settlement Systems (BPSS). Both of these are chaired by RBI Governor.

Local Boards

There are four local boards of RBI located in Chennai, Kolkata, Mumbai and New Delhi. These four local boards represent four regions of the country. Members and directors of local boards are appointed by central government for four-year terms. Each of these local boards consists of 5 members who represent regional interests, and the interests of co-operative and indigenous banks.

Departments of RBI

Reserve Bank of India has 33 departments which focus on policy issues in the Reserve Bank's functional areas and internal operations. These are as follows:

1. Consumer Education and Protection Department
2. Corporate Strategy and Budget Department
3. Department of Banking Regulation
4. Department of Banking Supervision
5. Department of Communication
6. Department of Cooperative Bank Regulation
7. Department of Cooperative Bank Supervision
8. Department of Corporate Services

9. Department of Currency Management
10. Department of Economic and Policy Research
11. Department of External Investments and Operations
12. Department of Government and Bank Accounts
13. Department of Information Technology
14. Department of Non-Banking Regulation
15. Department of Non-Banking Supervision
16. Department of Payment and Settlement Systems
17. Department of Statistics and Information Management
18. Financial Inclusion and Development Department
19. Financial Markets Operation Department
20. Financial Markets Regulations Department
21. Financial Stability Unit
22. Foreign Exchange Department
23. Human Resource Management Department
24. Inspection Department
25. Internal Debt Management Department
26. International Department
27. Legal Department
28. Monetary Policy Department
29. Premises Department
30. Rajbhasha Department
31. Risk Monitoring Department
32. Secretary's Department
33. Central Vigilance Cell

Regional and sub-offices of RBI

There are **19 regional offices and 9 sub-offices of RBI**. Most of the 19 regional offices are located in state capitals. They are shown in the below map:

Training centres of RBI

The training centres of RBI are as follows:

- The Reserve Bank Staff College, Chennai
- College of Agricultural Banking at Pune
- Zonal Training Centres, located at regional offices, train non-executive staff.
- Apart from that following are RBI funded Research Institutions:
- National Institute of Bank Management (NIBM) : Pune,
- Indira Gandhi Institute of Development Research (IGIDR) : Mumbai
- Institute for Development and Research in Banking Technology (IDRBT) : Hyderabad.

RBI's Subsidiaries

RBI has following subsidiaries

- Deposit Insurance and Credit Guarantee Corporation, DICGC
- National Housing Bank

- Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL)
- NABARD

Board for Financial Supervision (BFS)

Board of Financial Supervision (BFS) is one of the two assistive bodies for Central Board of Directors of RBI, other being Board for Payment and Settlement Systems .

It was established in 1994 and its main function is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies. It is chaired by RBI Governor. One of the deputy governors of RBI serves as Vice Chairman BFS. BFS meets typically every month.

Functions of BFS

BFS is working as the main guiding force behind RBI's regulatory and supervisory initiatives. The RBI carries out its functions related to financial supervision under the guidance of BFS. BFS Regulates and supervises commercial banks, Non-Banking Finance Companies (NBFCs), development finance institutions, urban co-operative banks and primary dealers. Some typical functions are:

- Restructuring of the system of bank inspections

- Introduction of off-site surveillance,
- Strengthening of the role of statutory auditors and
- Strengthening of the internal defences of supervised institutions.

Board for Payment and Settlement Systems (BPSS)

BPSS was established in 2005 to regulate and supervise the payment and settlement systems. It is one of the two assistive bodies to Central Board of Directors in RBI (other being BFS). This is also chaired by the Governor of RBI and its members are all the four Deputy Governors and two Non-Official Directors of the Central Board.

Key Functions of BPSS are:

- Lay down policies relating to the regulation and supervision of all types of payment and settlement systems.
- Set standards for existing and future systems
- Approve criteria for authorization of payment and settlement systems
- Determine criteria for membership to these systems, including continuation, termination and rejection of membership.

With regard to the payment and settlement systems, BPSS is the highest policy making body in the country. Electronic, non-electronic, domestic and cross-border payment and settlement systems which affect the domestic transactions are regulated by BPSS.

RBI's Monetary Policy

Meaning & Objectives of Monetary policy

Monetary policy refers all those operations, which are used to control the money supply in the economy. The overall objective of the monetary policy is twofold:

1. To maintain economic and financial stability
2. To ensure adequate financial resources for the purpose of development.

These objectives can be further simplified to:

1. Maintaining price stability
2. Adequate flow of credit to productive sectors
3. Promotion of productive investments & trade
4. Promotion of exports and economic growth

Reserve Bank of India announces Monetary Policy every year in the Month of April. This is followed by three quarterly Reviews in July, October and January.

Various tools / instruments of monetary policy

Various instruments of monetary policy can be divided into quantitative and qualitative instruments. Quantitative instruments are those which directly affect the quantity of money supply in the economy. Qualitative instruments are those which impact the money supply indirectly.

The quantitative instruments are:

- Open Market Operations
- Liquidity Adjustment Facility (Repo and Reverse Repo)
- Marginal Standing Facility
- SLR, CRR
- Bank Rate
- Credit Ceiling etc

On the other hand, qualitative instruments are: credit rationing, moral suasion and direct action (by RBI on banks).

Quantitative Instruments of Monetary Policy

Open Market Operations

Open Market Operations (OMO) refer to the purchase and sale of the Government Securities (G-Secs) by RBI from / to market. The objective of OMO is to adjust the rupee liquidity conditions in the economy on a durable basis. The working of OMOs is defines as below:

- When RBI sells government security in the markets, the banks purchase them. When the banks purchase Government securities, they have a reduced ability to lend to the industrial houses or other commercial sectors. This reduced surplus cash, contracts the rupee liquidity and consequently credit creation / credit supply.

- When RBI purchases the securities, the commercial banks find them with more surplus cash and this would create more credit in the system.

Thus, in the case of excess liquidity, RBI resorts to sale of G-secs to suck out rupee from system. Similarly, when there is a liquidity crunch in the economy, RBI buys securities from the market, thereby releasing liquidity. It's worth note here that the market for government securities is not well developed in India but still OMO plays very important role.

Liquidity Adjustment Facility

Liquidity Adjustment Facility (LAF) is the primary instrument of Reserve Bank of India for modulating liquidity and transmitting interest rate signals to the market. LAF was first introduced in June 2000. It refers to the difference between the two key rates viz. repo rate and reverse repo rate. Informally, Liquidity Adjustment Facility is also known as Liquidity Corridor. Under Repo, the banks borrow money from RBI to meet short term needs by putting government securities (G-secs) as collateral. Under Reverse Repo, RBI borrows money from banks by lending securities. These are done by auctions so called "repo auctions" or "reverse repo auctions". Other important points are as follows:

- The repo and reverse repo rates are decided by RBI on its own discretion.
- ONLY Government of India dated Securities/Treasury Bills are used for collateral under LAF as of now.
- While repo injects liquidity into the system, the Reverse repo absorbs the liquidity from the system.
- RBI only announces Repo Rate. The Reverse Repo Rate is linked to Repo Rate and is 100 basis points (1%) below repo rate. RBI makes decision regarding Repo Rate on the basis of prevalent market conditions and relevant factors.
- RBI conducts the Repo auctions and Reverse Repo auctions on daily basis from Monday to Friday except holidays.
- All the Scheduled Commercial Banks are eligible to participate in auctions except the Regional Rural Banks.
- Primary Dealers (PDs) having Current Account and SGL Account (Subsidiary General Ledger Account) with Reserve Bank are also eligible to participate in the Repo and Reverse Repo auctions.
- Under the Liquidity Adjustment Facility, bids need to be for a minimum amount of Rs.5 crore and in multiples of Rs. 5 Crore thereafter.

Marginal Standing Facility

Marginal Standing Facility is a new Liquidity Adjustment Facility (LAF) window created by Reserve Bank of India in its credit policy of May 2011.

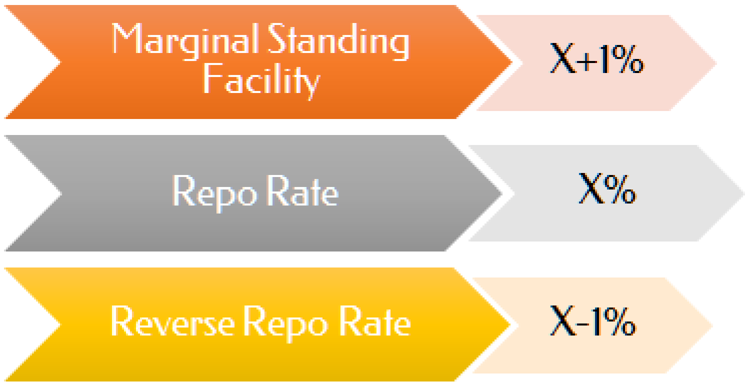
- MSF is the rate at which the banks are able to borrow overnight funds from RBI against the approved government securities.

Banks are already able to borrow from RBI via Repo Rate, then why MSF is needed?

MSF window was created for commercial banks to borrow from RBI in certain emergency conditions when inter-bank liquidity dries up completely and there is a volatility in the overnight interest rates. To curb this volatility, RBI allowed them to pledge G-secs and get more funds from RBI at a rate higher than the repo rate. Thus, overall idea behind the MSF is to contain volatility in the overnight inter-bank rates.

How the rate of interest in Repo, Reverse Repo and Marginal Standing Facility are related to each other?

The rate of interest on MSF is above 100 bps above the Repo Rate. The banks can borrow up to 1 percent of their net demand and time liabilities (NDTL) from this facility. This means that Difference between Repo Rate and MSF is 100 Basis Points. So, Repo rate will be in the middle, the Reverse Repo Rate will be 100 basis points below it, and the MSF rate 100 bps above it. Thus, if Repo Rate is X%, reverse repo rate is X-1% and MSF is X+1%.



Statutory pre-emptions

Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are called Statutory Pre-emptions. The RBI has been empowered by Banking Regulation Act and RBI act to mandate commercial banks to maintain a certain portion of their Net Demand and Time Liabilities (NDTL) in the form of cash with the Reserve Bank [this is called Cash Reserve Ratio (CRR)] and in the form of investment in unencumbered approved securities [this is called Statutory Liquidity Ratio (SLR)].

Statutory Liquidity Ratio (SLR)

The banks and other financial institutions in India have to keep a fraction of their total net time and demand liabilities in the form of liquid assets such as G-secs (Government Securities), precious metals, other approved securities etc. This fraction is called Statutory Liquidity Ratio (SLR).

It is one of the two statutory pre-emptions because it gets its legal sanction from the section 24 (2A) of Banking Regulation Act 1949, which initially mandated for a 23% SLR. To comply with the SLR, the banks can keep any of the following:

- Cash in hand
- Gold owned by the bank
- Balance with RBI
- Net balance in current account
- Investment in Government securities

SLR has to be maintained at the close of business on every day. In the 1980s and 1990s, the SLR was very high (around 38.5%) and the first Narsimham Committee recommended to bring it down from 38.5% to 25%. At present, the SLR is 21.5% (February 2015).

Why SLR is needed?

There are three purposes to keep SLR. These are:

- It is an instrument of credit control
- It works as a cushion against the possibility of bank failures
- It is a conduit for financing government deficits.

We note here that SLR is not very frequently changed; so as an instrument of Credit Control; its role is limited. However, most important function SLR is doing in current times is to "finance the government deficit". As far as its function as a cushion against bank failures is concerned, it is practically meaningless because weak commercial banks are not allowed to fail by the Government/RBI which is guided by the too-big-to-fail doctrine while resolving bank failures.

What is Double Financial Repression?

The Economic Survey 2014-15 pointed out the two side problem being faced by the banks in India. One the asset side, they are forced to keep a huge fraction of their assets in the form of SLR. It does not allow them to invest those assets in better avenues. On the liability side, they have to make huge fraction of their credits to Priority Sector. These two have led to the banks to reel under the so called "Double Financial Repression". The survey recommended to gradually abolish SLR and also bring down mandatory Priority Sector Lending.

What will happen if SLR is brought down?

As mentioned above, the most important function SLR is doing in current times is to "finance the government deficit". So, if SLR is abolished; the biggest casualty will be on the government borrowing programmes.

Cash Reserve Ratio

The Cash Reserve Ratio is the amount of funds that the banks are bound to keep with Reserve bank of India as a portion of their Net Demand and Time Liabilities (NDTL). This is also a statutory pre-emption because it draws its legality from Banking Regulation Act 1949.

The objective of CRR is to ensure the liquidity and solvency of the Banks. The CRR is maintained fortnightly average basis.

What happens when CRR is reduced?

When CRR is reduced, this means banks have to keep less funds with RBI and they have more funds to deploy in other businesses. When the banks have more money, they would try to lend it, thus increasing money supply in the system, and this might lead to reduction in the interest rates. Further, when money supply increases, too much money chases too few goods and this leads to rise in inflation. So, reducing CRR:

- Increases money supply
- Decreases interest rates on home loans, car loans etc. and in inter-bank market
- Reduces demand for money
- Increases inflation

What happens when CRR is increased?

When RBI increases the CRR, less funds are available with banks as they have to keep larger protions of their cash in hand with RBI. This means that banks will now have less money to play with. Moreover, Reserve Bank does not pay any interest on the CRR balances. Since commercial banks don't earn any interest, the banks are left with an option than to increase the interest rates. If RBI hikes this rate substantially, banks will have to increase the loan interest rates. The home loans, car loans and EMI of floating Rate loans increase. Thus hike in CRR leads to increase of interest rates on Loans provided by the Banks. Reduction in CRR sucks money out of the system causing to decrease in money supply. When money supply decreases, the inflation comes down. In summary, when increasing CRR:

- Decreases money supply
- Increases interest rates on home loans, car loans etc. and in inter-bank market
- Increases demand for money
- Decreases inflation

Bank Rate

Bank Rate refers to the official interest rate at which RBI will provide loans to the banking system which includes commercial / cooperative banks, development banks etc. Such loans are given out either by direct lending or by rediscounting (buying back) the bills of commercial banks and treasury bills. Thus, bank rate is also known as discount rate. Bank rate is used as a signal by the RBI to the commercial banks on RBI's thinking of what the interest rates should be.

What happens when Bank Rate is increased or decreased?

When RBI increases the bank rate, the cost of borrowing for banks rises and this credit volume gets reduced leading to decline in supply of money. Thus, increase in Bank rate reflects tightening of RBI monetary policy. When RBI decreases the bank rate, the cost of borrowing for banks falls and thus credit volume gets increased leading to surge in supply of money. Thus, decrease in Bank rate reflects loosening of RBI monetary policy.

Difference between Bank Rate and Repo Rate

Bank Rate and Repo Rate seem to be similar terms because in both of them RBI lends to the banks. However:

- Repo Rate is a short-term measure and it refers to short-term loans and used for controlling the amount of money in the market.
- On the other hand, Bank Rate is a long-term measure and is governed by the long-term monetary policies of the RBI.
- In broader term, bank rate is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries. RBI uses this tool to control the money supply.

Credit Ceiling

Under the credit ceiling, RBI informs the banks to what extent / limit they would be getting credit. When RBI imposes a credit limit, the banks will get tight in advancing loans to public. Further, RBI may also direct the banks to provide certain fractions of their loans to certain sectors such as farm sector or priority sector.

Qualitative instruments of monetary policy

Margin requirements, consumer credit regulation, RBI guidelines, Moral suasion and direct action are the qualitative tools of monetary policy of the RBI.

- **Margin requirements** refers to difference between the securities offered and amount borrowed by the banks.
- Consumer credit regulation refers to issuing rules regarding down payments and maximum maturities of installment credit for purchase of goods.
- **RBI Guidelines refers to the** oral, written statements, appeals, guidelines, warnings etc. to the banks by RBI.
- Rationing of the credit refers to control over the credit granted / allocated by commercial banks.
- Moral Suasion refers to a request by the RBI to the commercial banks to take certain

measures as per the trend of the economy. For example, RBI may ask banks to not to give out certain loans. It includes psychological means and informal means of selective credit control.

- **Direct Action** is taken by the RBI against banks that don't fulfill conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.

Monetary Policy Stance

Monetary policy stance is based upon the assessment of the macroeconomic and financial conditions and monetary measures taken on the basis of those conditions. The overall objective while taking such instance is to speed up the economic development of the nation and raise the national income and standard of living of the people. The examples of stance taken by RBI via its monetary policy are as follows:

- Immediately after independence, India entered into economic planning era. To contribute in the development of the economy, RBI took such an instance that it not only provides adequate financing and economic growth but also controls inflation. This was called monetary policy stance of "Controlled expansion".
- Similarly, when inflation is high, RBI uses the various policy instruments to reduce the money supply in the economy. To do this, it would raise the Bank Rate, Repo Rate, CRR and SLR. All these would suck he liquidity out of system and bring down too much money chasing too few goods. This would finally bring down inflation. Such instance is called Tight Monetary Policy.
- RBI works as the **monetary authority of India** and thereby operates the monetary policy.

Regulation of Banks

One of the most important functions of RBI is to work as regulator and supervisor of financial system[1]. RBI derives its regulating powers from **Banking Regulation Act 1949.** For other entities, it derives power from the **RBI act 1934**. The objectives of this function are to protect the interest of the depositors and maintain the safety and soundness of the banking and Financial System of the country. At micro level, the regulation and supervision is done by various departments. For example, Department of Banking Operations and Development (DBOD) frames regulations for commercial banks; while Department of Banking Supervision (DBS) undertakes supervision of commercial banks, including the local area banks and all-India financial institutions. Similarly, Department of Non-Banking Supervision (DNBS) regulates and supervises the Non-Banking Financial Companies (NBFCs), while Urban Banks Department (UBD) regulates and supervises the Urban Cooperative Banks (UCBs). Regulation of Regional Rural Banks (RRBs) and the Rural Cooperative Banks is done by Rural Planning and Credit Department (RPCD); while the supervision of these comes under

NABARD.

Key obligations for banks towards RBI

First thing is that to do the banking business, every Bank whether Indian or foreign needs a license from RBI to conduct the banking business. Apart from that they have to:

- To ensure high quality corporate governance, the banks should follow the "fit and proper" criteria for director of banks. This implies that a director bank must have special knowledge in the banking related field. RBI can also appoint additional directors to the board of a banking company.
- Banks need to comply with the statutory pre-emptions viz. CRR and SLR requirements.
- Banks need to adhere to the prudential norms[2]. RBI has also issued guidelines under the Basel II / Basel III for risk management.
- Banks need to maintain public disclosure of relevant information including capital adequacy, asset quality, liquidity, earnings aspects and penalties imposed. This is one of RBI's tool for market discipline.
- Banks need to adhere to KYC norms (Know Your Customer) Anti- Money Laundering (AML) and Combating Financing of Terrorism (CFT) guidelines.

- RBI undertakes annual on-site inspection of banks to assess their financial health and to evaluate their performance in terms of quality of management, capital adequacy, asset quality, earnings, liquidity position as well as internal control systems.
- RBI also analyzes the health of the banks via its OSMOS[3]

How RBI protects the interests of the small depositors and common man?

First, RBI maintains soundness of the entire banking system via its various regulatory tools and norms such as Corporate Governance norms, Fit and proper criteria for directors, statutory pre-emptions, prudential norms, public disclosure roles, Basel guidelines, KYC norms, Anti- Money Laundering (AML) guidelines, Combating Financing of Terrorism (CFT) guidelines, onsite and offsite surveillance etc.

Further, RBI has set up the Deposit Insurance and Credit Guarantee Corporation (DICGC) to protect the interest of small depositors, in case of bank failure. The DICGC provides insurance cover to all eligible bank depositors up to Rs.1 lakh per depositor per bank.

Para – banking Activities

Parabanking activities are those activities which don't come under the traditional banking activities. Examples of such activities are asset management, mutual funds business, insurance business, merchant banking activities, factoring services, venture capital, card business, equity participation in venture funds and leasing. The RBI has permitted banks to undertake these activities under the guidelines issued by it from time to time.

Currency in India

In India, the paper currency was first issued during British East India Company rule. The first paper currency issued in India was the Re. 1 note. The first paper notes were issued by the private banks such as Bank of Hindustan and the presidency banks during late 18th century. In those times, there were Government issued notes also but government had no monopoly in issuing paper notes.

Via the Paper Currency Act of 1861, the British Government of India was conferred the monopoly to issue paper notes in India.

Currency Circles

After the 1861 act, the Government of India had the monopoly to issue paper notes in India. But since making those notes popular was a difficult task in such a vast country; the government entered into agreements with the Presidency Banks to work as authorized agents to promote circulations of the paper notes across length and breadth of British India.

However, there were several limitations. The lack of mobility, lack of development and lack of education resulted in a major issue in redemption of these notes. Consequently, there were only some areas (such as major cities and nearby areas) in various parts of country, where the paper notes of Indian government were legal tenders. These areas were called "Currency Circles".

Controller of Currency

The agreements with the Presidency Banks to promote and popularize the bank notes was terminated in 1867. Subsequently, job of promoting, circulating and redemption of the currency notes was entrusted to Mint Masters, Accountant General and the Controller of Currency. This practice continued till RBI came into existence in 1935.

In which year the currency function moved from Controller of Currency to RBI?

Section 22 of the RBI Act 1934 makes provided that RBI has the sole right to issue Bank notes of all denominations. Thus, on 1 April 1935, 1935, the currency function moved from Controller of Currency to RBI. Today, Reserve Bank is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. In consultation with the Government, the Reserve Bank routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery of currency notes.

Decimalization of Coinage

When India got freedom, the basic unit of Indian currency was 1 Rupee which could be divided into 16 Annas (□□□) or 64 pice (□□□); pice was old spelling of paise. At that time, lowest denomination of Indian Rupee was Half-Pice, which became obsolete in 1947. At that time, the Government minted One Rupee, Half Rupee, Quarter Rupee, Two Annas, One Anna, Half Anna and One Pice coins.

This 16 Anna and 64 Pice structure remained till 1957, when decimalization of the coinage was done.

Henceforth, spelling of "pice" was changed to "Paisa" and 1 Rupee was divided into 100 Paise. This is called Decimalization of Coinage and it took place in 1957. The 100th part of Rupee was now called **Naya Paisa**. The term "naya" was dropped in 1964.

Role of RBI in coins in India

The distribution of Coins is undertaken by RBI as an agent of the Government, (coins are minted by the Government and not by RBI).

However RBI is the only source of legal tender money because distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government.

Current Paper Notes in Circulation

At present, paper currency notes in India are issued in the denomination of Rs. 5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.500 and Rs.1,000. The printing of Rs. 1 and Rs. 2 denominations has been discontinued, though the notes in circulation are valid as per the Coinage Act 2011.

- In February 2015, it was reported that RBI will again put in circulation rupee one notes after a gap of 20 years.

Reserve Bank of India has been authorized to issue notes of Rs. 5000 and Rs. 10000 also. In fact, as per RBI act, RBI can issue any note of any denomination but NOT exceeding Rs. 10,000. The notes denomination is notified by Government and RBI acts accordingly.

Signature on currency notes

Under Section 22 of the Reserve Bank of India Act, RBI has sole right to issue currency notes of various denominations except one rupee notes. The One Rupee note is issued by Ministry of Finance and it bears the signatures of Finance Secretary, while other notes bear the signature of Governor RBI.

Proportional Reserve System and Minimum Reserve System

Originally, the assets of the Issue department were to consist of not less than 2/5th of the Gold or sterling securities, provided Gold was not less than Rs. 40 Crores in value. Remaining 3/5th of the assets might be rupee coins. This was called "Proportional Reserve System". In 1956, this system was changed. Now, RBI is required to maintain a Gold and Foreign Exchange Reserves of Rs. 200 Crore of which at least Rs. 115 Crore should be in Gold. This is called Minimum Reserve System. This system continues till date.

Currency Chests

Currency chests are storehouses where bank notes and rupee coins are stocked on behalf of the Reserve Bank. The currency chests have been established with State Bank of India, six associate banks, nationalized banks, private sector banks, a foreign bank, a state cooperative bank and a regional rural bank. Deposits into the currency chest are treated as reserves with the Reserve Bank and are included in the Cash Reserve Ratio.

First printing press in India for bank notes

Currency Note Press (CNP), Nasik, Maharashtra was established in 1928. It was the first printing press for bank notes in India.

Locations of Various Bank Note Press

The **Security Printing and Minting Corporation of India Limited** (SPMCIL) prints the notes. It is a wholly owned company of the Government of India. Its printing presses are located at Nasik (Maharashtra) and Dewas (Madhya Pradesh).

Apart from that, the **Bharatiya Reserve Bank Note Mudran Pvt. Ltd**. (BRBNMPL), a wholly owned subsidiary of the Reserve Bank, also has set up printing presses. The presses of BRBNMPL are located at Mysore in Karnataka and Salboni in West Bengal.

Security Printing and Minting Corporation of India Limited (SPMCIL) has 4 mints for coin production located at Mumbai, Noida, Kolkata and Hyderabad.

Legal Tenders

One Rupee Note and One Rupee coins are legal tenders for **unlimited amounts.** 50 Paisa coins are legal tender for any sum not above Rs. 10. The coins of smaller than 50 paisa value are legal tenders of a sum below Re. 1.

Star Series Notes

The Star series notes are currently issued in Rs. 10, 20, 50 and Rs. 100. These notes are issued to replace the defected printed notes at the printing press. They have an additional character of a star and the bundles are NOT in series. Rest all the features are same.

Languages on currency notes

The amount of a banknote is written on it in 17 languages out of 22 official languages of India. The languages are Assamese, Bengali, Gujarati, Kannada, Kashmiri, Konkani, Malayalam, Marathi, Nepali, Oriya, Punjabi, Sanskrit, Tamil, Telugu and Urdu.

Issue Department and Currency Departments of RBI

RBI has a separate department called issue department whose assets and liabilities are kept separate from the Banking Department. Currency Management function of Reserve Bank is carried out at the "Department of Currency Management" located at Central Office Mumbai. There are 19 Issue offices. RBI authorizes selected branches of Banks to establish Currency Chests and Coin Deposits. At present there is a network of 4281 Currency Chests and 4044 Small Coin Deposits.

RBI as Banker of Government

For Central Government

As per the RBI Act, 1934, Central Government entrusts the Reserve Bank with all its money, remittance, exchange and banking transactions in India and the management of its public debt. The

Government also deposits its cash balances with the Reserve Bank. Further, note that the central government is required to maintain a minimum cash balance with the Reserve Bank. Currently, this amount is Rs. 10 crore on a daily basis and Rs.100 crore on Fridays, as also at the end of March and July. These provisions are as per the administrative arrangements (not as per any legislation).

For state governments

In case of state governments, RBI works has their banker only when a particular state enters into such agreement with RBI. Currently, the Reserve Bank acts as banker to all the State Governments in India, **except Jammu & Kashmir and Sikkim.** It has limited agreements for the management of the public debt of these two State Governments.

Banking of Individual Ministries

RBI used to handle banking of individual ministries in past. Currently, every ministry has been given a public sector bank to manage its operations. But still RBI functions for the ministries for which it is **nominated** to do so.

Central Accounts Section

Reserve Bank of India maintains the Principal Accounts of Central as well as State Governments at its Central Accounts Section, Nagpur. It has put in place a well structured arrangement for revenue collection as well as payments on behalf of Government across the country. A network comprising the Public Accounts Departments of RBI and branches of Agency Banks appointed under Section 45 of the RBI Act carry out the Govt. transactions.

Banks that conduct Government Business in India

At present all the public sector banks and three private sector banks viz. ICICI Bank Ltd., HDFC Bank Ltd. and Axis Bank Ltd. act as RBI's agents. Only authorized branches of Agency banks can conduct Govt. business.

RBI works as Debt Manager of Government

RBI helps both the central government and state governments to manage their public debt, float new loans, issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration. RBI's debt management policy aims at minimizing the cost of borrowing, reducing the roll-over risk, smoothening the maturity structure of debt, and improving depth and liquidity of Government securities markets by developing an active secondary market.

Ways and means advances (WMA)

Whenever there is a temporary mismatch in the cash flow of the receipts and payments of the State Governments, RBI provides them Ways and Means Advances (WMA). This also comes under debt management works of RBI.

RBI as banker to other banks

RBI is bank of all banks in India. As a banker of banks, RBI:

- Enables smooth and swift clearing and settlements of inter-bank transactions
- Provides efficient means of funds transfer for all banks
- Enables banks to maintain their accounts with RBI for statutory reserve requirements and maintenance of transaction balances
- Acts as lender of last resort (LORL)

Reserve Bank maintains current account of all other banks and provides them facility to maintain cash reserves and also to carry out inter-bank transactions. RBI provides the Real Time Gross Settlement System (RTGS) facility to the banks for inter-bank transactions.

Statuary Reserves

As per the Banking Regulations Act 1949, Banks have to keep a portion of their demand and time liabilities as cash reserves with the Reserve Bank, thus necessitating a need for maintaining accounts with the Bank. Earlier, (originally in the BR act) it was as follows – 5% of demand liabilities and 2% of time liabilities. But now it is the portion of Net Demand and Time Liabilities (NDTL). So, the RBI provides banks with the facility of opening accounts with itself. This is the 'Banker to Banks' function of the Reserve Bank, which is delivered through the Deposit Accounts Department (DAD) of RBI at regional offices.

RBI continuously monitors the transactions and operations of these accounts so that defaults don't take place.

Lender of the Last Resort (LORL)

The banks can borrow from the RBI by keeping eligible securities as collateral or any other arrangement and at the time of need or crisis, they approach RBI for financial help. Thus RBI works as Lender of the Last Resort (LORL) for banks.

How RBI regulated and supervises the Financial System?

One of the most important functions of RBI is to work as regulator and supervisor of financial system. RBI not only regulates and supervises the Indian Banks but also Foreign Banks, Regional Rural Banks, Local Area Banks, Cooperative Banks, Financial Institutions including Development Financial Institutions (DFIs) and Non-Banking Financial Companies.

Role of RBI in the management of foreign exchange reserves

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

Post independence, India's exchange rate was fixed by the RBI against pound sterling, under the fixed or pegged exchange rate mechanism. Subsequently the exchange rate under the fixed exchange rate mechanism was changed to dollars and then to a basket of currencies.

LERMS

The first step at reforms in exchange rate management was taken in 1993, and then referred to as 'Liberalized Exchange Rate Management System' or LERMS. Under this the dollar was used as intervention currency, which implied that primary exchange rate, all official government statistics would be dominated in U.S. dollar in terms of global trends and convenience. Under LERMS there was a 'dual exchange rate', one officially decided by the RBI and the other through market forces. All foreign exchange transactions upto 40% was to be at the official rate and the remaining at the market rate. However, after 1999 the official rate was discontinued and exchange rate became market-determined exchange rate (MDER).

Under MDER the forces of demand and supply of dollars in India determine the exchange rate. The demand for dollars is downward sloping (lower demand when more rupees have to be offered and higher demand when lesser rupees have to be offered). Similarly the supply of dollars is upward sloping (less is sold when lesser rupees are offered and more is sold when more rupees are offered). Thus this interaction of demand and supply determines the exchange rate, at which the demand and supply of dollars balance out.

Any surge in the inflow of dollars leads to the rupee gaining value (appreciation). This renders imports cheaper and exports expensive. To prevent impact on exports under MDER, the RBI purchases dollars by creating an artificial demand for the excess dollars in circulation. Any act of purchase of dollars by the RBI impacts liquidity as rupees get released into the system creating inflationary pressures. In such circumstances the RBI simultaneously goes for the reverse repo auction to soak up the excess liquidity created on account of purchase of dollars by the RBI. The reverse repo auction is done under the Market Stabilization Scheme (MSS). Any act of interference by a Central Bank like the RBI in influencing the exchange rate is called as 'dirty floats'.

But in India it is referred to as 'managed floats'. In adverse circumstances of demand for dollars going up more than the supply of dollars, it results in rupee losing value (depreciation). Though it can positively impact exports and discourage imports, it is usually seen as an erosion of faith in the home currency and can escalate into a currency crisis. In such circumstances the government has to sell foreign currency to augment the supply of dollars.

However, the experience has been that more the currency is sold, more is the depreciation. Thus RBI instead of targeting any exchange rate, intervenes in the foreign exchange market only to manage the volatility and disruptions to the macro economic situation.

[1] The financial system in India includes Commercial Banks, Regional Rural Banks, Local Area Banks, Cooperative Banks, Financial Institutions including Development Financial Institutions

(DFIs) and Non-Banking Financial Companies.

[2] Prudential Norms refers to ideal / responsible norms maintained by the banks to keep their balance sheets strong. Some of them are related to income recognition, asset classification and provisioning, capital adequacy, investments portfolio and capital market exposures.

[3] OSMOS refers to Off Site Surveillance and Monitoring System. The RBI requires banks to submit detailed and structured information periodically under OSMOS.

General Knowledge Today

Banking & Finance-3: Basics in Banking Business

Target 2016: Integrated IAS General Studies
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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Time deposits and demand deposits, Current Account & Saving Account, NRO, NR(E)RA and FCNR accounts, Deposit Insurance, Concept of credit creation, Various Types of Loans, Non-performing Assets, Provision Coverage Ratio, Priority Sector Lending.

Functions of Banks

The core functions commercial banks can be segregated into three main segments viz. Financial Intermediation, Payment System and Financial Services. Apart from these, various other functions of banks are as follows:

- Banks work as trustees for certain requirements of the businesses, governments and public.
- They issue Letter of credit for the purpose of facilitating trade.
- They help in the disbursement of the pension to pensioners.
- Enable Government to Government (G2G), Government to Corporate (G2C) transactions.
- Banks liaison with local government departments and government treasury.

Financial Intermediation

The key business of the banks is to accept different types of deposits from the public and then lend these funds to the borrowers. This is called Financial intermediation. In terms of the banks, the deposits represent the "liabilities" of the banks while loans advanced and investments made by banks represent their "assets".

Acceptance of Deposits

Banks are called custodians of public money and mobilization of the deposits from the public is the most important function of the commercial banks. There are mainly two types of deposits viz. Time deposits (Term Deposits) and Demand Deposits. As custodians of public money, the banks provide security to the money and valuables of the general public. In India, the bank deposits are covered under the deposit insurance scheme provided by DICGC. For security of valuables banks provide locker facilities.

Loans and Advances

There are various types of loans or advances, which can be divided on the basis of different sets of criteria. More information about various types of lending operations in India, click here.

Payment System

Payment refers to the transfer of an item of value from one party to another in exchange for goods or services or both; or to fulfill a legal obligation. In any economy, the banks are core to the payment systems. Banks not only enable transfer of money but also its mobilization. The basic method of financial transactions is by negotiable instruments such as cheques and drafts. In modern times, the electronic banking, wire transfers, real time settlements, internet banking etc. are various modes of financial transactions. Banks also enable the internal remittances, foreign exchange transactions, telegraphic transfers of money.

Financial Services provided by Banks

Apart from the above, Banks impart various financial services such as investment banking, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc. Banks also provide agency services to their customers which includes:

- Collection and payment of cheques and bills on behalf of customers.
- Collection of dividends, interest, rent etc. on behalf of customers, if so instructed by them.
- Purchase and sale of shares and securities on behalf of customers.
- Payment of rent, interest, insurance premium, subscriptions, on behalf of customers, if so instructed.
- Acting as a trustee or executor.

Deposits and Accounts

Time deposits and demand deposits

Banks are called custodians of public money and mobilization of the deposits from the public is the most important function of the commercial banks. Mainly, there are two types of deposits viz. Time Deposits and Demand Deposits. When money is deposited for a fixed period, before which it cannot be withdrawn; such deposits are called "Time deposits" or "Term deposits". The most common example of Time deposits is "**Fixed Deposit**". On the other hand, if money deposited can be withdrawn by the customer (depositor / account holder) at any time without any advanced notice to banks; it is called demand deposit. Most common example of demand deposit is our Saving Banks Account, Current Bank Accounts etc. We can withdraw the funds in these accounts on demand.

Different types of time deposits

On the basis of their nature, time deposits may be of three types as follows:

- **Fixed deposits:** A fixed rate of interest is paid at fixed, regular intervals
- **Re-investment deposits:** Interest is compounded quarterly and paid on maturity, along with the principal amount of the deposit. In the Flexi Deposits amount in savings deposit accounts beyond a fixed limit is automatically converted into term-deposits.
- **Recurring deposits:** Fixed amount is deposited at regular intervals for a fixed term and the repayment of principal and accumulated interest is made at the end of the term. These deposits are usually targeted at persons who are salaried or receive other regular income. A Recurring Deposit can usually be opened for any period from 6 months to 120 months.

Key Features of Time Deposits

- All time deposits are eligible for interest payments. Interest rate depends upon the tenure and amount of deposit. This rate varies from bank to bank.
- The interest rate is generally higher for time deposits of longer tenure.

Key features of demand deposits

- The money as demand deposit is liquid and can be encashed at any time. The ownership of demand deposits can be transferred from one person to another via cheques or electronic transfers. There is no fixed term to maturity for Demand Deposits.

- The demand deposits may or may not pay interest to the depositor. For example, while we get an interest on savings accounts; no interest is paid on current accounts.

Different types of Demand deposits

The demand deposits are those from which one can withdraw the funds any time by issuing cheque, using ATM or withdrawal forms at the bank branches. Thus, demand deposits can be of two types viz. savings accounts and current accounts.

Main features of current account

- A current account is always a Demand Deposit and the bank is obliged to pay the money on demand.
- The Current accounts bear no interest and they account for the smallest fraction among the current, saving and term deposits.
- They provide the convenient operation facility to the individual / firm.
- The cost to maintain the accounts is high and banks ask the customers to keep a minimum balance.

Main features of savings account

- Saving account is also a demand deposit but they are subject to some restrictions on the number of withdrawals as well as on the amounts of withdrawals during any specified period.
- Further, minimum balances may be prescribed in order to offset the cost of maintaining and servicing such deposits.
- Savings deposits are deposits that accrue interest at a fixed rate set by the commercial banks.

Key differences between current accounts and savings accounts

The basic objective of a Savings Bank Account is to enable the customer save his / her liquid assets and also earn money on that saving. The Savings banks Accounts are preferred by individuals and provide liquidity for private and small businesses sometimes. On the other hand the current account is basically a transactional account which is preferred by business people. The basic objective of the current accounts is to provide flexible payment methods to the business people and entities. These payment methods include special arrangements such a overdraft facility, accommodation of standing orders, direct debits, offset mortgage facility. The Key differences are thus listed below:

Difference	Saving Account	Current Account
Basic Objective	Enable the customer to save liquid assets and also earn interest on that	Provide flexible payment method for individuals, businesses and entities.
Preference	Preferred by individuals savers	Preferred by businesses.

Difference	Saving Account	Current Account
Transaction scale	Usually low scale transactions	Usually high scale transactions
Interest	Earns interest	Earns no interest
Overdraft Facility	No overdraft facility	There is overdraft facility
Minimum Balance Requirement	May or May not need	Not need

CASA Deposits

CASA Deposits refers to Current Account Saving Account Deposits. As an aggregate the CASA deposits are low interest deposits for the Banks compared to other types of the deposits. So banks tend to increase the CASA deposits and for this they offer various services such as salary accounts to companies, and encouraging merchants to open current accounts, and use their cash-management facilities. The Bank is High CASA ratio (CASA deposits as % of total deposits) are in a more comfortable position than the Banks with low CASA ratios , which are more dependent on term deposits for their funding, and are vulnerable to interest rate shocks in the economy, plus lower spread they earn.

Deposits which have features of both time and demand deposits

Banks also provide a combination of demand and time deposits in the form of various products. Examples of such products include Recurring Deposits, Flexible RDs, Multiplier FDs, Special Term deposit accounts etc.

Account Operations

Opening of Deposit Account & KYC

The Banks have to follow the KYC (Know Your Customer) norms to open new bank accounts. Currently, the RBI has directed the banks to accept a single document, like a driving license, which contains the applicant's photograph and address to open an account.

The officially valid documents for KYC include

- passport
- driving license
- voter ID card
- PAN card
- Aadhaar letter issued by UIDAI and
- job card issued by MNREGA and signed by a state government official

Nomination

Nomination is a procedure wherein a depositor declares the name of the person to whom the money can be disbursed on account of former's death. The name of the nominee has to be declared while opening the account. The Banking Companies (Nomination) Rules, 1985 allows the banks to pay all dues to the nominee without any succession certificate or any claims of the legal heir. The features of nomination are:

- Nomination can be made in case of safe lockers, bank deposits, safe custody articles.
- One deposit account can only have one nominee irrespective of the account being held singly or jointly.
- In case of safe lockers, there can be 2 nominees for jointly held lockers.
- In case of a minor account, a person who is legally entitled to use his account can also file nomination on behalf of the minor.

Procedures followed to operate a deposit account

- Deposits are usually by filling a deposit or pay-in slip. The depositor or the account holder has to fill in all the particulars and undersign it. In case of transaction of above a certain denomination the depositor has to furnish the PAN (Permanent Account Number) too. Also, the deposits can be made by submitting a cheque and filling in the same deposit slip.

Withdrawals from deposit accounts

Deposits can be withdrawn from one's account in three ways:

- **Withdrawal Form:** The customer is supposed to fill various particulars in the deposit form. The latter is presented with the passbook. After a few checks like balance, signature match etc. the banker clears the form for cash to be collected at the counter.
- **Cheque:** These unlike withdrawal forms can be used to make payments to other parties. The payment can be taken from the same bank or any other bank by the other person.
- **ATM (Automated Teller Machine):** It can be used both for savings and current accounts. It can be operated by a magnetic card with a secret access PIN (Personal Identification Number) number. They work 24X7.

Passbook

A passbook is a vital document to all banking transactions.

- It carries a final and unquestionable record of all transactions between the banker and the customer.
- It is usually a true copy of the entries in the ledger of the bank.
- It also contains all the rules and regulations to operate a savings bank account.
- It is given at the time of opening the account and carries the name of the depositor, account number, customer ID, etc.
- Some banks only issue periodic bank statements to customers and not issue a proper

passbook.

- Banks issue duplicate passbooks in case of loss, mutilation or any kind of spoilage, the passbook is reissued at a nominal charge.

Closure of account of the customers

Banks have the right to close any bank account without any prior intimation if the account has not been operated for a stipulated amount of time. There can be many reasons under which bank can initiate such proceedings. They are:

- If many cheques are repeatedly issued and there are insufficient funds.
- Cheques are not honoured.
- Failing to remit funds which cover bills domiciled at the bank

Banks should however serve timely notice to the customers before initiating such proceedings.
The customers can however withdraw the balance to his credit and not give any prior notice.
In case of pre-mature closures of recurring or fixed accounts a small penalty is charged.

Procedure to Issue of a cheque book.

- Cheque-book is issued at the time of opening of the account. It is given to the depositor or any person so authorized by the former after proper acknowledgement.

- If the cheques are frequently returned or dishonored, the bank reserves the right to proceed with closure of the account.
- A person may sign for an option to not to use a cheque book at the time of opening the account.
- Person receiving the cheque book should verify the number of leaves and report any damage to the bank officer.
- It should be kept in secured possession and any loss or theft should be immediately reported to the bank.
- Banks like SBI give 40 cheque leaves free in a year. Any additional cheque leaves are issued at a service charge. This varied with banks.

Procedure for Issue of fixed deposit receipt

- A fixed deposit receipt represents the funds which a customer deposits in a bank for fixed or long-term deposits.
- The term of the deposit and the rate of interest are fixed in advance.
- A person having any type of dealing or account can open a fixed deposit account.
- In case of minors, the fixed deposit account can be opened under the guardianship of parents or other designated adults.
- If the fixed deposit receipt is lost or damaged, a duplicate slip can also be issued after an indemnity bond is furnished in a prescribed format accompanied by the bank guarantee.

Procedure for Closure of fixed and recurring deposits.

Banks have the right to close any bank account without any prior intimation if the account has not been operated for a stipulated amount of time. There can be many reasons under which bank can initiate such proceedings. They are:

- If many cheques are repeatedly issued and there are insufficient funds.
- Cheques are not honoured.
- Failing to remit funds which cover bills domiciled at the bank

Banks should however serve timely notice to the customers before initiating such proceedings.

The customers can however withdraw the balance to his credit and not give any prior notice.

In case of pre-mature closures of recurring or fixed accounts a small penalty is charged.

Different types of account holders

A bank account is a monetary account of a customer with a banking institution. It is a record of balance of money. A bank allows many different types of account holders. They are:

- **Individual:** It is an account held by an individual for use by his own needs. The banks usually differentiate their services like minimum balance requirements, ATM usage, fees etc. for different types of holders.

- **Joint account:** It is an account opened in name of two or more people. The account can be operated by either of the account holders. These can also be opened in names of associations, cooperative societies etc.
- **Illiterate account:** These accounts are opened on discretion of the banks if the person personally goes to the bank along with a witness already known to the bank and the depositor. No cheque books are issued for such accounts. Any withdrawal is done by a thumb impression of the depositor in presence of the bank officer who is able to verify the identity.
- **Minor account:** Savings account in name of a minor can be opened in a bank. It can be operated either by the natural guardian or a guardian appointed by the court. The minor can operate the account after an age of 21 years.
- **Married women account:** A married woman can have a bank account to which her husband has no access. Such accounts are generally provided by private banks and come with facilities like internet banking, ATM, debit cards, online bill payment.
- **Non-Resident Accounts:** NRIs can open accounts based on either repatriation facility or currency of account. These are- Non-Resident Ordinary account; Non-Resident External Rupee; Foreign Currency Non-Resident account and Resident Foreign Currency Account.

Difference between individual account and joint account.

Individual Account	Joint Account
Held by an individual for his own needs	Held by two or more individuals
It can be operated only by the individual	It can be operated by either of two or more individuals operating the account.
In case of death, the balance can be withdrawn by the nominee	In case of death of any of the account holders, the others can operate the account.
It is not required	A mandate of operation can be furnished in the account opening form.
It is not applicable in this case.	A cheque drawn by one of the account holders can be stopped by another, even if the latter is not authorised to operate the account. Such cheques can only be paid with the consent of all account holders.

Precautions the bankers should take while opening an account in the name of a married woman

A married woman can enter into a valid banking contract and can have her own bank account without giving any rights to her husband to operate it. In case of debt, only she will be responsible and her husband cannot be held liable unless under special circumstances.

- A banker should take specific precautions to open account for a pardanashin woman as her identity cannot be ascertained. The banker should get her signature attested by any responsible person.
- An overdraft facility is provided to her if she has sufficient property to her name and is prompt in her dealings.
- The banker should thus secure sufficient property which can be easily converted into liquid assets.
- As an agent of her husband banker should ensure she does not overdraw.
- Banker should include a "Free Will" clause in loans or overdraft agreements
- In case of joint accounts banks should be sure of who should operate the account and to whom the payment will be made in case of death of any one holder.

Peculiarities of non-resident accounts

A NRI account should have the following peculiarities different from basic bank accounts:

- Funds are held in Indian currency.
- One has to pay tax on interests earned.
- A person can have a resident of India as a joint account holder.

- It can be converted to a normal resident account if the NRI shifts back to India.
- Funds can be easily deposited or withdrawn from such an account
- In case of a NRE account, one can have an option of "No Questions Asked" policy to send funds to India.
- In case of FCNR account, funds can be held in foreign currency.

Procedures to open account in the name of a Joint Hindu family

A Joint Hindu Family stands for persons who have the same ancestry. A joint Hindu family is governed by the Mitakshara or Dayabhaga laws.

- Banker should be cautious that any debt on the family head is binding on the estate of the family if the loan was sought for purposes of family benefit.
- Banker has to be careful and should have awareness about the ownership and inheritance rights as they can pose serious challenges to the banks.
- The Banker generally takes declaration signed by all members of the family giving rights of operation and decision to the senior-most male member of the house.
- The head or Karta will govern all transactions done in the account.

The banker takes residential proof, ID and also PAN Card of the Karta when starting the account.

Accounts for Non-Residents

There are several kinds of accounts available for non resident Indians , Persons of Indian Origin and Overseas Citizens of India. These mainly include NRO, NR(E)RA and FCNR account.

NRO Account

NRO refers to Non Resident Ordinary Account. Such account can be opened by any person outside India. Normally, when a resident becomes a non resident, his domestic rupee account gets converted into the NRO account. This helps the NRI to get his credits which accrue in India, for example rent or interest from investments.

NR(E)RA Account

NR(E)RA refers to Non-Resident (External) Rupee Account. This account was introduced as NRE scheme in 1970. It's a Rupee account and the NRI can remit money to India from the funds abroad.

FCNR Account Scheme

Foreign Currency Non-Resident Account Bank or FCNR (B) was first introduced in 1993. While NRERA Account is a rupee account and the depositor is exposed to the Currency rates risk; FCNR is opened in foreign currency only. Currently, FCNR Account can be opened in six designated currencies viz. US Dollar (USD), Great Britain Pound (GBP), Euro (EUR), Japanese Yen (JPY), Canadian Dollar (CAD) and Australian Dollar (AUD).

- However, it's worth note that the FCNR account is opened ONLY in the form of Term Deposits and NOT in the form of Demand Deposits. The term is from 1 year to 5 years.

- The person who opens FCNR account is allowed to repatriate the principal and interest after maturity. Interest on such accounts is paid only on maturity.

Deposit Insurance

In India, the bank deposits are covered under the insurance scheme provided by Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly owned subsidiary of the Reserve Bank of India. DICGC is a statutory body, created by an act of parliament in 1961. The idea behind the Deposit Insurance is to boost the faith of the public in the banking system, and provide protection against the loss of deposits to a significant extent.

Banks which are covered under Deposit Insurance Scheme

All commercial & cooperative Banks (state, district and Urban cooperative banks) are insured by DICGC; however there are a few exceptions. The following are not covered under deposit insurance scheme:

1. Primary Agricultural Credit Societies (PACS)
2. Cooperative banks from Meghalaya
3. Cooperative Banks from Union Territories of Chandigarh, Lakshadweep and Dadra and Nagar Haveli.

This implies that:

1. All commercial banks including branches of foreign banks functioning in India, local area banks and regional rural banks **are insured** by the DICGC.
2. All State, Central and Primary cooperative banks, also called urban cooperative banks, functioning in States / Union Territories **are covered under** the Deposit Insurance System.
3. At present all co-operative banks **other than** those from Meghalaya, Chandigarh, Lakshadweep and Dadra and Nagar Haveli **are covered** under the deposit insurance system of DICGC.

Primary cooperative societies (PACS) , which are village level cooperatives and disburse short term credits in the country are **NOT insured** by the DICGC. So around 95000 PACS in the country are out of coverage of the DICGC.

Kinds of deposits that are insured under Deposit Insurance

The DICGC insures all deposit accounts including savings, fixed, current, recurring, except:

1. Deposits of the Foreign Governments
2. Deposits of the Central and State Governments.

How Deposit Insurance works?

When a bank covered by Deposit insurance scheme of DICGC fails, or undergoes liquidation or is merged with another bank; the DICGC pays the amount due to depositors via the officially appointed liquidator in a time bound manner. All claims are settled by DICGC within two months from the receipt of the claim from the liquidator.

Maximum amount insured under deposit insurance

The maximum amount per depositor insured is Rs. 1 Lakh including Principal and Interest. This means that

1. If a person has principal amount of Rs. 91000 and interest Rs. 7,000 then the amount insured by DICGC is Rs. 98,000.
2. However, if the same person has deposits Rs. 98000 and interest is Rs. 8000 then , the amount insured by the DICGC would be Rs. 1 Lakh.

The insurance cost is borne by the bank which is insured. The DGCIC charges 10 paise per Rs. 100 as insurance premium.

If a person has different accounts in different branches of the same bank, then the deposits in different branches are totaled and the maximum cover of □1-lakh is applied. In case of the joint accounts and other accounts one had, all deposit accounts one holds in his / her name in the same bank are clubbed together to apply the maximum cover. This implies that if someone has savings, fixed, current and recurring deposit accounts in different branches of the bank, he / she will get only Rs. 1 Lakh if the bank fails. However, if one maintains deposits in different capacities in different banks; the Rs. 1 Lakh limit is applied separately for each bank.

Bancassurance

Bancassurance or Bank Insurance Model refers to the distribution of the insurance and related financial products by the Banks whose main business is NOT insurance. So, simply Bancassurance, i.e., banc + assurance, refers to banks selling the insurance products. Bancassurance term first appeared in France in 1980, to define the sale of insurance products through banks' distribution channels.

Benefits of Bancassurance

Bancassurance helps both the banks and Insurance Companies as follows:

- This is a referral business in which the banks tend to leverage the existing clientele.
- Insurance companies get the benefit because they can have distribution relationships with multiple insurers.

Business Model in Bancassurance

For Bancassurance, the Banks need to obtain a prior license from the IrDA or Insurance Regulatory and Development Authority, so that they can work as "Composite Corporate Agent" or may have "Referral Arrangement" with the Insurance Companies.

Major problem of Bancassurance

Banks have to follow RBI as well as IrDA regulations for Bancassurance Business. The present regulations do not allow banks to sell insurance products of more than one insurance company.

Lending policy of the commercial banks

Lending is an indispensible function of banks. Commercial banks consider have to consider many factors while deciding lending policy. These are:

- **Liquidity:** A bank has to ensure sufficient liquidity under all conditions. Any bank indulging in lending finances generally makes its investments in non-liquid assets and manages funding of loans with short-term liabilities. A bank has to thus forecast its liquidity requirements and have emergency standby credit lines at other banks.
- **Profitability:** Profits in banking are derived from the difference on the interests paid on deposits and the interests it charges on loans (lending). This is also known as "spread" between the costs of funds and interest rates of loans.
- **Safety Issues:** The failure of many banks across the world has brought the issue of safe lending to the fore.
- **Diversification of risk:** It has great effect on the performance of the bank. The most important advantage of diversification is lower cost of capital.

Major safety issues banks need to consider in lending policy

Banks across the world have faced failures due to lack of lending precautions and adopting safety valves. Banks have to tread carefully and consider the following points for successful lending:

- **Leverage:** It is a dangerous option for any bank irrespective of the quality of credit analysis behind any loan. Banks should adhere to minimum leverage and check for capital adequacy requirements, risk measurement, restrict lending against real estate, shares etc.
- **Fully Collateralized loans:** Riskless loans are completely collateralized with actively traded assets. Collateral has to be valued at its liquidation value. It thus requires liquidity and transparency of assets accepted as collateral. The level of transparency thus warranted is supported by the Open electronic limit order book market.

Diversification of Risks

Diversification of risks have a tremendous effect on bank's performance. A well-diversified bank can effectively channelize its cash flow from less efficient operations to the ones where diversification is most beneficial. Banks can thus mainly diversify on two broad parameters:

- **Geographically:** Geographically diversified banks have high annual stock returns than geographically focused banks. Also , this leads to an access to more capital markets which can stem a lower cost of funds due to a large deposit base. Banks may also achieve economies of scale via this route.
- **Activity:** Some banks diversify in terms of activities they undertake and diversify to include

newer roles and peripherals.

Policy of risk-return trade-off

Risk-return trade-off means the amount of risk a bank can take while not getting uneasy with other investments. Risk as per the dictionary is the possibility of actual returns on investment being different than the expected returns. Risks are associated with low and high levels of uncertainty. A risk-return trade-off is successful if there is proper balance between the lowest possible risk and maximum possible return. Banks often resort to diversification to manage the trade-off between portfolio risk and return. They generally have diversified portfolios. Larger banks have multiple specialized business lines and small banks have a higher ratio of marketable securities.

Credit Creation

Concept of credit creation

Credit is created by commercial banks in two ways- advancing loans and by purchasing securities.

- Banks maintain some part of deposits as liquid cash termed as cash reserve. This is in minimum requirement as specified by RBI. The excess or surplus is given out as loans and advances.
- When giving a loan, banks open deposit account in the name of the borrower. This is known as secondary or derivative deposit.
- The deposit left after giving out loans is known as credit multiplier. Thus, credit is created from secondary deposits.
- Credit multiplier indicates the number of times primary deposits are multiplies and is the inverse of CRR.
- Thus, the entire process of credit creation rests on the following assumptions:
- Banking system is fully developed
- Transactions are through cheques
- Excess of CRR is kept as cash
- Credit policy stays the same.

Merits and demerits of credit creation

Merits:

- Banks are able to diversify risks with the help of credit creation.
- The loans and advances are generally done from excess or surplus reserves.
- This money which is lying passive joins the active process of credit creation

Demerits

Banks have to face a lot of limitations for successful credit creation.

- It is directly dependent on the volume of excess reserves available with the banks.

- CRR-the minimum cash limit of the bank which varies from 3-15%. Any increase in CRR leads to less credit.
- Risk-averse nature of customers which makes them keep some cash with them for emergencies while banks prefer giving more loans to keep credit creation going.
- Periods of economic recessions call for less loan demands from the customers.

Different types of credits

The need for credit comes from demand and supply side of the economy. The consumers of demand side require credit to acquire simple assets like consumer durables. The demand for credit from supply side corporate houses arises due to their needs for long-term investments. Types of loans:

Commercial loans: Loans which are given to supply side. These are given for 2 purposes:

1. For acquiring fixed assets
2. For maintaining the business

Individual loans: Loans which are given to demand side. These are given for 3 broad purposes:

1. Consumption
2. Acquiring durables

- Housing finance

Installment credit: Credit amount is decided in advance and the amount is disbursed either in stages or all at once. It is however, repaid in installments.

Operating credit: This is given to meet the daily credit requirements for operations. Banks decide the credit limit and provide a current account from which money can be withdrawn.

Receivable finance: Credit is in form of bills of finance.

Types of Loans

There are various types of loans or advances, which can be divided on the basis of different sets of criteria. They include non-fund based / fund based loans; secured / unsecured loans; term / demand loans; personal / commercial loans; working capital / project finance; priority sector loans; MSME credit; rural / agricultural loans, retail loans etc.

Non-fund based lending and fund based lending

The Fund based lending is direct form of loans on which actual cash is given to the borrower by the bank. Such loan is backed by primary and / or a collateral security.

In Non-fund based lending, bank does not make any funds outlay but only gives assurance. The "letter of credit" and "bank guarantees" fall into the category of non-funding loans. The non-funding loan can be converted to a fund-based advance if the client fails to fulfill the term of contract with the counterparty. In banking language, the non-funding advances are called Contingent Liability of the banks.

Secured loan and unsecured loan

In the secured loans, the borrower has to pledge some assets (such as property) as collateral. Most common secured loan is Mortgage loan in which people mortgage their property or asset to get loans. Other examples are Gold Loan, Car Loan, Housing loan etc. In unsecured loans, the borrowers assets are not pledged as collateral. Examples of such loans are personal loans, education loans, credit cards etc. They are given out on the basis of credit worthiness of the borrowers. We note here that the interest rates on unsecured loans is higher than the secured loans. This is mainly because the options for recourse for lender in case of unsecured loans are limited.

Term Loans and Demand Loans

The commercial banks provide loans of both short term (short term credit), Medium and long term. Short term loans are those loans whose tenure is less than one year. Medium term tenure is between 1 to 3 years and long term is above 3 years. However, In case of agriculture loans, there are three types of loans viz. Short term (tenure <15 months), medium term (tenure 15 months to 5 years) and long terms (tenure > 5 years). The demand loans are the loans which can be recalled by bank on demand at any time. The above info is presented in the below table:

Loan Term	Farm Loans	Other loans
Short term	Less than 1 year	Less than 15 months
Medium term	1 to 3 years	15 months to 5 years
Long Term	Above 3 years	More than 5 years

Personal loans and Commercial loans

If the debtor is an individual person (consumer) or a business; it is called personal loan or consumer loan. Common examples of personal loans are mortgage loans, car loans, credit cards, educational loan etc. The credit worthiness (or credit score) of the debtor is major criteria for banks to impart such loan facility. Commercial loans include commercial mortgages and corporate bonds. The credit rating of commercial organizations is one criterion for availing such loans.

Working Capital Finance and Project finance

If the loan amount is used for operating purposes of the business, and its utilization results in the creation of the current assets; it is called Working Capital finance. To provide such loans, the lending banks carry out detailed analysis of the borrowers' working capital requirements and then fix the credit limits. Normally, this loan is a secured loan and the working capital finance is primarily secured by the inventories and receivables of the business. The common examples of Working capital finance include Cash Credit Facility and Bill Discounting. On the other hand, project finance mainly refers to extending the medium-term and long-term rupee and foreign currency loans to the manufacturing and infrastructure sectors. Various tools of project finance include Share capital, Term loan, Debenture capital etc. Difference in Cash Credit and Overdraft

MSME Credit

Banks grant a substantial amount of loans to the micro, small and medium enterprises (SMEs) as a part of Priority sector. Banks usually follow the cluster based approach while sanctioning such loans. This sector plays very important role in the economy and given its importance, RBI has taken several measures to increase flow of institutional credit to this segment. The Small Industries Development Bank of India (SIDBI) also facilitates the flow of credit to MSME sector at reasonable rates.

Retail Loans

The banks offer an array of various retail loan products such as home loans, automobile loans, personal loans (such as loans for marriage, medical expenses etc.), credit cards, consumer loans (for TV sets, personal computers etc) and loans against time deposits and loans against shares. All of them come under the umbrella of retail loans. The target market for retails loans are the consumers in the middle and high income segment, salaried or self employed. Banks participate in the credit scoring programme to judge the credit worthiness of individuals. While granting such loans, banks use reports from agencies such as the Credit Information Bureau (India) Limited (CIBIL).

Factors that should be considered before granting loans to corporate houses

Banks have to weigh many factors before extending credit to large corporate houses. These are involved in legal activity with the sole purpose of making profit. Various factors which banks consider are as follows:

- Banks extend loans to corporate houses based on their balance sheets, length of their cash cycle and the products available with the banks.
- Banks also study audited balance sheets to study the needs and capacity to absorb credit.
- The borrowers are required to provide their financial details in the form of CMA data to the bankers and file a formal loan application.
- The banks offer many types of loans to the corporate clients depending on their needs. They are of two types: Short-term finance (for daily, seasonal and temporary working capital needs) and Long-term finance (to meet costs of acquisition of fixed assets).

General modes for securing advances

Advances are secured by attaching a tangible security against which the loan is granted. These securities are of two types:

- Primary security: The one against which the loan is given.
- Collateral security: It is given in addition to the existing primary security.

The securities maybe movable or fixed and thus the charges on them also varies accordingly. The charge on movable properties is levied in five different ways. They are:

- Pledge: It is a contract in which the possession of the goods goes to the lender for giving credit to the borrower.
- Hypothecation: It is another way of charging a security in which the possession of goods lies with the borrower. Hypothecation has to be registered under Section 125 of the Companies Act.
- Assignment: It is charge created on assets like receivables and debtors.
- Banker's lien: It is a general lien under Section 171 of Contract Act, 1872.
- Mortgage: It is known as transfer of interest especially in a fixed asset to secure debt.

Precautions to be taken while granting advances against security of goods

Secured advances involve the security of a tangible asset against which the lender gives loans. The borrower deposits goods as security for a loan. As in a pledge, banks who are the lenders take the possession of the goods to extend the credit to the borrower.

- Banks should maintain a reasonable difference between the value of goods and the amount of credit permitted and the latter should be less than the former.
- Banks should ensure that the goods are withdrawn with its prior approval.
- Banks have to also ensure that any additions and withdrawals from the pledged security happens with the bank's permission.

- In case of a mortgage, the banks should carefully spell out the conditions of the mortgage.

Procedure adopted by the bank for loan appraisal and disbursal

Banks have to analyze the loan profiles of the borrowers from many angles.

- Banks have to conduct an initial appraisal to approve the loan. It takes care of the technological, financial, managerial and market analysis of the borrower.
- Banks then have to take a call on the way of financing which will best suit the client.
- A bank is required to know the details of the cash requirements of the borrower and the type of advance will suit his requirement.
- Final decisions comprises the way the funds will be dispensed i.e. whether in a lump-sum amount or in instalments.

Loan administration and loan pricing

Loan administration and pricing is highly essential for effective lending.

- Loan officers should know their roles and powers. High sanctioning powers of loan officers generally leads to the increase in risk of the banks.
- Bank's loan policy should clearly define the sanctioning powers of the loan officers regarding the credit limit.
- Loan pricing in turn should effectively utilise the surplus funds with the banks which both covers the costs of the bank and also leaves a margin for the bank.

- Banks should have three main objectives in loan pricing:

1. Maintain margins
2. Balance risk and rewards

- Ensure market rates

NPAs

The assets of the banks which don't perform (that is – don't bring any return) are called Non Performing Assets or bad loans. Bank's assets are the loans and advances given to customers. If customers don't pay either interest or part of principal or both, the loan turns into bad loan.

How NPA is defined?

According to RBI, terms loans on which interest or installment of principal remain overdue for a period of more than 90 days from the end of a particular quarter is called a Non-performing Asset. However, in terms of Agriculture / Farm Loans; the NPA is defined as under:

- For short duration crop agriculture loans such as paddy, Jowar, Bajra etc. if the loan (installment / interest) is not paid for 2 crop seasons , it would be termed as a NPA.
- For Long Duration Crops, the above would be 1 Crop season from the due date.

Standard Asset

If the borrower regularly pays his dues regularly and on time; bank will call such loan as its "Standard Asset". As per the norms, banks have to make a general provision of 0.40% for all loans and advances except that given towards agriculture and small and medium enterprise (SME) sector.

However, if things go wrong and loans turn into bad loans, the PCR (Provision Coverage Ratio[1]) would increase depending up the classification of the NPA.

Special Mention Account

Banks are required to classify nonperforming assets further into three main categories (Sub-standard, doubtful and loss) based on the period for which the asset has remained non performing. This is as per transition of a loan from standard loan to loss asset as follows:

- If the borrower does not pay dues for 90 days after end of a quarter; the loan becomes an NPA and it is termed as "**Special Mention Account**".

Sub-standard Account

- If a loan remains Special Mention Account for a period less than or equal to 12 months; it is termed as **Sub-standard Asset**. In this case, bank has to make provisioning as follows:
    - 15% of outstanding amount in case of Secured loans
    - 25% of outstanding amount in case of Unsecured loans

Doubtful Asset

- If sub-standard asset remains so for a period of 12 more months; it would be termed as "Doubtful asset". This remains so till end of 3rd year. In this case, the bank need to make provisioning as follows:

- Up to one year: 25% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans
- 1-3 years: 40% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans
- more than 3 years: 100% of outstanding amount in case of Secured loans; 100% of outstanding amount in case of Unsecured loans

Loss Asset

- If the loan is not repaid even after it remains sub-standard asset for more than 3 years, it may be identified as unrecoverable by internal / external audit and it would be called loss asset. An NPA can declared loss only if it has been identified to be so by internal or external auditors.

Impact of Implications of the NPAs on Banks

The most important implication of the NPA is that a bank can neither credit the income nor debit to loss, unless either recovered or identified as loss. If a borrower has multiple accounts, all accounts would be considered NPA if one account becomes NPA.

Difference between Gross NPA and Net NPA

The NPA may be Gross NPA or Net NPA. In simple words, Gross NPA is the amount which is outstanding in the books, regardless of any interest recorded and debited. However, Net NPA is Gross NPA less interest debited to borrowal account and not recovered or recognized as income. RBI has prescribed a formula for deciding the Gross NPA and Net NPA.

How SARFAESI Act helps to recover NPAs?

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues. When a borrower makes any default in repayment and his account is classified as NPA; the secured creditor has to issue notice to the borrower giving him 60 days to pay his dues. If the dues are not paid, the bank can take possession of the assets and can also give it on lease or sell it; as per provisions of the SAFAESI Act.

Asset Reconstruction Companies

If a bad loan remains NPA for at least two years, the bank can also resale the same to the **Asset Reconstruction Companies** such as Asset Reconstruction Company (India) (ARCIL). These sales are only on Cash Basis and the purchasing bank/ company would have to keep the accounts for at least 15 months before it sells to other bank. They purchase such loans on low amounts and try to recover as much as possible from the defaulters. Their revenue is difference between the purchased amount and recovered amount.

Wilful default

Willful default means that a party does not make loan repayment out of its will. There are four conditions when it is assumed that the default is a willful default:

- When a borrower defaults despite his capacity to repay
- When a borrower defaults but diverts finance away from the purpose it was availed for.
- The funds are available in the other form of assets but party does not make payment.
- Party disposed off the removable assets / immovable property which was used for thr purpose of secured loan, without knowledge of the bank.

The SS Kohli Committee had recommended some penal measures against the willful defaults. Some of them are as follows:

- The willful defaulters are not able to access the markets, so a copy of the list of the willful defaulters are shared by the RBI to SEBI.
- No facility is provided by a Bank / FI to a willful defaulter till 5 years from the date of publishing its name in the list of willful defaulters.
- Expeditious legal action is initiated against for the recovery of the amount.

The banks and FIs are required to compile the list of the suit filed willful defaulters and submit the same to the Credit Information Bureau of India Ltd. every quarter, provided the outstanding amount is Rs. 25 Lakh or more.

NPA and Provision Coverage Ratio

For every loan given out, the banks to keep aside some extra funds to cover up losses if something goes wrong with those loans. This is called provisioning. **Provisioning Coverage Ratio** (PCR) refers to the funds to be set aside by the banks as fraction to the loans.

- PCR is the ratio of provision to gross non-performing assets (NPAs).
- A key relationship in analyzing asset quality of the bank.
- A measure that indicates the extent to which the bank has provided against the troubled part of its loan portfolio.
- A high ratio suggests that additional provisions to be made by the bank in the coming years would be relatively low (if gross NPAs do not rise at a faster clip).
- Thus, PCR refers to the percentage of the loan amount that the bank has set aside as provisions to meet an eventuality where the loan might have to be written off it becomes irrecoverable.
- It is a measure that indicates the extent to which the bank has provided (set aside money to bear the loss) against the troubled part of its loan portfolio.
- PCR = Cumulative provisions / Gross NPAs

Thus, more the NPAs lesser will be the PCR. Kindly note that till 2011, the RBI had mandated the banks to keep a 70% PCR. This implied that more they had NPAs, more they needed to keep aside additional funds to cover up the losses. The requirement was withdrawn by RBI on the ground that such requirement would wipe out their quarterly profits.

Priority Sector Lending

Priority sector was first properly defined in 1972, after the **National Credit Council** emphasized that there should be a larger involvement of the commercial banks in the priority sector. The sector was then defined by Dr. K S Krishnaswamy Committee. The priority sectors include those sectors which may not get adequate institutional credit due to social, cultural and economic reasons.
Common priority sectors include Agriculture Finance, Small Enterprises, Retail Trade, Micro Credit, Education Loans and housing loans.

Sectors that come under Priority Sectors

As per Reserve Bank of India, Priority sector includes the following:

- Agriculture and Allied Activities viz. dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture.
- Small scale industries (including setting up of industrial estates)
- Small road and water transport operators (owning up to 10 vehicles).
- Small business (Original cost of equipment used for business not to exceed 20 lakh)
- Retail trade (advances to private retail traders up to 10 lakh)
- Professional and self-employed persons (borrowing limit not exceeding 10 lakh of which not more than Rs.2 lakh for working capital; in the case of qualified medical practitioners setting up practice in rural areas, the limits are Rs.15 lakh and Rs.3 lakh respectively and purchase of one motor vehicle within these limits can be included under priority sector)
- State sponsored organizations for Scheduled Castes/Scheduled Tribes
- Education (educational loans granted to individuals by banks)
- Housing [both direct and indirect – loans up to 5 Lakhs (direct loans up to Rs 10 lakh in urban/ metropolitan areas), Loans up to Rs.1 lakh and Rs.2 lakh for repairing of houses in rural/ semi-urban and urban areas respectively].
- Consumption loans (under the consumption credit scheme for weaker sections)
- Micro-credit provided by banks either directly or through any intermediary; Loans to self help groups(SHGs) / Non Governmental Organizations (NGOs) for on lending to SHGs
- Loans to thesoftware industry (having credit limit not exceeding Rs 1 crore from the banking system)
- Loans to specified industries in the food and agro-processing sector having investment in

plant and machinery up to Rs 5 crore.

- Investment by banks inventure capital (venture capital funds/ companies registered with SEBI)

Priority Sector Targets

In 1974, the banks were given a target of **33.33 %** as share of the priority sector in the total bank credit. On the basis of Dr. K S Krishnaswamy committee, the target was raised to 40%. The current Priority sector targets are as follows:

Priority Sector Targets		
Categories	Domestic commercial banks / Foreign banks with 20 and above branches	Foreign banks with less than 20 branches
Total Priority Sector	40	32
Total agriculture	18	No specific target
Weaker Sections	10	No specific target

Why RBI imposes the Priority Sector Targets?

The overall objective of priority sector lending program is to ensure that adequate institutional credit flows into some of the vulnerable sectors of the economy, which may not be attractive for the banks from the point of view of profitability.

Priority Sector lending in India has been made a salient feature of the banking in India mainly due to the social and economic objectives that underlie PSL. However, banks are also required to keep certain amount to maintain Statutory Liquidity Ratio (SLR) and from the remaining disposable amount, 40 per cent is dedicated for the priority sector. Thus, large fraction of banks' resources cause the so called "Double Repression" on the banking system. The economic survey has brought this issue to the forefront and has recommended the government to re-structure SLR and Priority Sector Lending.

[1] For every loan given out, the banks to keep aside some extra funds to cover up losses if something goes wrong with those loans. This is called provisioning.

General Knowledge Today

Banking & Finance-4: Cards, Negotiable Instruments, Basel-III

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Debit Cards vs. Credit Cards, Kisan Credit Card, Micro Credit, Negotiable instruments, Promissory Note, Bill of Exchange, Cheques, CTS2010, Demand Draft, Basel, Capital Adequacy, Tier-1 and Tier-II capital.

Part-I : Debit Cards, Credit Cards

Debit Cards / Credit Cards

Debit Card

A **debit card** is a plastic card that provides a cardholder electronic access to his / her bank account. It can be used to withdraw funds or to make purchases using money in the bank account. Since a debit card is essentially linked to a checking account (saving / current), it is also known as a Checking Card. A balance in the checking account is must for the use of debit card.

Credit card allows its holder to buy goods and services based on the holder's promise to pay for these goods and services.

Credit Card

A credit card is a payment card which allows the cardholder to pay for goods and services on the basis of **line of credit** granted to him / her by the issuing bank. A credit card essentially creates a revolving account from which cardholder can borrow money for payment to merchant (and also withdraw cash). A credit card is not linked to a bank account but is linked to the bank / financial institution which has issued it.

First Credit Card of the world

The use of Credit Card first started in 1920s in United States of America for selling the fuel to the automobile owners. Later, it reached the customers when when Diners Club was launched in early 1950s. In 1958, the Bank of America issued the BankAmericard in the California state and this is known to be the first successful modern credit card.

Differences between Debit Card and Credit Card

- A debit card is like an electronic cheque book, which is linked to the account of cardholder. Balance in the account is essential to use debit card. Credit cards give a line of credit to the cardholders and they don't need a linked bank account. Credit Card payment is like a loan which needs to be paid back within a fixed period (such as 30 days).
- There is no monthly bills to be paid on debit cards. In case of Credit cards, monthly bills need to be paid by the customer. Late payments are charged a high interest.
- Obtaining the debit card is quite easy. Now a days, most banks provide Debit cards to checking account holders. After the RBI guidelines in 2005; obtaining a Credit Card has become difficult and it depends on many factors including credit score of the applicant.
- The Credit worthiness of the account holder plays no role in case of Debit Cards. The limit of usage is dependent on the balance in linked account. However, in case of credit cards, the limit of usage or credit line may increase or decrease depending on cardholder's creditworthiness. This limit is set by the card issuer.

- Debit Card payments invite no interest charges; Credit card loans have one of the highest interest rates.

Major players in the Credit Card transactions

There are several players in the working of credit card / debit cards.

- The **cardholder**is the authorized user of a credit or debit card.
- **Merchant**or **Point of sale** is any business entity that is authorized to accept cards for the payment of goods and services; it can be a brick and mortar shop or a website.
- **Merchant Bank or Acquirer** is a financial institution that provides card processing services to the merchant.
- **Card Issuer** is a financial institution that issues payment cards and contracts with its cardholders for billing and payment of transactions.
- Further, there is a Credit Card Network orAssociation, which is a membership organization of financial institutions that issue payment cards and/or sign merchants to accept such cards for payment of goods and services. There are two Credit Card Associations – Visa's and MasterCard.

How Credit Card transaction works?

The process can be divided into two parts viz. authorization and Clearing & Settlement.

Authorization

A credit card holder finalizes the goods to be bought and presents his card to the merchant. Merchant processes the card and while processing it seeks authorization from the Merchant Bank giving it information on transaction information. Merchant Bank submits the authorization request to Credit Card Network (MasterCard or VISA). Credit Card Network sends the request to the Card Issuer which is ICICI bank. Card Issuer either approves or declines the transaction. If it authorizes, the Credit Card Network forwards this authorization to merchant bank. Merchant bank forwards this response to the Merchant and Merchant once receiving this authorization completes the transaction.

Clearing and Settlement

The merchant deposits the transaction receipt with the merchant bank, which credits the Merchant's account and submits this transaction to Credit Card Network for settlement. Credit card Network pays the Merchant Bank and debits the account of Card Issuer. The Card Issuer posts the transaction to the account of Card holder. The cardholder received monthly statement from the Issuer. The Cardholder pays as per the conditions.

Size of the Credit Card

ISO/IEC 7810 is the international standard which defines the shape and size of the I-Cards. In most countries, it defines ATM cards, credit cards, debit cards etc. as ID-1 which corresponds to

85.60×53.98 mm.

Swipe Card

Swipe card or magstripe or Magnetic stripe card has a band of magnetic material on the card and is capable of storing data. It was first developed by IBM for a US Government security system. IBM engineer Forrest Parry is known to have discovered Swipe Card, thanks to his wife (search Google). The data on the strips can be read by the most point-of-sale hardware.

Credit Card Number

The Credit Card numbers are governed by the **ISO/IEC 7812** which is a numbering system for the identification of issuers of cards that require an issuer identification number (IIN) to operate in international, inter-industry and/or intra-industry interchange. The Length of the number is from 14 to 19. The first 6 digits are known as the Issuer Identification Number (IIN). Out of them, the first 2 or more digits identify the Card network. For example- The card number that begins with 34, 35, 36 or 37 is an American Express Card; another which begins with 51,52,53,54 or 55 is a MasterCard and the number which becomes with 4 is a Visa card.

National Payments Corporation of India's (NPCI)

National Payments Corporation of India's (NPCI) was established in 2008 and is being promoted by

State Bank of India, Punjab National Bank, Canara Bank, Bank of Baroda, Union Bank of India, Bank of India, ICICI Bank, HDFC Bank, Citibank and HSBC. NPCI is an umbrella organization for all retail payment systems in the country owned and operated by banks. Its National Financial Switch (NFS) is linked to 61702 ATMs (September 2010). The relevant data is released by NPCI.

Cumulative monthly transaction volumes recorded by the National Payments Corporation of India's (NPCI) crossed the 10-crore mark for the first time in August 2010. The Switch recorded 7.32 crore ATM transactions in July 2010.

Floor Limit and Card Limit

Floor limit is the discretion to the merchant establishment up to which it can accept the card for payment. The Card limit is the limit up to which a holder can use the card. This is restored on making the previous payments.

Hot Card v/s Hot List

A hot card is a lost or stolen card. A hot list is the list of caution against the use of a credit card by a defaulter holder.

Common Credit Card Grievances

Some of the most common issues with the Credit Cards pertain to the late statements, harassment by the issuer, incorrect bills and cards issued without intimating the customer. The delayed payments attract an interest penalty of 2.95% of the billed amount but if the customer received the bill late, he/she is not able to make a timely payment. In many cases, the banks executives call the customer on the pretext of increased the credit limit and try to sell other products. Sometimes, the time made payment also is charged a penalty, due to errors and omissions causing the complaints of the incorrect billing. Further, prior to the stringent action of RBI, the customers were issued credit cards without even asking for it.

RBI guidelines on Credit Card Business

To regulate credit/ATM/debit card businesses RBI constituted a 'Working Group on Regulatory Mechanism for Cards' and on the recommendation of this group, notified guidelines for card issuers laying down their duties and obligations. The salient features of the RBI guidelines, which came into effect on November 30, 2005, are as follows:

- All credit card issuers should provide Most Important Terms and Conditions (MITCs) to customers/prospective customers. MITCs should include information like joining fee, annual membership fee, cash advance fee, service charges for certain transactions, interest free grace period (illustrated with examples), finance charges for revolving credit and cash advances, overdue interest charges and charges in case of default.
- MITCs should be in Arial-12 points and not in fonts that are difficult to read with the naked eye.

- Card issuers should quote annualised percentage rate on card products (separately for retail purchase and cash advance).
- Card issuers should not provide unsolicited cards, loans and any other credit facilities or unilaterally increase credit limits. Card issuing banks/non-banking financial companies (NBFCs) should maintain Do Not Call Registries containing phone numbers of customers and non-customers who have informed them that they do not wish to receive unsolicited calls/SMSes for marketing of credit card products.
- Card issuing banks/NBFCs would be responsible as the principal for all acts of omission or commission of their agents (direct sales agents/direct marketing agents and recovery agents).
- Card issuers should follow RBI's Fair Practice Code for Lenders and Indian Banks Association's Code for Collection of Dues and Repossession of Security.

Further, the RBI guidelines provide that a customer, who fails to get a satisfactory response from a card issuer within 30 days of lodging of complaint may approach the concerned Banking Ombudsman for redressal of grievances before the expiry of one-year period from the date of receipt of reply from the bank or 13 months from the date of representation to the bank. Currently, there are 15 Banking Ombudsmen located in different state capitals who try to resolve complaints of customers through a process of conciliation or mediation.

Kisan Credit Card

Kisan Credit Card scheme was introduced by NDA Government in August 1998 with the aim to provide adequate and timely short-term credit needs of farmers during the cropping season. It was first proposed in the Budget 1998-99 by then Finance Minister Yashwant Sinha.

NABARD had prepared a Model Kisan Credit Card Scheme in consultation with the Major Banks on the basis of R V Gupta Committee.

Objective & Rationale Behind Kisan Credit Card Scheme

Due to lack of awareness among farmers and unnecessary delays, cumbersome procedure and improper practices adopted by institutional lending agencies; a large number of Farmers heavily depend on non-institutional sources of credit for their frequent needs to purchase farm inputs such as seeds, fertilizers, pesticides etc. The non-institutional credit is not only expensive but also counter-productive. The Kisan Credit Card scheme was launched to provide adequate, timely and cost effective institutional credit from the banking system to the farmers for their cultivation needs. Farmers can not only purchase inputs but also can withdraw cash from this credit card for their input needs.

How Kisan Credit Card Scheme works?

Kisan Credit Cards are issued to the farmers on the basis of their land holdings and other criteria such as timely payment of past credits etc. Farmers covered under the Kisan Credit Card scheme are issued with a credit card and a pass book or a credit card cum pass book incorporating the name, address, particulars of land holding, borrowing limit, validity period, a passport size photograph of holder etc., which may serve both as an identity card and facilitate recording of transactions on an ongoing basis.

Loans provided under Kisan Credit Card Scheme

The Kisan Credit Card scheme is implemented by public sector commercial banks, RRBs and cooperative banks. It was launched to provides short term loans in the form of production credit. However, later its scope was extended to term loans for agriculture and allied activities and reasonable component for consumption loan. Thus, currently this scheme provides:

- Production credit
- Working capital requirements for allied activities
- Ancillary credit requirements related to crop production
- Contingent needs and
- Accidental insurance of KCC borrowers.

Crop loans disbursed under KCC scheme for notified crops are covered under National Crop Insurance scheme. The purpose of the scheme is to protect the interest of farmers against crop loss caused by natural calamities, pest attacks etc.

Benefits of Kisan Credit Card Scheme?

- Simplifies disbursement procedures
- Removes rigidity regarding cash and kind
- No need to apply for a loan for every crop
- Assured availability of credit at any time enabling reduced interest burden for the farmer.
- Helps buy seeds, fertilizers at farmer's convenience and choice
- Helps buy on cash-avail discount from dealers
- Credit facility for 3 years – no need for seasonal appraisal
- Maximum credit limit based on agriculture income
- Any number of withdrawals subject to credit limit
- Repayment only after harvest
- Rate of interest as applicable to agriculture advance
- Security, margin and documentation norms as applicable to agricultural advance
- Access to adequate and timely credit to farmers
- Full year's credit requirement of the borrower taken care of.

- Minimum paper work and simplification of documentation for drawal of funds from the bank.
- Flexibility to draw cash and buy inputs.
- Assured availability of credit at any time enabling reduced interest burden for the farmer.
- Flexibility of drawals from a branch other than the issuing branch at the discretion of the bank.

Key Features of Kisan Credit Card Scheme?

- Farmers eligible for production credit of Rs. 5000 or more are eligible for issue of Kisan Credit Card.
- Eligible farmers to be provided with a Kisan Credit Card and a pass book or card-cum-pass book.
- Revolving cash credit facility involving any number of drawls and repayments within the limit.
- Limit to be fixed on the basis of operational land holding, cropping pattern and scale of finance.
- Entire production credit needs for full year plus ancillary activities related to crop production to be considered while fixing limit.
- Sub-limits may be fixed at the discretion of banks.

- Card valid for 3 years subject to annual review. As incentive for good performance, credit limits could be enhanced to take care of increase in costs, change in cropping pattern, etc.
- Each drawals to be repaid within a maximum period of 12 months.
- Conversion/re-scheduling of loans also permissible in case of damage to crops due to natural calamities.
- Security, margin, rate of interest, etc. as per RBI norms.
- Operations may be through issuing branch (and also PACS in the case of Cooperative Banks) through other designated branches at the discretion of bank.
- Withdrawals through slips/cheques accompanied by card and passbook.

Benefits to Banks under KCC scheme

- Reduction in work load for branch staff by avoidance of repeat appraisal and processing of loan papers under Kisan Credit Card Scheme.
- Minimum paper work and simplification of documentation for drawal of funds from the bank.
- Improvement in recycling of funds and better recovery of loans.
- Reduction in transaction cost to the banks.
- Better Banker – Client relationships.

Insurance facility under KCC scheme

Kisan Credit Card holders are covered by a personal accident insurance. This cover is available when the person enters the scheme. The cover is as follows:

- Death : Rs. 50,000
- Disability: Rs. 25000
- Maximum Age to enter : 70 years

Loan disbursement

Under KCC scheme, the loan amount is disbursed in cash through drawings made via withdrawal slips accompanied by KCC-cum-passbook. Cheque books are also issued to literate KCC holders enjoying KCC limit of Rs. 25000 and above.

Interest and other charges on Kisan Credit Cards

The interest rates on Kisan Credit Cards varies from bank to bank and also on borrowing limits. Generally, 9% per annum interest rate is charged for KCC borrowing limit up to Rs. 3 Lakh. However, central government provides interest subvention to the financing institutions. If the track record of the card holder is good; a further 2% interest subsidy is provided. After three years sound track record, a card holder can also get the credit limit enhanced.

Apart from that there are some overhead costs for borrowing under KCC. These include processing fee, charges on land mortgage deed, passport photo charges, insurance premium etc.

Micro Credit

Microcredit refers to the small credit (Below Rs. 50,000) given to poor by banks via SHGs (Self Help Groups) or JLGs (Joint Liability Groups) mechanism or by a NBFC (Non Banking Financial Company) or MFI Microfinance Institution. Reserve bank of India encourages the commercial banks to expand the coverage of micro finance in India.

The target market of the Micro Credit Institutions includes those individuals who lack collateral, steady employment and a verifiable credit history and therefore cannot meet even the most minimal qualifications to gain access to institutional credit. These include artisans, tiny and small industries, grocers, vegetable vendors, rickshaw pullers, roadside retailers and persons engaged in activities such as small farming, poultry, cattle rearing, piggery, fishery etc.

Microcredit is a part of microfinance. The term Microfinance is used for the provision of a wider range of financial services to the very poor. The United Nations declared 2005 the International Year of Microcredit.

Origin of the concept

The innovative idea of Microcredit originated in 1970s with the Grameen Bank in Bangladesh. The Grameen Bank is a microfinance organization of Bangladesh. Its founder Professor Muhammad Yunus launched a research project in 1976 to examine the possibility of designing a credit delivery system to provide banking services targeted to the rural poor. This bank successfully enabled extremely impoverished people to engage in self-employment projects that allow them to generate an income and, in many cases, begin to build wealth and exit poverty. Due to its achievements, the bank and its founder were jointly awarded Novel Prize in 2006.

Self Help Group

A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs belonging to homogenous social and economic background. They come together voluntarily to save small amounts regularly and contribute to a common fund to meet their emergency needs on mutual help basis. They are able to ensure proper end use of the credit and timely repayment on the basis of collective wisdom and peer pressure.

SHG provides strength to an economically poor individual as part of a group. Financing through SHGs reduces transaction costs for both lenders and borrowers.

Lenders have to handle only a single SHG account instead of a large number of small-sized individual accounts, borrowers as part of a SHG cut down expenses on travel (to & from the branch and other places) for completing paper work and on the loss of workdays in canvassing for loans.

History of micro credit in India

Prior to the nationalization of banks in 1969, most of the small loan was given out by cooperative banks only. Commercial banks were not easily accessible to small borrowers. Those were the days of security-oriented approach and nobody could think of a loan, big or small, without a guarantor or mortgage of immovable property.

Nationalization changed the picture and the nationalized banks opened branches in the remotest corners of the country. They were to implement various government schemes such as Twenty Point Program, Antodaya, subsidized differentiated rate of interest loan etc.

SHG-Bank Linkage Programme

In 1991-92, NABARD had launched a pilot project to provide micro-credit. In this project, it was envisaged to provide micro-credit by linking SHGs with banks. This is called SHG-Bank linkage Programme. RBI had then advised commercial banks to actively participate in this linkage programme. The scheme was later extended to RRBs and co-operative banks.

Objective of this programme was to make it possible facilitating smoother and more meaningful banking for poor. This programme envisaged several models of linkages. For example:

- SHGs were directly linked to Banks without any NGO facilitation.
- SHGs were linked to banks with facilitation by NGOs and other formal agencies.
- NGO working as a facilitator and financing agency for the SHGs.

NGO's undertake social intermediation like organizing SHGs of micro entrepreneurs. They entrust them to banks for credit linkage or financial intermediation like borrowing bulk funds from banks for on-lending to SHGs.

Who provides Microcredit?

- Domestic Commercial Banks: Public Sector Banks; Private Sector Banks & Local Area Banks
- Regional Rural Banks
- Co-operative Banks
- Co-operative Societies
- Registered NBFCs
- Unregistered NBFCs
- Other providers like Societies, Trusts, etc.

Are there any targets fixed by RBI?

No. For microcredit, there are no fixed targets and banks are free to formulate their own models. Banks are also free to design their products for promotion of microfinance. However, banks have been asked by the RBI to devise and integrate the microcredit plans in their block level, district level and state level credit plans

Banks are free to choose intermediaries, suitable branches, pockets, areas for implementation of microcredit programme. They are also free to devise appropriate lending and saving products. However banks have been instructed to include micro credit, in their branch, block and district &

state credit plans. This has to be reviewed on quarterly basis.

Major problems with Micro-Credit

Despite of all these measures the performance of micro finance in India has neither been quite satisfactory quantitatively nor qualitatively. The money disbursed has not been adequate, nor has it yielded the desired results. Instead of being recycled, the major portions of loans have been lost as bad debt.

Micro Finance Development Fund

A Rs. 100 Crore Micro Finance Development Fund was created within NABARD in 2001 to impart training and exposure to SHGs, NGOs, Banks etc. for micro-finance.

Part-II: Negotiable Instruments

Introduction to NI Act

Negotiability means transfer of an instrument from a person / entity to another person / entity. The transfer should be without restriction and in good faith. As per section 13 of the Negotiable Instruments Act, 1881, a negotiable instrument means a promissory note , bill of exchange or a cheque , payable either to order or to bearer. Kindly note that a Currency Note is **not** a negotiable instrument as per section 21 of the Indian Currency Act .

Negotiable instruments covered under NI Act

Negotiable Instruments Act 1881 had been passed in 1882 and was modified in 1989 and 2002, as some more sections were added into the age old law. This act is applicable in entire India , including Jammu & Kashmir. J & K was brought in the ambit of the act in 1956. The act has provisions of Negotiable Instruments such as Promissory Notes, Checks, Drafts , Bills of exchanges etc. There are 147 different sections in this act. Initially it did not have provisions regarding the Demand Draft, which were later inserted by amendment. Key sections of this act are as follows:

- Section 4 deals with promissory notes
- Section 5 deals with Bill of Exchange
- Section 6 deals with Cheque
- Section 9 deals with holder and holder in Due course.
- Section 15 deals with Endorsements
- Various other sections such as 123-131 deal with crossing of cheques.

Holder versus Holder in Due Course

Holder is the person who is entitled in his own name to the possession of a negotiable instrument. Normally a payee or endorsee is a holder.

- **Please note that holder may be or may not be with possession of the Instrument**.
- If the payee or endorsee dies, then the legal heir is the holder .

- If there is a forged endorsement then , last endorsee is the holder.
- If it is a bearer cheque, the person in whose name it is made is a holder.
- If it is damaged the payee or last endorsee is the holder.
- If it is stolen, then also payee or last endorsee is holder because a thief cannot become holder.
- The holder has the right to obtain a duplicate of instrument is lost.
- A holder can cross a cheque if it is not already crossed.

Holder in Due Course:

Holder in due course means a person who **must have the possession of the instrument**. This is the basic difference between the Holder and Holder in Due course.

- Holder in Due course must obtain the instrument in Good Faith.
- If the instrument bears not-negotiable crossing , then the NO person can be a holder in due course.
- If the instrument bears A/C payee crossing and restricted endorsement then NO person can be a holder in due course.
- Forgery / theft / deceit do not convey any title.

Promissory Note

PN means a paper with a writing which has a promise. But it does not mean that we write "I owe You" and it becomes a PN. When a person issues a promissory note, he/ she would have to stamp it as per the Indian Stamp Act and normally a revenue stamp is affixed on the PN signed by the promissory. Thus:

- PN is always in writing.
- PN has an unconditional undertaking called promise
- The promise is to pay money
- The money has to be paid to the certain person.

As per section 4 of the Negotiable Instruments Act, 1881, an instrument in writing containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of instrument is called Promissory note.

Different types of Promissory Notes

There are two types of the promissory notes viz. Demand Promissory Note or Usance Promissory Note. Demand Promissory Note has to be paid immediately on demand and Usance Promissory Note has to be paid after certain time period.

Parties are there to a Promissory note

There are two parties in the PN. The maker is who promises to pay and the payee is who is promised to pay.

Is Currency Note a promissory note?

Although currency Notes bear the following:

I promise to pay the bearer a sum of ________Rupee/ Rupees.

However , Currency notes are money and they don't fulfill the conditions of the Promissory note. The currency is excluded from NI act and governed by Indian Currency Act. So Currency notes are Not promissory Notes.

Bill of Exchange

BEO is a written negotiable Instrument which contains an unconditional order which is signed by the Maker; directs a certain person to pay; certain sum of Money only to, certain person or the bearer. Thus, while Promissory note has two parties, Bill of Exchange has three parties viz. **Drawer, Drawee** and **Payee.** Here drawer is the person who orders to pay; drawee is the person who is directed to pay; and payee is the person who is authorized to obtain a payment.

Under the NI Act, a minor (person of age less than 18 years) can be a Drawer but not a Drawee because he can not incur liability. Once the Drawee accepts the BOE, he becomes acceptor.

What is an Inland Bill of exchange? How it is different from Foreign Bill of Exchange?

A bill that is **drawn in India** and **paid in India or out of India** to a person, who is **in India,** whether **Indian or Foreigner, is** Inland Bill. Simply, a bill drawn in India and paid in India is a Inland Bill. A bill which is NOT drawn in India but is payable in India to a person, who is **in India and is Indian or a foreigner** is a Foreign Bill.

What is a Hundi?

Hundi is the Desi version of a bill of Exchange. They are used conventionally, not stamped and a vernacular language is written on them. They are still in use and are governed by local practices only.

- **Darshani Hundi** is akin to a Demand Promissory Note
- **Miadi Hundi** is akin to a Usance Promissory Note
- **Khoka** is also a Hundi which refers to a bill of exchange that has been paid and canceled.

BOE , as per the NI act are charged at the rate of 18% per annum interest.

Cheque

A cheque is a bill of exchange in which one party (Drawee) is a Bank. So a Drawer (account Holder) draws the Cheque on the (Drawee bank) in the name of a Payee.

What if different amounts in words and figures are written on a cheque?

The Drawer has to write the amount in both in figures and words. If different values are written in Figures and words, the value of words can be paid as per section 18 NI act. If the amount is written in words only and NOT in figure than NO payment will be made because it would be Inchoate (incomplete).

Bearer cheque

Bearer cheque is payable to the bearer. Sometimes "Self" is written, that is also a bearer cheque payable to the account holder.

Antedated Cheque and a post dated cheque

If a check does not bear a date, it will be returned. The holder / bearer can fill a date , if there is no date written. If the date filled is a holiday, it can be paid only after that Holiday. If a person opens an account on November 10, 2010 and gives a check to somebody with date say October 25, 2010, **then it is Valid** and will be paid. This is called "Ante dated Cheque". A post dated check can bear any date of future and the payment can be stopped.

Validity of a cheque

Normal validity is 3 months but can be restricted by the account holder. The check older than 3 months is called Stale Cheque and is NOT paid and will be returned. After the state Cheque is returned , it can be revalidated for any number of times and each time it becomes valid for next 3 months.

Crossing of Cheque

Crossing provides an additional security. Crossing means that sum of that cheque can only recovered from a specified banker and it will be credited to the holders account. The crossed cheques are not paid at the counter. Crossing is applicable in case of cheques only and not in case of Bill of Exchange or promissory notes.

- Crossing may be General crossing or Special crossing. General crossing (NI Act Section 123) is where a cheque bears two parallel lines with words such as a/c payee etc.
- In Special crossing (NI Act Section 124) the cheque bears the name of the banker also. Section 126 directs that such cheques shall be paid to the banker to whom it is crossed specially or to his agent for collection.

Endorsement

The section 15 of the Negotiable Instruments Act 1881 defines endorsing as "signing on the face or an instrument for the purpose of negotiating a negotiable instrument (such as Cheque)."

Endorsing is signing in the instrument either on face or on back, for the purpose of negotiation of a NI. The person who signs is called endorser. The person in whose favor the instrument has been transferred is called Endorsee.

- The holder of the instrument endorses the instrument.
- If he signs only and does not mention anything else it is called Blank Endorsement.
- If he endorses and adds a direction to pay the amount to a specified person it is called Endorsement in full.
- If he signs and adds direction for restriction on further negotiability, then it is called

Restrictive Endorsement.

- Partial endorsement is NOT valid. This means that if Suresh issues you a check of Rs. 10000 and endorses on the backside of the check that "Pay Ramesh Rs. 5000" it is NOT a Valid endorsement. Again if Suresh issues you a check of Rs. 10000 and endorses with a direction that " Pay Ramesh when he passes his examination", this is again NOT a valid endorsement. Both these conditions are called partial endorsements.
- A minor is NOT a valid endorser.

Difference between a Crossed cheque and A/C Payee cheque

A person who signs the cheque and transfers the instrument is an endorser and in whose favor it is transferred is endorsee. The endorsee acquires a right to negotiate the instrument to anyone he / she likes. By making an endorsement the endorser promises that in case of dishonor, he / she provides a guarantee to compensate the holder.

Crossing a cheque by making two parallel lines with or without such words as ___& company is general crossing. Section 126 of the NI Act says that this is a direction to the bank to not to pay the cheque across the counter.

This crossed cheque is no more a bearer cheque where anyone can negotiate and get payment across the counter.

In case of a crossed cheque, the payee is free to make further endorsements.

For example , Ayesha receives a check from Rohan which has been crossed, Ayesha can get this payment in her account only and not across the counter. But in this case Ayesha is free to endorse the cheque in favor of Suresh and further Suresh is free to endorse the instrument in favor of Mukesh and so on…This means that crossing a cheque does not put restrictions on endorsements. In case the cheque gets dishonored, Mukesh can sue Suresh and Suresh can sue Ayesha and Ayesha can sue Rohan.

Now let's discuss A/C Payee cheques. The NI act does not talk about the A/C payee crossing. There is no definition of A/C payee crossing in the NI act and it is a child of banking practice. Making a cheque A/C Payee is a result of custom, use and practice and is now accepted legally.

But, the A/C payee cheque cannot be further endorsed. This means that if the cheque in the above example which is in favor of Ayesha bears "A/C Payee", payment can be collected in Ayesha's account only. The paying bank makes sure that amount is being credited to the account of the payee only

Cheque Truncation

The NI act was amended in 2002 and after that Cheque also means a Cheque in electronic form. The clearing of checks on the basis of electronic checks is called Cheque Truncation. The Electronic image is generated and it is used for clearing, thus at that point the Physical Movement of the

Cheque is stopped.

So simply, Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/ images or both without physical exchange of instrument.

This results in faster clearance, (T+0) in local and T+1 in intercity clearing. Faster realization is accompanied by a reduction in costs for the customers and the banks. Banks can also offer innovative products and services based on CTS and there is an additional advantage of reduced reconciliation and clearing fraud.

In cheque truncation, at some point in the flow of the cheque, the physical cheque is replaced with an electronic image of the cheque and that image moves further. The processing is done on the basis of this truncated cheque and physical cheque is stored. MICR data is very useful in check truncation. The electronic cheques are issued in electronic form with digital signatures / biometric signatures / encrypted data. The negotiable Instruments (Amendment) Act of 2002 gives constitutional validity to the electronic cheques.

CTS-2010

From January 1, 2013, cheques which do not conform to CTS-2010 standards are not entertained by banks. CTS-2010 is a set of benchmarks towards achieving standardization of cheques issued by banks all over India. These include provision of mandatory minimum security features on cheque forms such as quality of paper, watermark, bank's logo in invisible ink, void pantograph and standardization of field placements on cheques.

This standard has been adopted due to growing use of multi-city and payable-at-par cheques for handling of cheques at any branches of a bank.

Benefits of adopting CTS-2010

- The security features in cheque forms will assist the presenting banks to identify the genuineness of the drawee banks' instruments while handling them in the image-based scenario.
- The homogeneity in security features will act as deterrent against frauds.
- The fixed field placement specifications will facilitate straight-through-processing at drawee banks' end through the use of optical/image character recognition technology.

The benefits from CTS are as follows:

- Shorter clearing cycle
- Superior verification and reconciliation process
- No geographical restrictions as to jurisdiction
- Operational efficiency for banks and customers alike
- Reduction in operational risk and risks associated with paper clearing

The images of the cheques are taken using the scanners. To ascertain the uniqueness of a physical cheque and cheque image; there is a rigorous quality check process at the level of the Capture Systems and the Clearing House Interface (of the presenting bank). The CTS-2010 prescribes certain mandatory and optional security features to be available on cheques, which will also add to the uniqueness of the images.

Security of images in Cheque Truncation

The image and data transmitted over the network is secured via a comprehensive Public Key Infrastructure (PKI).

Demand Draft

Demand draft is discussed in section 85(A) of the NI Act. A Demand draft is an order to pay money drawn at one office of a Bank upon another office of the **same bank** for a sum of money payable to order on demand.

- A Demand Draft is payable on demand
- A Demand Draft can NOT be paid t a bearer
- A DD is negotiable and its features are similar to Bill of Exchange and NOT a Check.
- If a Bank fails to honor the Draft, the Bank is liable and not the person.
- If there are wrong signatures on the Bank Draft, the Bank is liable.
- If there is a prior arrangement , the DD can be payable by different bank also.

When a Bank draft is purchased , the relations between the purchaser and bank are that of a debtor and creditor , and as soon as this bank reaches the Payee, the Payee becomes beneficiary and the Bank becomes trustee.

Please note that once, the payee gets a DD, the payment CANNOT be stopped unless there is an order by a competent court. So, when a draft reaches a payee, the relationship between the purchaser and Bank comes to an end.

- A demand draft can be prepared with cash payment if the value is less than 50,000.
- For a value of 50,000 or more, only paid through bank account.

Draft is valid for 3 months. On expiry of this date, the draft can be revalidated by the Bank.

Difference between a Cheque and Draft

Cheque has been defined in Negotiable Instruments Act 1881 section 6. A cheque is a bill of exchange drawn on a specified bank and not expressed to be payable otherwise than on demand.

A demand draft has been defined by Negotiable Instruments Act 1881 in section 85. A demand draft is an order to pay money drawn by one office of a bank upon another office of the same bank bank for a sum of money payable to order on demand.

Following are some more differences:

- A cheque can be made payable to bearer but a Demand Draft cannot.
- A demand draft can be cleared in a specified branch of the issuer bank
- A cheque can get dishonored but Demand draft is always honored.
- An issuer party of the cheque is liable to the cheque and not backed by a Bank Guarantee, A demand draft is backed by a bank guarantee.

Part-III: International Banking Regulation

The role of banks in global and national economies is very important. The banking industry holds reliance of the entire economy and it is important for the authorities to maintain control over the practices of banks. The most common objectives of banking regulations are

- Prudential Objectives: to reduce the level of risk to bank creditors i.e. to protect the depositors.
- Systemic risk reduction—to reduce the risk of failure of banks
- Avoid misuse of banks—to reduce the risk of banks being used for criminal purposes such as money laundering
- To protect banking confidentiality
- Credit allocation—to direct credit to favored sectors

General Principles of Banking Regulation

The general principles that deal with the banking regulation include Minimum requirements, supervisory review and market discipline. They have been discussed below:

Minimum requirements

Certain minimum requirements are imposed on banks, which are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirements include the Capital Requirements and Reserve Requirements.

- **Capital Requirements:**The capital requirement sets a framework on how banks must handle their capital in relation to their assets. The first international level capital requirements were introduced by the Basel Capital Accords in 1988. The current framework of capital requirements is called Basel III.
- **Reserve Requirements:** The reserve requirement sets the minimum reserves each bank must hold to demand deposits and banknotes. Reserve requirements have also been used in the past to control the stock of banknotes and/or bank deposits. Required reserves have at times been gold coin, central bank banknotes or deposits, and foreign currency.

Supervisory review

This includes licensing by the regulator, obtaining undertakings, giving directions, imposing penalties or revoking the bank's license.

Market discipline

The central bank requires the banks to publicly disclose financial and other information, and depositors and other creditors. The bank is thus made subject to market discipline.

Basel Committee on Banking Supervision

The secretariat of Bureau of International Settlement (BIS); which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations; are located in Basel, a city in Switzerland. The Basel Committee on Banking Supervision (BCBS) is a committee of banking supervisory authorities established in 1974 by the governors of the central banks of G-10. This committee provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It has 27 members including India and major economies of the world.

Box: The 27 countries are Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. Out of them 12 are permanent members.

Basel-I

The Basel Committee on Banking Supervision (BCBS) had introduced a capital measurement system in 1988. It was called Basel capital accord or Basel-I. The focus of Basel-I was entirely on credit risk. It gave a structure of risk weighted assets (RWA). RWA implies that the assets with different risk profiles are given different risk weights. For example, personal loans would carry higher loans in comparison to loans that are backed by assets. The Basel-I fixed minimum capital requirement at 8% of risk weighted assets (RWA). India adopted Basel 1 guidelines in 1999.

Basel-II

The Basel-II guidelines were published by BCBS in 2004. These guidelines refined the Basel-I norms on the base of three parameters as follows:

- Banks should maintain a minimum capital adequacy requirement of 8% of risk assets
- Banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks
- Mandatory disclosure of risk exposure.

Basel II norms in India and overseas are yet to be fully implemented.

Basel-III

The Basel-III guidelines were issued in 2010 as a response to global financial crisis of 2008. The idea was to further strengthen the banking system. It was felt that the quality and quantity under Basel-II were insufficient to contain any further risk; so the Basel-III norms aim at making banking activities more capital-intensive. The objective of these guidelines is to achieve a resilient banking system by focusing on four key banking parameters viz. capital, leverage, funding and liquidity. The ultimate aim is to:

- Improve the banking sector'sability to absorb shocks arising from financial and economic stress.
- Improve risk management and governance
- Strengthen banks' transparency and disclosures.

Capital Adequacy

In Banking Industry, Capital refers to the stock of Financial Assets which is capable of generating income. The Capital Adequacy Ratio is a thermometer of Bank's health, because it is the ratio of its capital to its risk. So simply, Capital Adequacy Ratio = Capital ÷ Risk.

Thus, Capital Adequacy can indicate the capacity of the Bank's ability to absorb the possible losses. The Regulators check CAR to monitor the health of the Bank, because a good CAR protects the depositors and maintains the faith and confidence in the banking system.

Capital to Risk (Weighted) Assets Ratio (CRAR)

CRAR is a standard metric to measure balance sheet strength of banks. BASEL I and BASEL II are

global capital adequacy rules that prescribe a minimum amount of capital a bank has to hold given the size of its risk weighted assets. The old rules mandate banks to back every Rs. 100 of commercial loans with Rs. 9 of capital irrespective of the nature of these loans. The new rules suggest the amount of capital needed depends on the credit rating of the customer.

Banks compute the CRAR as follows:

Total capital ratio (CRAR) = Eligible Total Capital / RWA for (Credit risk + Market risk + Operational risk)

Tier-1 and Tier-2 Capital

The Basel accords define two tiers of the Capital in the banks to provide a point of view to the regulators. The Tier-I Capital is the core capital while the Tier-II capital can be said to be subordinate capitals.

Tier 1 mainly includes permanent shareholders' equity (which includes issued and fully paid ordinary shares / common stock and perpetual non-cumulative preference shares) and disclosed reserves (or profits created or increased by appropriations of retained earnings or other surplus, e.g.: share premiums, retained profit, general reserves and legal reserves). On the other hand, Tier-II includes undisclosed reserves and other subordinate capital. The following table differentiates between Tier-1 and Tier-2 capital.

Tier-I Capital	Tier-II Capital
Paid up Capital	Undisclosed reserves and cumulative perpetual preference shares.
Statutory Reserves	Revaluation Reserves
Other disclosed free reserves	General Provisions and loss reserves
Capital Reserves which represent surplus arising out of the sale proceeds of the assets.	Hybrid debt capital instruments such as bonds.
Investment Fluctuation Reserves	Long term unsecured loans
Innovative Perpetual Debt Instruments (IPDIs)	Debt Capital Instruments.
Perpetual Noncumulative Preference Shares.	Redeemable cumulative Preference shares
Minus:	Perpetual cumulative preference shares.
Equity Investment in subsidiaries.	
Intangible assets.	
Losses (Current period + past carried forward)	

Apart from the above, the banks may also at the discretion of their central bank employ a third tier of capital which consists of short-term subordinated debt for the sole purpose of meeting a proportion of the capital requirements for market risks. This is called Tier-III capital.

Three pillars of Basel-III

Basel III has three mutually reinforcing pillars as follows:

- Pillar 1 : **Minimum Regulatory Capital Requirements** based on Risk Weighted Assets (RWAs) : Maintaining capital calculated through credit, market and operational risk areas.
- Pillar 2 : **Supervisory Review Process** : Regulating tools and frameworks for dealing with peripheral risks that banks face.
- Pillar 3: **Market Discipline** : Increasing the disclosures that banks must provide to increase the transparency of banks

Common Equity

Currently, the bank's capital comprises Tier 1 and Tier 2 capital. The restriction is that Tier 2 capital cannot be more than 100% of Tier 1 capital. Under Basel III, with an objective of improving the quality of capital, the Tier 1 capital will predominantly consist of Common Equity. Common Equity is the amount that all common shareholders have invested in a company. Most importantly, this includes the value of the common shares themselves. It also includes retained earnings and additional paid-in capital. *Thus, most important part of the common equity comprises the Paid up Capital + retained earnings.*

- Although the minimum total capital requirement will remain at the current 8% level, Under Basel-III, the capital adequacy requirement was raised to 10.50%.
- Basel III norms prescribe minimum common equity of 4.5 per cent.

Elements of Common Equity

The seven elements of Common Equity include the following:

- Common shares (paid-up equity capital) issued by the bank which meet the criteria for classification as common shares for regulatory purposes;
- Stock surplus (share premium) resulting from the issue of common shares; .
- Statutory reserves;
- Capital reserves representing surplus arising out of sale proceeds of assets;
- Other disclosed free reserves, if any;
- Balance in Profit & Loss Account at the end of the previous financial year;
- Current year profits can be reckoned on quarterly basis provided incremental NPA provision at end of any of 4 quarters of previous financial year have not deviated more than 25% from average of the 4 quarters.

Deductions: Regulatory adjustments / deductions to be made from total of 1 to 7.

The Capital Conservation Buffer

The banks will require to hold a capital conservation buffer of 2.5%. The aim of asking to build conservation buffer is to ensure that banks maintain a cushion of capital that can be used to absorb losses during periods of financial and economic stress.

Countercyclical Buffer

The countercyclical buffer has been introduced with the objective to increase capital requirements in good times and decrease the same in bad times. The buffer will slow banking activity when it overheats and will encourage lending when times are tough i.e. in bad times. The buffer will range from 0% to 2.5%, consisting of common equity or other fully loss-absorbing capital.

Leverage Ratio

Basel III rules include a leverage ratio to serve as a safety net. A leverage ratio is the relative amount of capital to total assets (not risk-weighted). This aims to put a cap on swelling of leverage in the banking sector on a global basis. A 3% leverage ratio of Tier 1 will be tested before a mandatory leverage ratio is introduced in January 2018.

Liquidity Ratios:

Under Basel III, a framework for liquidity risk management has to be created. A new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are to be introduced in 2015 and 2018, respectively.

Key differences between Base-II and Basel-III

The following table summarizes the key differences between Basel-II and Basel-III requirements.

A comparison of Basel II and Basel III Requirements		
Requirements	Basel II	Basel III
Minimum Ratio of Total Capital To RWAs	8%	10.50%
Minimum Ratio of Common Equity to RWAs	2%	4.50% to 7.00%
Tier I capital to RWAs	4%	6.00%
Core Tier I capital to RWAs	2%	5.00%
Capital Conservation Buffers to RWAs	None	2.50%
Leverage Ratio	None	3.00%
Countercyclical Buffer	None	0% to 2.50%
Minimum Liquidity Coverage Ratio	None	TBD (2015)
Minimum Net Stable Funding Ratio	None	TBD (2018)

Risk weighted assets

The Risk Weighted Assets (RWA) refer to the fund based assets such as Cash, Loans, Investments and other assets but their value is assigned a risk weight (for example 100% for corporate loans and 50% for mortgage loans) and the credit equivalent amount of all off- balance sheet activities. Each credit equivalent amount is also assigned a risk weight.

Degree of risk expressed % weights assigned by the Reserve Bank of India

The degree of risk expressed % weights assigned by the Reserve Bank of India. The following table shows the Risk weights for some important assets assigned by RBI in an increasing order.

Asset	Weighted Risk
Cash	0%
Balance with Reserve Bank of India	0%
Central/ state Government Guaranteed advances	0%
SSI advances up to CGF guarantee	0%
Loans against FD (Fixed Deposits), LIC Policy	0%
Government approved Securities	2.50%
Balance with Banks other than RBI which maintain the 9% CRAR	20%
Secured Loan to the Staff Members	20%
Housing Loans	50%
Housing Loans >Rs. 30 Lakhs	75%
Loans against Gold and Jewelry	50%
Retail Lending up to Rs. 5 crore	75%
Loans Guaranteed by DGCGC / ECGC	50%
Loans to Public Sector Undertakings	100%
Foreign Exchange and Gold in Open Position	100%
Claims on unrated corporates	100%
Commercial Real estate	100%
Consumer Credit	125%
Credit Cards	125%
Exposure to Capital Markets	125%
Venture Capital Investment as a part of Capital Market exposure	150%

In the above table we can have a broad idea that the assets which are in the form of Cash, Government Guaranteed securities, against the LIC policies etc. are safest assets with 0% Risk weighted assigned to them. On the other hand, the venture Capital Investment as a part of Capital Market exposure has the maximum risk weight assigned to them.

How does this work?

Let's take this example, For a AAA client, the risk weight is 20%, which means banks have to set aside its own capital of Rs. 1.80 for every Rs 100 loan (this means 20% of 9% of Rs. 100). Similarly, in case of 100% risk weight (such as capital markets exposures) , banks have to keep aside its own capital of Rs 9 on the loan.

Calculation of the Ratio

Under Basel-III, banks are to compute ratio as follows:

- CommonEquity Tier-I Capital Ratio = Common Equity Tier-I Capital / RWA for (Credit risk + Market risk + Operational risk)

- Tier-I capital ratio = Tier-I Capital / RWA for (Credit risk + Market risk + Operational risk)
- Total capital ratio (CRAR) = Eligible Total Capital / RWA for (Credit risk + Market risk + Operational risk)

General Knowledge Today

Banking & Finance-5: Money Markets, Futures, Derivatives

Target 2016: Integrated IAS General Studies

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Call Money, Notice Money and Term Money, Treasury Bills, Certificate Of Deposits, Commercial Paper, Functions of Money Markets, M0, M1, M2, M3, M4, Narrow Money / Broad Money, Derivatives, Mutual Funds, Real Return of Rate, Real Assets and Financial Assets, Short Term and Long Term Investment Options.

Part-I : Money Markets

There are two kinds of markets where borrowing and lending of money takes place between fund scarce and fund surplus individuals and groups. The markets which cater to the need of short term funds are called Money Markets while the markets that cater to the need of long term funds are called Capital Markets.

Thus, money markets is that segment of financial markets where borrowing and lending of the short-term funds takes place. The maturity of the money market instruments is one day to one year. In our country, Money Markets are regulated by both RBI and SEBI. Money markets are also sometimes called discount markets.

How Money markets are different from capital markets?

While money markets are markets for short term fund needs; capital markets are markets for long term funds, debts, equity, shares etc.

Segments of money markets in India

Money Market in India is divided into unorganized sector and organized sector. The Unorganized market is old Indigenous market which includes indigenous bankers, money lenders etc. Organized market includes Governments (Central and State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial / Cooperative Banks, Public Sector Undertakings (PSUs), Insurance Companies and Financial Institutions and Non-Banking Financial Companies (NBFCs). Organized Money Market is regulated by RBI as well as SEBI.

Various instruments of Money Markets

The organized money market in India is not a single market but is a conglomeration of markets of various instruments, which are called Sub-markets of Money Market. These include Call Money / Notice Money / Term Money Market, Treasury Bills, Commercial Bills, Certificates of Deposits, Commercial Bills, Commercial Papers, Money Market Mutual Funds and Repo / Reverse Repo. The most active segment of the money market is "Overnight Call market" or repo.

Call Money, Notice Money and Term Money Markets

Call Money, Notice Money and Term Money markets are sub-markets of the Indian Money Market. These refer to the markets for very short term funds. Call Money refers to the borrowing or lending of funds for 1 day. Notice Money refers to the borrowing and lending of funds for 2-14 days. Term money refers to borrowing and lending of funds for a period of more than 14 days.

Why the call / notice money market is called Inter-Bank Market?

In India, 80% demand comes from the public sector banks and rest 20% comes from foreign and private sector banks. Then, around 80% of short term funds are supplied by Financial Institutions such as IDBI and Insurance giants such as LIC. Rest 20% of the short term funds come from the banks. In this way, major players in call / notice money markets are banks and financial institutions, which are both lenders and borrowers. Due to this, the call / notice money market is also called Inter-Bank Market.

Interest rates in call / notice money markets

Call Money / Notice Money market is most liquid money market and is indicator of the day to day interest rates. If the call money rates fall, this means there is a rise in the liquidity and vice versa. Interest Rates in Call / Notice Money Markets are market determined i.e. by the demand and supply of short term funds. The intervention of RBI is prominent in the short term funds money market in India and it can influence the rates prominently.

MIBOR

MIBOR refers to Mumbai Interbank Offer Rate. It is the standard reference of interest rates in call / notice money markets in India. It is the average of the call money rates offered by a set of specific banks on a given day. MIBOR is calculated by the NSE (National Stock Exchange) after taking quotes from a specific set of Banks. MIBOR serves as a benchmark to which various entities in the market benchmark their short term interest rates.

Where do you find the call / notice money market in India?

The short term fund market in India is located only in big commercial centres such as Mumbai, Delhi, Chennai and Kolkata.

Bill market

Bill is a generic term which can mean a bank note, an invoice, a bill of exchange, bill of lading (in export-import business), waybill (in shipments) etc. In case of money market; bills are short term money market instruments. The bill market is a sub-market of the money market in India. There are two types of bills viz. Treasury Bills and commercial bills. While Treasury Bills or T-Bills are issued by the Central Government; Commercial Bills are issued by companies/ financial institutions.

Treasury Bills

Treasury means government treasury. The Treasury Bills or T-Bills are short term money market instruments which are released by Central Government of India to meet its need short term funds. They were introduced in 1917 for the first time.

Kindly note, State Governments don't issue Treasury Bills. The maturity of Treasury Bills in India is less than 365 days. At present, the active T-Bills are 91-days T-Bills, 182-day T-Bills and 364-days T-Bills. In 1997, the Government had also introduced the 14-day intermediate treasury bills. Auctions of T-Bills are conducted by RBI.

How the lenders earn interest on T-Bills?

Central Government issues the T-Bills on a discount to face value, however, the lender / investor gets the face value on maturity. The return on T-Bills is the difference between the issue price and face value. This return o depends upon auctions. When the liquidity position in the economy is tight, returns are higher and vice versa. Interest on the treasury bills is determined by market forces.

Who can purchase T-Bills?

Individuals, Firms, Trusts, Institutions and banks can purchase T-Bills. The commercial and cooperative banks can use T-Bills for fulfilling their SLR requirements, because they are government securities. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000.

What are advantages of T-Bills to Government and Investors?

Objective of issuing T-Bills is to fulfill the short term money borrowing needs of the government. For investors, T-bills have an advantage over the other instruments such as:

- Zero Risk weightage associated with them, because they are issued by government.
- High liquidity because 91 days and 364 days are short term maturity.
- Transparency
- Thesecondary market of T-Bills is very active so they have a higher degree of tradability.

Commercial Bills

Commercial bills market is basically a market of instruments similar to Bill of Exchange. The participants of commercial bill market in India are banks and financial institutions but this market is not yet developed.

Certificate Of Deposits (CDs)

Certificate of Deposit (CD) is yet another money market instrument, which is negotiable and equivalent to a promissory note. It is either issued in demat form or in the form of a usance promissory note. This instruments is issue in lieu of the funds deposited at a bank for a specified time period.

Who can Issue a Certificate of Deposit?

A Certificate of Deposit in India can be issue by:

- All scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs)
- Select All India Financial Institutions permitted by RBI

A commercial bank can issue Certificate of Deposit as per its own requirements. A financial institution can issue Certificate of Deposit within a limit prescribed by RBI. A thumb rule for FI is that CD together with other instruments, viz. term money, term deposits, commercial papers and inter-corporate deposits should not exceed 100 per cent of its net-owned funds, as per the latest audited balance sheet.

Certificate of Deposit can be issued to individuals, corporations, companies, trusts, funds, associations etc. The No resident Indians are also eligible for CDs provided they don't repatriate the funds.

What is Minimum amount for Certificate of Deposit?

- Minimum amount for Certificate of Deposit in India has been fixed at Rs. 1 Lakh, to be accepted from a single subscriber
- Larger amounts have to be in the multiples of Rs. 1 Lakh.

What is maturity tenure of Certificates of Deposits?

Certificates of Deposit are money market instruments and their maturity period is between seven days to one year for commercial banks. For Financial Institutions, the maturity is not less than a year and not more than three years.

What is Return on Certificates of Deposits?

The CDs are issued at a discount on face value. Return on them is difference between the issue value and face value.

How CDs can be transferred from one person to other?

If CD has been issued in physical form (as usance promissory notes), they can be freely transferred by endorsement and delivery. If they have been released in Demat form, they can be transferred as per the procedure applicable to other demat securities.

What is the lock in period for certificates of deposits

There is no lock-in period for certificates of deposit

What are conditions before banks when they issue Certificates of Deposit?

Banks/FIs cannot grant loans against CDs. They cannot buy back their own CDs before maturity. Banks need to maintain cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

Commercial Paper (CP)

Commercial Paper (CP) is yet another money market instrument, which was first introduced in 1990 to enable the highly rated corporates to diversify their resources for short term fund requirements. They are issued either in the form of a promissory note or in a dematerialized form through any of the depositories approved by and registered with SEBI. They are essentially unsecured debt instruments.

Who is eligible to issue commercial papers?

Corporate, Primary Dealers and All India Financial Institutions are eligible to issue CP. To be eligible to issue Commercial Paper, the Corporate need to have a tangible net worth of minimum Rs. 4 Crore. Further,

- the company must have been sanctioned working capital limit by banks or all-India financial institutions

- The borrower account of the company should be high rated i.e. it should be classified as Standard Asset by the Financial Institutions.

Also, the Corporate, Primary Dealers as well as Financial Institutions must obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time, for the purpose.

What are Denominations and Maturity of Commercial Paper?

Maturity of Commercial Paper is minimum of 7 days and a maximum of up to one year from the date of issue. CP can be issued in denominations of Rs.5 lakh or multiples thereof.

Who can Invest in CP?

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

and Exchange Board of India (SEBI) from time-to-time.

What is return on CP?

CP is issued at a discount to face value as may be determined by the issuer. The difference between issue price and face value is return. Further, CPs are traded in the OTC markets.

What is difference between Commercial Paper and Certificates of Deposits?

- CD is issued by the Commercial banks and Finance Institutions, while commercial papers are issued by corporates, primary dealers (PDs) and the All-India Financial Institutions (FIs).
- CD is issued for Rs. 1 Lakh or its multiples while CP is issued in denominations of Rs.5 lakh or multiples thereof.

Money Market Mutual Funds (MMMFs)

Money Market Mutual Funds (MMMFs) were introduced by RBI in 1992 but since 2000, they are brought under the purview of the SEBI. They provide additional short-term avenue to individual investors.

Repo and Reverse Repo auctions

Repo (repurchase agreement) was introduced in December 1992. Repo means selling a security under an agreement to repurchase it at a predetermined date and rate. Repo transactions are affected between banks and financial institutions and among bank themselves, RBI also undertake Repo. IN 1996, Reverse Repo was introduced. Reverse Repo means buying a security on a spot basis with a commitment to resell on a forward basis. Reverse Repo transactions are affected with scheduled commercial banks and primary dealers.

Discount And Finance House of India (DFHI)

Discount and Finance House of India was established in 1988 by RBI and is jointly owned by RBI, public sector banks and all India financial institutions, which have contributed to its paid up capital. DFHI plays important role in developing an active secondary market in Money Market Instruments. From 1996, it has been assigned status of a Primary Dealer (PD). It deals in treasury bills, commercial bills, CDs, CPs, short term deposits, call money market and government securities.

Various problems of Money Markets in India

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. Various problems of money markets in India include Dichotomy, Lack of Coordination & Integration, Diversity in the Interest Rates, Seasonality in the markets, shortage of funds, absence of a developed Bill market, Inefficient management etc.

Overall, India's money markets are relatively less developed and have yet to acquire sufficient depth and width.

Salient features of Indian Money Market

Salient features of Indian Money Market includes:

- Presence of large unorganized market
- Less developed and less popular in comparison to developed countries.
- Seasonal interest rates. Too much difference in interest rates in busy season and slack season.
- The busiest season is November to May-June, funds are required to move the crops and this busy season causes lack of liquidity and hike in the interest rates.
- Highly volatile call / notice money market.

Main functions of Money Markets

Due to short maturity term, the instruments of money market are liquid and can be converted to cash easily and thus are able to address the need of the short term surplus fund of the lenders and short term borrowing requirements of the borrowers. Thus, the major function of the money markets is to cater to the short term financial needs of the economy. The other functions are as follows:

1. Money Markets help in effective implementation of the RBI's monetary policy
2. Money markets help to maintain demand and supply equilibrium with regard to short term funds
3. They cater to the short term fund requirement of the governments

4. They help in maintaining liquidity in the economy

Monetary Aggregates

Money supply & Total Stock of Money

All the money held with public, RBI as well as government is called Total Stock of Money. Money Supply is that part of this Total Stock of Money which is with public. By public we refer to the households, firms, local authorities, companies etc. Thus, public money does not include the money held by the government and the money held as CRR with RBI and SLR with themselves by commercial banks. The reason of excluding the above two categories from money supply is that this money held by the Government and RBI is out of circulation. Thus, we can conclude that the money in circulation is the money supply. This money may be in the following forms:

- Currency Notes and Coins
- Demand Deposits such as Saving Banks Deposits ,
- Other Deposits such as Time Deposits / Term Deposits / Fixed Deposits
- Post Office Saving Accounts
- Cash in Hand (Except SLR) and Deposits of Banks in other Banks / RBI (except CRR)

In other way, this money has two components viz. Currency Component and Deposit Component. Currency Component consist of all the coins and notes in the circulation, while Deposit component is the money of the general public with the banks, which can be withdrawn by them using cheques, withdrawals and ATMs. Deposit can be either Demand Deposit or Time Deposit.

Monetary Aggregates

The Reserve bank of India calculates the four concepts of Money supply in India. They are called Monetary Aggregates or Money Stock Measures. These monetary aggregates are: M1 (aka Narrow Money; M2, M3 (aka Broad Money) and M4. Further, there is one more concept called M0 or Reserve Money.

Narrow Money (M1)

At any point of time, the money held with the **public** has two most liquid components

- **Currency Component:** This consists of all the coins and notes in the circulation
- **Demand Deposit Component:** Demand Deposit component is the money of the general public with the banks, which can be withdrawn by them using cheques, withdrawals and ATMs.

The above two components i.e. currency component and demand deposit component of the public money is called **Narrow Money** and is denoted by the RBI as **M1.** Thus,

M1 = Currency with the public + Demand Deposits of public in Banks

When a third component viz. Post office Savings Deposits is also added to M1, it becomes M2.

M2 = M1 + Post Office Savings.

Broad Money

Narrow money is the most liquid part of the money supply because the demand deposits can be withdrawn anytime during the banking hours. Time deposits on the other hand have a fixed maturity period and hence cannot be withdrawn before expiry of this period. When we add the time despots into the narrow money, we get the broad money, which is denoted by M3.

M3 = Narrow money + Time Deposits of public with banks

We note here that the Broad money does not include the interbank deposits such as deposits of banks with RBI or other banks. At the same time, time deposits of public with all banks including the cooperative banks are included in the Broad Money.

Now, we understand that the major distinction between the M1 and M3 is "Treatment of deposits with the banks". If we go a little deep, the M3 is the treatment of "Time Deposits" of the public, since demand deposits are available against cheques and ATMs.

When you add the Post Office Savings money also into the M3, it becomes M4.

Why M2 and M4 are irrelevant in monetary aggregates?

Both M2 and M4 which include the Post office Savings with narrow money and broad money

respectively are now a days irrelevant. Post Office savings was once a prominent figure when the banks had not expanded in India as we see them today all around. The RBI releases the data at times regarding the money supply in India and Post Office Savings Deposits have not been updated frequently. There is NOT much change in the money of people deposited with the Post office and RBI did not care to update this money. Further, there was a time when the Reserve Bank used broad money (M_3) as the policy target. However, with the weakened relationship between money, output and prices, it replaced M3 as a policy target with a multiple indicators approach. RBI started using the Multiple Indicator Approach since 1998

Currently, Narrow Money (M_1) and Broad Money (M_3) are relevant indicators of money supply in India. The RBI in all its policy documents, monthly Bulletins and other documents shows these aggregates.

Reserve Money (M0)

The other name of the Reserve Money is "High Powered Money" and also "Monetary Base". Reserve Money is all the Cash in the economy and denoted by M. This has the following components:

- Currency with the Public
- Other Deposits with the RBI
- Cash Reserves of the banks held with themselves
- Cash Reserves of the Banks held with RBI

Here we should know that Cash Reserves are also of two types viz. Required Reserves (RR) and

Excess Reserves (ER). RR are those reserves which the banks are statutorily required to keep with the RBI. At present the Banks are required to keep 4.25% CRR (Cash Reserve Ratio) of their total time and demand liabilities. All reserves excess of RR are called Excess Reserves. ER are held with the Banks while RR is held with RBI. Banks hold the ER to meet their currency drains i.e. withdrawal of currency by depositors.

Part-II: Derivative Instruments & Derivative Markets

Derivative Instruments & Derivative Markets

Derivatives are products whose value is derived from the value of one or more basic variables, which are called **Underlying Assets**. The underlying asset can be equity, index, foreign exchange (Forex), commodity or any other asset. This means that any instrument that *derives its value* on its underlying equity, index, foreign exchange (Forex), commodity or any other asset, is a Derivative Instrument.

Please note that derivative products initially emerged as hedging devices against fluctuations in commodity prices and commodity-linked derivatives remained the sole form of such products for almost three hundred years. But after 1970s, the financial derivatives came into spotlight thanks to the growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two thirds of total transactions in derivative products.

Different Types of Derivatives

The derivatives can be **Forwards** or **Futures** or **Options** or **Warrants**.

Forward & Future Contract: A **forward contract** is a customized contract between two parties to buy or sell an asset at a specified future time at a price agreed upon today. Futures contracts are special types of forward contracts in the sense that they are standardized exchange-traded contracts, such as futures of the Nifty index.

Options: An Option is a contract which gives the right, but not an obligation, to buy or sell the underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him.

Options are of two types – Calls and Puts options.

- **'Calls'** give the buyer the *right but not the obligation to buy* a given quantity of the underlying asset, at a given price on or before a given future date.
- 'Puts' give the buyer the *right, but not the obligation to sell* a given quantity of underlying asset at a given price on or before a given future date. Please note that options generally have lives of

up to one year. The majority of options traded on exchanges have maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-the counter.

Long forward and short forward contracts

We suppose that Suresh wants to buy a house in next year October. At the same time, Ramesh has a house worth Rs. 15 Lakh and he plans to sell it in October next year. Since the current price is Rs. 15 Lakh, Ramesh and Suresh enter into an agreement via which Suresh will buy that house in October 2013 in Rs. 17 Lakh. This would be called a Forward Contract. The price agreed upon would be called **Delivery price**. Since Suresh is buying it, for him, it would be called **Long Forward Contract**. On the other side, Ramesh is selling it; it would be called **Short Forward Contract**.

Spot contract

Now, we suppose that in next year October, instead of Rs. 17 Lakh, the market price of that house becomes Rs. 20 Lakh. Since Ramesh is already in contract with Suresh to sell him the house in Rs. 17 Lakh, Suresh would earn a profit of Rs. 3 lakh. Ramesh would lose Rs. 3 Lakh. Here we note that forward contract is in contrast with the **Spot contract**. **Spot contract** is an agreement to buy or sell an asset today.

Non-Deliverable Forward

There is one more term related to Forward Contracts called **NDF** or **Non-Deliverable Forward**. Non-deliverable forwards are over-the-counter transactions settled not by delivery but by exchange of the difference between the contracted rate and some reference rate such as the one fixed by the Reserve Bank of India. For example, if Ramesh pays Suresh Rs. 3 Lakh without delivering the actual house, it would be called NDF. The same is basic *funda* for commodity forward contracts and currency forward contracts.

Role of Future Markets in Economy

There are two important roles of the Futures markets.

- **Price Discovery:** Price discovery is the process of determining the price of an asset in the marketplace through the interactions of buyers and sellers. The forward markets provide the collective assessment of a large number of individual market participants about the direction and price trends of a commodity in future. The price discovery is affected by the internal knowledge about the likely production, crop size, weather projections etc of the buyers and sellers.
- The benefit of forwards is that the producers of commodities such as farmers can plan production and to shift acreage or production facilities from one commodity to another. The fight for acreage between wheat, soya bean and corn is an example of the demand forecast given by futures against the backdrop of complex interplay of forces like by forces bio-fuel

demand, meat consumption (giving rise to larger utilization of feed to animals- in turn larger demand) etc.

- **Hedging of price Risk:** if a producer or buyer has a general sense of the likely future price, the he can lock the produce so that his risk of price or for that matter availability is mitigated.

However, **Speculators** are one of the biggest segment of future markets participants. The speculative investors pour their money into the futures markets and thus are held responsible for increased volatility in commodities.

In any case, the social utility of futures markets is considered to be mainly in the transfer of risk, and increased liquidity between traders with different risk and time preferences. However, it does not take much time to convert the hedger into a speculator.

Option Premium

At the time of buying an option contract, the buyer has to pay premium. The premium is the price for acquiring the right to buy or sell. It is price paid by the option buyer to the option seller for acquiring the right to buy or sell. Option premiums are always paid up front.

Commodity Futures

FCRA Forward Contracts (Regulation) Act, 1952 defines "goods" as "every kind of movable property other than actionable claims, money and securities". Futures' trading is organized in such goods or commodities as are permitted by the Central Government. At present, all goods and products of agricultural (including plantation), mineral and fossil origin are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCRA.

Commodity derivatives market trade contracts for which the underlying asset is commodity. It can be an agricultural commodity like wheat, soybeans, rapeseed, cotton, etc or precious me tals like gold, silver, etc.

First Commodity Future Market in India

In our country, the Commodity Futures market dates back to more than a century. The first organized futures market was established in 1875, under the name of 'Bombay Cotton Trade Association' to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, foodgrains, etc.

The futures market in India underwent rapid growth between the period of First and Second World War. As a result, before the outbreak of the Second World War, a large number of commodity exchanges trading futures contracts in several commodities like cotton, groundnut, groundnut oil, raw jute, jute goods, castorseed, wheat, rice, sugar, precious metals like gold and silver were flourishing throughout the country. In view of the *delicate supply situation of major commodities in the backdrop of war efforts mobilization, futures trading came to be prohibited* during the Second World War under the Defence of India Act.

After Independence, especially in the second half of the 1950s and first half of 1960s, the commodity futures trading again picked up and there were thriving commodity markets. However, in **mid-1960s, commodity futures trading in most of the commodities was banned** and futures trading continued in two minor commodities, viz, pepper and turmeric.

Commodity Exchange

Commodity Exchange is an association, or a company of any other body corporate organizing futures trading in commodities. In a wider sense, it is taken to include any organized market place where trade is routed through one mechanism, allowing effective competition among buyers and among sellers – this would include auction-type exchanges, but not wholesale markets, where trade is localized, but effectively takes place through many non-related individual transactions between different permutations of buyers and sellers.

Difference between Commodity and Financial derivatives

The basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. However there are some features which are very peculiar to commodity derivative markets. In the case of financial derivatives, most of these contracts are cash

settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing. Similarly, the concept of varying quality of asset does not really exist as far as financial underlyings are concerned. However in the case of commodities, the quality of the asset underlying a contract can vary at times.

Badla System

Badla System is an outdated Indian term for a trading system with a mechanism for deferring either payment for shares purchased or delivery of shares sold. The system, discontinued by the Securities and Exchange Board of India (SEBI), from March 1994, was applicable to a group or 'Specified' shares.

Mutual Funds

A mutual fund is a fund that is created when a large number of investors put in their money, and is managed by professionally qualified persons with experience in investing in different asset classes-shares, bonds, money market instruments like call money, and other assets like gold and property.

The name of the mutual fund gives a good idea about what type of asset class a fund, also called a scheme, will invest in. For example, a diversified equity fund will invest in a large number of stocks, while a gilt fund will invest in government securities while a pharma fund will mainly invest in stocks of companies from the pharmaceutical and related industries.

Is SEBI approval necessary for Mutual Funds?

Yes. Mutual funds are compulsorily registered with the Securities and Exchange Board of India (Sebi), which also acts as the first wall of defence for all investors in these funds.

Who runs Mutual Fund?

A mutual fund is run by a group of qualified people who form a company, called an asset management company (AMC) and the operations of the AMC are under the guidance of another group of people, called trustees.

Both, the people in the AMC as well as the trustees, have a fiduciary responsibility because these are the people who are entrusted with the task of managing the hard-earned money of people who do not understand much about managing money.

How to Invest in Mutual Funds?

An investor willing to invest in a mutual fund can approach a fund house or a distributor working for the fund house (which could be an individual, a company or even a bank), and ask a person qualified to sell mutual funds to explain how to go about it.

After some regulatory requirement is fulfilled, the investor can fill up a form and write a cheque-the fund house or the distributor will take care of the process after that. Once the cheque is cleared by the investor's bank, the fund house will allot what are called 'units' to the investor, at a price that is fixed through a process approved by Sebi.

This price is based on the net asset value (NAV), in simple terms which is the total value of investments in a scheme divided by the total number of units issued to investors in the same scheme.

In most mutual fund schemes, NAVs are computed and published on a daily basis. However, when a fund house is launching a scheme for the first time, the units are sold at Rs 10 each.

What are kinds of Mutual Funds?

There are three types of schemes in which an investor can invest in. These are open-ended schemes, closed-ended schemes, and exchange-traded funds (ETFs).

Open Ended Fund:

An open-ended fund is the one which is usually available from a mutual fund on an ongoing basis that is an investor can buy or sell as and when they intend to at a NAV-based price.

As investors buy and sell units of a particular open-ended scheme, the number of units issued also changes every day.

The value of the scheme's portfolio also changes on a daily basis. So, the NAV also changes on a daily basis. In India, fund houses can sell any number of units of a particular scheme, but at times fund houses restrict selling additional units of a scheme for some time.

Close-ended Fund:

A close-ended fund usually issue units to investors only once, when they launch an offer, called new fund offer (NFO) in India.

Thereafter, these units are listed on the stock exchanges where they are traded on a daily basis. As these units are listed, any investor can buy and sell these units through the exchange.

As the name suggests, close-ended schemes are managed by fund houses for a limited number of years, and at the end of the term either money is returned to the investors or the scheme is made open-ended.

However, usually, units of close ended funds which are listed on the stock exchanges, trade at a high discount to their NAVs. But as the date for closure of the fund nears, the discount between the NAV and the trading price narrows, and vanishes on the day of closure of the scheme.

Exchange Traded Funds

ETFs are a mix of open-ended and close-ended schemes.

ETFs, like close-ended schemes, are listed and traded on a stock exchange on a daily basis, but the price is usually very close to its NAV, or the underlying assets, like gold ETFs.

What are Advantages and Disadvantages of Mutual Funds?

If one invests in a well-managed mutual fund scheme, the advantages outweigh disadvantages and in the long term, which is 10 years or more. There is a very high probability of investors making more

money than by investing in other risk-free investments such as FDs, public provident fund, etc.

Advantages of investing in MFs include diversification, good investment management services, liquidity, strong government-backed regulatory help, professional service, and all these at a low cost. The disadvantages of mutual fund investing include lack of flexibility to sell or buy a stock or a portfolio of stocks of choice. The investor does not have any freedom relating to customize the fund's portfolio. Another disadvantage is that although in the long term MFs give good returns, the returns are not as predictable as say in bank FDs and PPF.

Legislations that control the securities market

Major legislations that control the securities market are the SEBI Act, 1992, the Companies Act, 1956, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996 & Prevention of Money Laundering Act, 2002. Please note that previously we had a British Era legislation Capital Issues (Control) Act, 1947, which has been repealed now.

When was SEBI established?

SEBI was established and empowered statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market.

Jurisdiction of SEBI extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

What are key provisions of Securities Contracts (Regulation) Act, 1956?

This act provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

What are key provisions of Depositories Act, 1996

Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities

of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of wnership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

What are key provisions of Companies Act, 1956?

It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other information.

What are key provisions of Prevention of Money Laundering Act, 2002?

The primary objective of the Act is to prevent money-laundering and to provide for confiscation of property derived from or involved in money-laundering. The term money-laundering is defined as whoever acquires, owns, possess or transfers any proceeds of crime; or knowingly enters into any transaction which is related to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India commits the offence of money laundering. Besides providing punishment for the offence of money-laundering, the Act also provides other measures for prevention of Money Laundering. The Act also casts an obligation on the intermediaries, banking companies etc to furnish information, of such prescribed transactions to the Financial Intelligence Unit- India, to appoint a principal officer, to maintain certain records etc.

Apart from the above legislations, government has framed rules under the SCRA, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by market participants.

Basics of Investments

What is the real return on investments?

The money which we earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle we would like to use savings in order to get return on it in the future. This is called Investment. We invest because of many reasons. One important reason is that we want to meet the cost of Inflation. The Inflation which is the rate, at which the cost of living increases, indicates the rate at which the prices of the goods and services we need are increasing.

If there is inflation, the money loses value, because it will not buy the same amount of a good or a service in the future as it does now or did in the past.

For example, we suppose that if there was a 6% inflation rate for the last 20 years, a Rs. 100 purchase in 1992 would cost Rs. 321 in 2012. So, whenever we make a long term investment strategy, we need to consider inflation. An investment's real return is that return which is after deducting the inflation. This means that if the annual inflation rate is 6%, what we invest should earn more than 6% annually so that we get a positive real return.

What are Real Assets and Financial Assets?

A person can invest in **Physical assets** like real estate, gold/jewellery, and commodities etc or **Financial assets** such as fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension fund etc. Apart from that an investor can invest in **securities market related instruments** like shares, bonds, debentures etc.

What are major Short Term Investment Options?

There are short term investment options such as savings bank account, money market/liquid funds and fixed deposits with banks.

- Out of them the Savings Bank Account is often the first banking product people use, which offers low interest, making them only marginally better than fixed deposits.

- In India, the interest rate on savings bank accounts is now deregulated as the banks themselves decide the interest rates.
- The *Money Market or Liquid Funds* are a specialized form of mutual funds that invest in extremely short-term fixed income instruments and thereby provide easy liquidity.

There is a big difference between the Mutual Funds and Liquid Funds. Unlike most mutual funds, money market funds are primarily oriented towards protecting the investor's capital and then, aim to maximise returns. Money market funds usually yield better returns than savings accounts, but lower than bank fixed deposits. Lastly, the Fixed Deposits with Banks can be long term as well as short term investment options as minimum investment period for bank FDs is 30 days. Fixed Deposits with banks are for investors with low risk appetite, and may be considered for 6-12 months investment period as normally interest on less than 6 months bank FDs is likely to be lower than money market fund returns.

What are Long Term Investment Options?

The Long term investments typically comprise the Post Office Savings Schemes, Public Provident Fund, Company Fixed Deposits, Bonds and Debentures, Mutual Funds etc.

Post Office Investments:

- Post Office Monthly Income Scheme is a low risk saving instrument, which can be availed through any post office. It provides an interest rate of around 8% per annum, which is paid monthly.
- Minimum amount, which can be invested, is Rs. 1,500/- and additional investment in multiples of 1,000/-.
- Maximum amount is Rs. 3,00,000/- (if Single) or Rs. 6,00,000/- (if held Jointly) during a year. It has a maturity period of 6 years. Premature withdrawal is permitted if deposit is more than one year old. Post office also provides time deposits for 1, 2, 3, 5 years. The monthly scheme and term deposits of Post offices don't provide any Tax benefits.

Public Provident Fund:

PPF is a long term savings instrument with a maturity of 15 years and interest payable at 8.25 % per annum (2011-12, it was 9.5 per cent paid in 2010-11) compounded annually. A PPF account can be opened through a nationalized bank at anytime during the year and is open all through the year for depositing money.

Tax benefits can be availed for the amount invested and interest accrued is tax-free. A withdrawal is permissible every year from the seventh financial year of the date of opening of the account and the amount of withdrawal will be limited to 50% of the balance at credit at the end of the 4th year immediately preceding the year in which the amount is withdrawn or at the end of the preceding year whichever is lower the amount of loan if any.

Corporate FDs

Corporate FDs or Company Fixed deposits are short-term (six months) to medium-term (three to five years) borrowings by companies at a fixed rate of interest which is payable monthly, quarterly, semi-annually or annually. They can also be cumulative fixed deposits where the entire principal along with the interest is paid at the end of the loan period. The rate of interest varies between 6-9% per annum . The interest received is after deduction of taxes.

Bonds

Bonds are fixed income instruments issued for a period of more than one year with the purpose of raising capital. The central or state government, corporations and similar institutions sell bonds. A bond is generally a promise to repay the principal along with a fixed rate of interest on a specified date, called the Maturity Date.

Mutual Funds

- The Mutual funds are operated by an investment company which raises money from the public and invests in a group of assets (shares, debentures etc.), in accordance with a stated set of objectives. Mutual Funds are for those who are unable to invest directly in equities or debt because of resource, time or knowledge constraints.
- Mutual Funds come with benefits such as professional money management, buying in small amounts and diversification. Mutual fund units are issued and redeemed by the Fund Management Company based on the fund's net asset value (NAV), which is determined at the end of each trading session.
- NAV is calculated as the value of all the shares held by the fund, minus expenses, divided by the number of units issued. Mutual Funds are usually long term investment vehicle though there some categories of mutual funds, such as money market mutual funds which are short term instruments.

General Knowledge Today

Banking & Finance-6: Capital Markets

Target 2016: Integrated IAS General Studies

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Unlimited Company versus Limited Company, Private Limited Company versus Public Limited Company, Share and Share Capital, Types of Share Capital, Capital Reserves versus Reserve Capital, Preference Shares and Equity shares, IPO, Book Building, Red Herring Prospectus, FPO, Voting Rights & Differential Voting Rights (DVR), Debt instruemtns, Debentures, Debentures and Shares.

Types of Companies

Main types of companies in India

The companies registered under the Companies Act 1956 are of three types as follows:

- Unlimited Company
- Company Limited by Guarantee
- Company Limited by Shares: These are of two types-
    - Private company
    - Public Company

Further, the Companies Act 2013 has also provisions to start a **One Person Company (OPC)** in India.

Unlimited Company

The unlimited company is a company where there is no limit on the liability of its members. This means that if the company suffers a loss and the company's property is not enough to pay off its debts, the private property of its members is used to meet the claims of the creditors. This means that there is a huge risk in such companies. <u>Unlimited companies are not found in India</u>; instead, their space is occupied by the proprietary kind of businesses.

Limited Company

In a limited company is limited either by Guarantee or Shares. On this basis, there are two types of limited companies in India.

- Company Limited by Guarantee: In such a company, the liability of the members is limited to the extent of guarantee given by them in the event of winding up of the company.
- Company Limited by Shares: In this kind of the company, the liability of the members is strictly limited to the extent of nominal value of shares held by each of them. If a member has already paid the full amount of the shares, he shall not be liable to pay any amount. If a member has partly paid the shares, he can be forced to pay the remaining amount during the existence of the company as well as during the winding up. Such companies are of two kinds, private and public.

Private Limited Company

In India, a private company is the one which has a minimum paid up share capital of ` 100000 or such higher capital as prescribed by the Companies Act. Its Article of association mentions that the company

- Restricts the right to transfer its shares
- Limits the number of its members from 2 to 50
- Cannot go for invitation from public to subscription to any of its shares
- Cannot accept deposits from persons other than its members, directors and relatives.

What is a Public Limited Company?

A public company means a company which is not a private company and has minimum of 7 shareholders/subscribers. It has to have a minimum paid-up share capital of ` 5 Lakh.

What are the differences between a Public Limited Company and Private Limited Company?

Distinction	Private Company	Public Company
Minimum Paid-up Capital	1 Lakh	5 Lakh
Minimum Number of Members	2	7
Maximum Number of Members	50	No restriction
Transerferability of shares	Complete Restriction	No Restriction
Issue of Prospectus	Prohibited	Free
Number of Director	At least 2	At least 3
Commencement of Business	Immediately after incorporation	Only after commencement of business certificate is obtained
Statutory meeting	No Obligation	Obligatory
Quorum	2 members	5 members
Managerial remuneration	No restriction	Can not exceed more than 11% of Net Profits

Share Markets

Understanding Shareholding

Every business needs some capital to start up. When a new business is started, the personal savings of an entrepreneur along with contributions from friends and relatives are the source of fund. The entrepreneur in this case can also be called a promoter. This may not be feasible in case of large projects as the required contribution from the entrepreneur (promoter) would be very large even after availing term loan; the promoter may not be able to bring his / her share (equity capital).Thus availability of capital can be a major constraint in setting up or expanding business on a large scale, because of this limited pool of savings of small circle of friends and relatives.

However, instead of depending upon this small pool, the promoter has the *option of raising money from the public across the country by selling (issuing) shares of the company*. For this purpose, the promoter can invite investment to his or her venture by issuing offer document which gives full details about track record, the company, the nature of the project, the business model, the expected profitability etc. If an investor is comfortable with this proposed venture, he / she may invest and thus become a shareholder of the company. *This means that a shareholder is an owner of the company to the extent of his / her shareholding.* The values of these shares are very small, but when the large number of shares aggregate, it makes substantial amount which is usable for large corporates.

Share

The total capital of the company is divided into units of small denominations as mentioned above. Each unit is called a share. For example if the total capital f the company is ` 10 Lakh divided into 1 Lakh units of Rs. 10 each, each Rs. 10 unit will be called a share. Shares are numbered so that they can be identified.

Please note that following are the properties of all kinds of shares of a public company:

- They are movable property
- They are transferable in the manner prescribed in the Articles of Association
- They are treated as Goods under the Sale of Goods Act , 1930.
- *A member who holds the shares of a company* ***does not imply*** *that the member owns any of the company's assets. This is because assets would be still possessed by the company which is a legal person in itself. However, if the company is wound up, after selling its assets, the shareholder has the right to participate in the assets after the debts have been paid. This means that* ***it is the right to what assets remain after liquidation.*** *At the same time, the shareholder is also liable for the amount, if any unpaid on the shares held by him.*

Share versus Share Capital

Please note that in context of a company, Capital means the share capital only. The reason is that many investors and promoters contribute varying sums to the Company's capital yet, there is no separate Capital account for each investor or promoter. Hence, there is a single consolidated Capital Account which is called the Share Capital Account.

Here are some important observations:

- Equity is an instrument for its owner for share in profits (and losses). Equity shares are instruments issued by companies to raise capital and it *represents the title to the ownership of a company*. An investor becomes an owner of a company by subscribing to its equity capital (whereby investor will be allotted shares) or by buying its shares from its existing owners. As a shareholder, investors bear the entrepreneurial risk of the business venture and are entitled to benefits of ownership like share in the distributed profit (dividend) etc. The returns earned in equity depend upon the profits made by the company, company's future growth etc.
- Equity share is initially issued to those who have contributed capital in setting up an enterprise. This would be called the Public Issue. Apart from a Public Issue, equity shares may

originate through an issue of *Bonus Shares, Convertible securities etc. All of them are collectively called Common Stock or Simply Stock.*

- *Please note that if the company fails or gets liquidated otherwise, the claim of equity shareholders on earnings and on assets in the event of liquidation, follows all others. Similarly, the dividend on equity shares is paid after meeting interest obligations and dividends to Preference shareholders. That is why the holders of the Equity shares are also known as '**residual owners**'.* Since the equity shareholders bear such risks, they expect handsome returns by way of DIVIDENDS and price appreciation of the share, when their enterprise performs well.
- The total equity capital of a company is divided into equal units of small denominations, each called a share. For example, in a company the total equity capital of Rs 2,00,00,000 is divided into 20,00,000 units of Rs 10 each. Each such unit of Rs 10 is called a Share. Thus, the company then is said to have 20,00,000 equity shares of Rs 10 each. The holders of such shares are members of the company and have voting rights.

Different Types of Share Capital

There are various terms used in connection with the share capital of the company. They are as follows:

Authorized / Registered / Nominal Capital

This is the Maximum Capital which the company can raise in its life time. This is mentioned in the Memorandum of the Association of the Company. This is also called as Registered Capital or Nominal Capital.

Issued Capital

This is the part of the Authorized Capital which is issued to the public for Subscription. The act of creating new issued shares is called issuance, allocation or allotment. After allotment, a subscriber becomes a shareholder. The number of issued shares is a subset of the total authorized shares and

Shares authorized = Shares issued + Shares unissued

Subscribed Capital

The issued Capital may not be fully subscribed by the public. Subscribed Capital is that part of issued Capital which has been taken off by the public i.e. the capital for which applications are received from the public. So, it is a part of the Issued Capital as follows:

Issued Capital = Subscribed Capital + Unsubscribed Capital

This can be understood by an example. If we say that 15000 shares of Rs. 100 each are offered to the public and public applies only for 12000 shares, then the Issued Capital would be Rs. 15 Lakh and Subscribed Capital would be Rs. 12 Lakh.

Please note that once the shares have been issued and purchased by investors and are held by them, they are called Shares Outstanding. These outstanding shares have rights and represent ownership in the corporation by the person that holds the shares. The unsubscribed capital is also known as **Treasury shares**, which are shares held by the corporation itself and have no exercisable rights. Shares outstanding plus treasury shares together amount to the number of issued shares.

Called – up Capital

The Company may not need to receive the entire amount of capital of capital at once. It may call up only part of the subscribed capital as and when needed in installments. Thus, the called – up Capital is the part of subscribed capital which the company has actually called upon the shareholders to pay. Called – up Capital includes the amount paid by the shareholder from time to time on application, on allotment, on various calls such as First Call, Second Call, Final Call etc. The remaining part of subscribe capital not yet called up is known as Uncalled Capital. The Uncalled Capital may be converted, by passing a special resolution, into Reserve Capital; Reserve Capital can be called up only in case of winding up of the company, to meet the liabilities arising then.

Paid-up Capital

The Called-up Capital may not be fully paid. Some Shareholders may pay only part of the amount required to be paid or may not pay at all. Paid-up Capital is the part of called-up capital which is actually paid by the shareholders. The remaining part indicates the default in payment of calls by some shareholders, known as Calls in Arrears. Thus,

Paid-up Capital = Called-up Capital – Calls in Arrears.

Reserve Capital: As mentioned above, the company by special resolution may determine that a portion of the uncalled capital shall not be called up, except in the event of the winding up of the company. This part is called Reserved Capital. It is kept reserved for the Creditors in case of the winding up of the company.

Capital Reserves versus Reserve Capital

Here please note that **Capital Reserve** and **Reserve Capital** are two different animals. **Capital Reserves** are those reserves which are created out of the **Capital Profits. Capital Profits** are those profits which are not *earned in the normal course of the business*. Some examples are as follows:

- Profit on sale of fixed assets
- Profit on revaluation of fixed assets
- Premium on issue of shares and debentures
- Profit on redemption of debentures
- Profit earned by the company prior to its incorporation

Please note that Capital Reserves cannot be utilized for the distribution of dividends as dividends are something which can be given from a profit that is earned by normal business of a company.

Understanding Shares

"A share is the share in the Capital of the Company" so defines the Companies Act 1956. A Company can issue two types of shares viz. Equity Shares and Preference Shares.

- Equity Shares:**Equity shares** or the **Ordinary Shares** means that part of the share capital which is not a Preference share capital. It means all such shares which are not Preference shares.
- Preference Shares: Preference shares are those shares which fulfil both the following two conditions:
    - They carry preferential share right in respect of dividend at a fixed rate,
    - They also carry preferential right in regard to payment of capital on winding up of the company.

Preference Shares

Apart from the other differences, the major difference between Ordinary shares and preference shares is of "dividend". Preference shares are those shares which carry the following two rights:

- They have the right to receive dividend at a fixed rate before any dividend is paid on the equity shares
- When the company is wound up, they have a right to return of the capital before that of equity shares.

- Apart from the above, the preference shares may carry some more rights such as the right to participate in excess profits which a specified dividend has been paid on the equity shares or the right to receive a premium at the time of redemption.

Different Types of Preference Shares

When we buy shares, we do not invest in the stock market itself but in the equity shares of a company. That makes us a shareholder or part-owner in the company. This means that we own part of the assets of the company, and we are entitled to a share in the profits these assets generate. A company may keep a fraction of profit generated within it. This will be utilised to buy new machinery or more raw material or to reduce its loan with the bank. It distributes the other fraction as dividend.

Cumulative Preference Shares:

Please note that when we buy equity shares or ordinary shares, we are not automatically entitled to a dividend every year. *The dividend will be paid only if the company makes a profit and declares a dividend.* But that is not the case with the **preference shares**. A preference shareholder is entitled to a dividend every year. Please note that it may be possible that a company doesn't have the money to pay dividends on preference shares in a particular year. The dividend is then added to the next year's dividend. If the company can't pay it the next year as well, the dividend keeps getting added until the company can pay. These are known as cumulative preference shares. Thus, cumulative preference shares are those preference shares, the holders of which are entitled to recover the arrears of preference dividend, before any dividend is paid on equity shares.

Non-cumulative Preference Shares:

Some preference shares are non-cumulative — if the company can't pay the dividend for one particular year, the dividend for that year lapses. If the company does not declare a dividend in any year due to any reason, such shareholders get nothing nor they can claim unpaid dividend of any year in any subsequent year.

Participating Preference Shares

They have fixed preference dividend and also a right to participate in surplus profits after a dividend is paid.

Non-Participating Preference Shares:

Such shares get only a fixed rate of dividend every year and there is no right to participate in the surplus profits.

Convertible Preference Shares:

Holders of these shares have right to get their preference shares to be converted into equity shares

(but not debentures or other debt securities)

Non-Convertible Preference Shares

Holders of these shares have no right of getting their preference shares converted into equity shares

Differences between Preference Shares and Equity shares

The differences between them are listed in the following table:

Difference between Preference Shares and Equity shares		
Basis of Distinction	Preference Shares	Equity Shares
Rate of Dividend	Paid at fixed rate	May vary , depending upon the profits
Arrears of Dividend	Get accumulated for cumulative preference shares	No accumulation
Preferential Rights	Before Equity shares	After
Winding up	Have a right to return of capital before equity shares . This means they are safer.	Only paid when preference share capital is paid fully
Voting Rights	No voting rights	Voting rights

Difference between Preference Shares and Equity shares		
Right to participate in Management	Have NO right	Have right

Investment in which type of share is safer?

The preference shares are safer investments than the equity shares. In case the company is wound up and its assets (land, buildings, offices, machinery, furniture, etc) are being sold, the money that comes from this sale is given to the shareholders. After all, shareholders invest in a business and own a portion of it.

Can a retail investor purchase Preference shares?

Please note that usually, the preference shares are most commonly issued by companies to institutions. That means, it is out of the reach of the retail investor. For example, banks and financial institutions may want to invest in a company but do not want to bother with the hassles of fluctuating share prices. In that case, they would prefer to invest in a company's preference shares. Companies, on the other hand, may need money but are unwilling to take a loan. So they will issue preference shares. The banks and financial institutions will buy the shares and the company gets the money it needs. This will appear in the company's balance sheet as 'capital' and not as debt (which is what would have happened if they had taken a loan).

Are preference shares traded in Stock Exchanges?

Preference Shares are NOT traded in stock exchange. This also means they are not 'liquid' assets; there's little scope for the price of these shares to move up or down. On the other hand, ordinary or equity shares are traded in the markets and their prices go up and down depending on supply and demand for the stock. But, that does not mean the investor is stuck with his shares. After a fixed period, a preference shareholder can sell his/ her preference shares back to the company. This cannot be done with the ordinary shares. Ordinary shares can be only sold to another buyer in stock market. One can sell the ordinary shares back to the company only if the company announces a buyback offer.

Procedure of issuing the shares

There are several stages in the process of issuing shares such as issuing a prospectus, application of Shares, allotment of Shares, book building etc.

Prospectus

Whenever shares are to be issued to the public the company must issue a prospectus. Prospectus means an open invitation to the public to take up the shares of the company thus a private company need not issue prospectus. Even a Public Company issuing its shares privately need not issue a prospectus. However, it is required to file a "Statement in lieu of Prospectus" with the register of companies.

The Prospectus contains relevant information like names of Directors, terms of issue, etc. It also states the opening date of subscription list, amount payable on application, on allotment & the earliest closing date of the subscription list.

Over-subscription and Under Subscription

A person intending to subscribe to the share capital of a company has to submit an application for shares in the prescribed form, to the company along with the application money before the last date of the subscription mentioned in the prospectus.

Over Subscription: If the no. of shares applied for is more than the no. of shares offered to the public then that is called as over Subscription.

Under Subscription: If the no. of shares applied for is less then the no. of shares offered to the public then it is called as Under Subscription.

Allotment of Shares

After the last date of the receipt of applications is over, the Directors, Provide with the allotment work. However, a company cannot allot the shares unless the minimum subscription amount mentioned in the prospectus is collected within a stipulated period. The Directors pass resolution in

the board meeting for allotment of shares indicating clearly the class & no. of shares allotted with the distinctive numbers. Then Letters of Allotment are sent to the concerned applicants. Letters of Regret are sent to those who are not allotted any shares & application money is refunded to them.

Partial Allotment: In partial allotment the company rejects some application totally, refunds their application money & allots the shares to the remaining applicants.

Pro-rata Allotment

When a company makes a pro-rata allotment, it allots shares to all applicants but allots lesser shares then applied for E.g. If a person has applied for three hundred shares he may get two hundred shares.

Calls on Shares

The remaining amount of shares may be collected in instalments as laid down in the prospectus. Such instalments are called calls on Shares. They may be termed as “Allotment amount, First Call, Second Call, etc.”

- **Calls–in–Arrears:** some shareholders may not pay the money due from them. The outstanding amounts are transferred to an account called up as “Calls-in-Arrears” account. The Balance of calls-in-arrears account is deducted from the Called-up capital in the Balance Sheet.
- **Calls–in–Advance:** According to sec.92 of the Companies Act, a Company may if so authorized by its articles, accept from a shareholder either the whole or part of the amount remaining unpaid on any shares held by them, as Calls in advance. No dividend is paid on

such calls in advance. However, interest has to be paid on such calls in advance.

Issue of Shares on discount and Premium

A limited company may issue the shares on following different terms.

1. Issue of Shares for Consideration other than cash or for cash or on capitalization of reserves.
2. Issue of Shares at par i.e. at face value or at nominal value.
3. Issue of Shares at a Premium i.e. at more than face value.
4. Issue of Shares at a Discount i.e. at less than the face value.

Issue of shares at a premium

When the shares are issued at a price higher than the nominal value of the shares then it is called as shares issued at a premium. The amount of premium is decided by the board of Directors as per the guide lines issued by SEBI. Please note that the Securities Premium is a profit to the company, but it is not a revenue profit, it is treated as **Capital Profit**, which can be utilized only for the following purposes:

- Issue of fully paid bonus shares to the existing shareholders.
- Writing off the preliminary expenses of the company.
- Writing off the expenses of issue or the commission paid or discount allowed on any issue of shares / debentures.
- Providing the premium payable on redemption of preference shares or debentures. The company can utilize the security Premium for any other purpose only on obtaining the sanction of the court.

Issue of shares at a discount

The companies can issue the shares at a discount subject to the following conditions:

1. The issue must be of a class of shares already issued.
2. Not less than 1 year has at the date of issue elapsed since the date on which the company became entitled to commence business.
3. The issue at a discount is authorized by a resolution passed by the company in the general meeting & sanctioned by the company law board.
4. The maximum rate of discount must not exceed 10% or such rate as the company law board may permit.
5. The shares to be issued at a discount must be issued within two months of the sanction by the company law board or within such extended time as the company law board may allow

IPO

When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public, it is called **Initial Public Offering** or IPO. An IPO paves way for listing and trading of the issuer's securities.

How Pricing of IPO is done?

When a company makes an IPO, the prior requirement would be to decide a price of the Issue / share. The question is -who will decide what should be the price? In India, there is a system of **free pricing** since 1992. However, there are guidelines that the company (Issuer) will decide the price in consultation with Merchant Banker. Still there is no formula for deciding the price of an IPO. *Please note that SEBI does not play any role on pricing of shares, but the company and merchant banker are required to give full disclosures of the parameters which they had considered while deciding the issue price.* While deciding the prices, there are two possibilities,

- Where company and Lead Merchant Banker fix a price. This is called Fixed Price.
- Where the company and the Lead Manager (LM) stipulate a floor price or a price band and leave it to market forces to determine the final price. This is called the **Price discovery through book building process.**

Book Building

Book Building is basically a process used in IPOs for efficient price discovery. It is a mechanism where, during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date.

Please note that in our country, the Price discovery through book building process is more popular than a normal issue. In the case of Price discovery through book building process, the price at which securities will be allotted is not known, while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.

Role of SEBI in issuing shares

Many companies float public issues in market everyday. They also advertise the IPO and often when we read such advertisements we come across such lines printed in small font.

Please read the prospectus carefully prior to investing.

While most of the companies are genuine, there are also few who may want to exploit the investors. Therefore, it is very important that an investor before applying for any issue to judge and identify the future potential of a company. SEBI guidelines stipulate that the company must provide "***disclosure of information to the public***". This disclosure would include the information such as what is the reason for raising money, how this money will be spent, what are possible returns on expected money. All this contained in a document which is called "Prospectus".

Apart from the above, the Prospectus would also cover information regarding the size of the issue, the current status of the company, its equity capital, its current and past performance, the promoters, the project, cost of the project, means of financing, product and capacity etc. It also contains lot of mandatory information regarding underwriting and statutory compliances. The sole objective of the Prospectus is to provide investors an opportunity to evaluate short term and long term prospects of the company.

Draft Offer Document

Now, we understand that Prospectus gives information to the public about the potential of an IPO and its issuer company. But what if the company shows the people a rosy picture in its prospectus? It is not possible, because before a prospectus is available to the general public, the company has to make a "Offer document' , which is a "Prospectus" in case of a public issue or offer for sale and "Letter of Offer" in case of a rights issue which is filed with the Registrar of Companies (ROC) and Stock Exchanges (SEs). An offer document is thus a "Draft Prospectus", which covers all the relevant information to help an investor to make his/her investment decision. The draft offer documents are filed with SEBI, at least 30 days prior to the registration of **Red Herring Prospectus**. Since it's a draft, SEBI may specify changes, if any, in the draft Offer Document and the issuer or the lead merchant banker shall carry out such changes in the draft offer document before filing the Offer Document with ROC. The Draft Offer Document is made available on the SEBI website for public comments for a period of 21 days from the filing of the Draft Offer Document with SEBI.

Red Herring Prospectus

The literary meaning of idiom "Red Herring" is the rhetorical tactic of diverting attention away from an item of significance. In terms of capital markets, Red Herring Prospectus is a prospectus which contains all information about the IPO barring a few key details such as issue price.

Draft Red Herring Prospectus

The Indian regulatory framework is based on a disclosure regime. A company which wants to raise funds from public via public issues is needed to file a draft prospectus with SEBI(Securities and Exchange Board of India).

This prospectus has most information related to company's operations, its directors, its past record etc. except some key details such as issue price. There is a bold disclaimer which mentions that the information is preliminary and subject to change. This is called **Draft Red Herring Prospectus**.

What SEBI does with DRHP?

SEBI reviews and ensures that adequate disclosures are made by the issuer to enable investors to make an informed investment decision in the issue. It must be clearly understood that SEBI does not 'vet' and 'approve' the offer document. Also, SEBI does not recommend the shares or guarantee the accuracy or adequacy of DRHP. SEBI'S observations on the draft offer document are forwarded to the merchant banker, who incorporates the necessary changes and files the final offer document with

SEBI, Registrar of Companies (RoC) and stock exchanges. After reviewing the DRHP, the market regulator gives its observations which need to be implemented by the company. Once the observations are implemented, it gets final approval & the document then becomes RHP (Red Herring Prospectus).

When RHP's registration with RoC becomes effective, a final prospectus which contains IPO price and issue size is released.

Follow on Public Offer

FPO refers to follow on public offering. It is also known as **Further Issue**. A Further Issue is s when an already listed company makes either a fresh issue of securities to the public or an offer for sale to the public, through an offer document.

What are Issue Price & Market Price?

The price at which a company's shares are offered initially in the primary market is called as the Issue price. When they begin to be traded, the market price may be above or below the issue price.

Market Capitalization

The market value of a quoted company, which is calculated by multiplying its current share price (market price) by the number of shares in issue, is called as market capitalization. For example, if a company A has 150 million shares in issue and current market price is Rs. 100. The market capitalisation of company A is Rs. 15000 million.

What is 'Listing & Delisting of Securities"?

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading. The term 'Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Voting Rights & Differential Voting Rights (DVR)

Please note that the owners of equity shares have the voting rights in the annual general meetings of the company. Traditionally, voting right was like universal suffrage such as ownership of one share conferred one vote. Voting rights of a person in a company were equal to shares owned. However, concept of shares with differential rights was introduced by the Companies (Amendment) Act 2000. Section 86 of the Act was amended to make a provision to issue differential shares by Indian companies. These shares are expected to benefit the investors as well as corporates. As per section 86, equity shares with differential rights as to dividend, voting or otherwise can be issued.

A DVR share is like an ordinary equity share, but it provides fewer voting rights to the shareholder. *The objective of issuing DVR shares is for prevention of a hostile takeover and dilution of voting rights.* It also helps strategic investors who do not want control, but are looking at a reasonably big investment in a company. At times, companies issue DVR shares to fund new large projects, due to fewer voting rights, even a big issue does not trigger an open offer.

The Companies Act permits a company to issue DVR shares when, among other conditions, the company has distributable profits and has not defaulted in filing annual accounts and returns for at least three financial years. However, the issue of such shares cannot exceed 25 per cent of the total issued share capital.

Denomination

A public limited company is free to make right or public issue of equity shares in any denomination determined by it. It has however to comply with SEBI regulations that shares should not be of decimal of rupee and at any point of time there shall be only one denomination.

Face Value of Shares

Face Value is the nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate; for bonds, it is the amount paid to the holder at maturity. Face Value is also known as the par value or simply par. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and does not have much bearing on the price of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price. For a debt security, face value is the amount repaid to the investor when the bond matures (usually, Government securities and corporate bonds have a face value of Rs. 100). The price at which the security trades depends on the fluctuations in the interest rates in the economy.

Premium and Discount values

Securities are generally issued in denominations of 5, 10 or 100. This is known as the Face Value or Par Value of the security as discussed earlier. When a security is sold above its face value, it is said to be issued at a Premium and if it is sold at less than its face value, then it is said to be issued at a Discount.

Forfeiture of shares

When shares are allotted to an applicant, it becomes a contract between the shareholder & the company. The shareholder is bound to contribute to the capital and the premium if any of the company to the extent of the shares he has agreed to take as & when the Directors make the calls. If the fails to pay the calls then his shares may be forfeiture by the directors if authorised by the Articles of Association of the company. The Forfeiture can be only for non-payment of calls on shares and not for any other reasons.

Bonus Shares

Profit making companies may desire to convert their profit into share capital. This can be done by issue of bonus shares. Issue of Bonus shares is also called as conversion of profit into share capital or capitalisation of profits. Bonus can be of two types:

- Making partly paid shares into fully paid by declaring bonus without requiring shareholders to pay for the same.
- Issue of fully paid equity shares as bonus shares to the existing equity shareholders

Rights Shares

A company can issue additional shares at any time by passing an ordinary resolution at its General Meeting. However such additional shares must be first offered to the existing equity shareholders in the proportion of the shares already held by them. Such additional shares are called "Rights Shares". Rights shares should be within the limits of the authorized capital. If not so, then the authorized capital must be increased first suitably. The issue of Rights Shares is to be made after two years from the formation of the company or after one year from the first allotment of shares.

Primary Market & Secondary Market

The mechanism by which the companies raise capital from the issuing if the shares is called Primary Market. Thus, Primary market is for raising the *Equity capital or share capital, which is the owners' interest on the assets of the enterprise after deducting all its liabilities.* It appears on the balance sheet / statement of financial position of the company.

When the shareholder needs the money back, he / she would not sell it back to the company except in some cases, (such as buyback offer) but would sell them to other new investors. *The trade of shares does not reduce or alter the company's capital.* This trading of shares is facilitated by the Stock Exchanges, which bring such sellers and buyers together and facilitate trading. Therefore, companies raising money from public are required to list their shares on the stock exchange. *This mechanism of buying and selling shares through stock exchange is known as the secondary markets.*

Stock Exchanges & Stock Markets

Stock exchanges are defined by the Securities Contract (Regulation) Act, 1956 [SCRA]. As per this act, anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities, is called Stock Exchange. Stock exchange may be a regional stock exchange whose area of operation/jurisdiction is specified at the time of its recognition or national exchanges, which are permitted to have nationwide trading since inception. Examples are Delhi Stock Exchange and National Stock Exchange respectively.

Who owns the Stock Markets?

Please note that broker members of the exchange are both the owners and the traders on the exchange and they further manage the exchange as well. However, there can be two cases viz, Mutualized and demutualized exchanges. In a mutual exchange, the three functions of ownership, management and trading are concentrated into a single Group. This at times can lead to conflicts of interest in decision making. A demutualised exchange, on the other hand, has all these three functions clearly segregated, i.e. the ownership, management and trading are in separate hands.

What are the Factors that influence the price of a stock?

Factors that influence the price of a stock can be stock specific or market specific. The stock-specific factor is related to people's expectations about the company, its future earnings capacity, financial health and management, level of technology and marketing skills. The market specific factor is influenced by the investor's sentiment towards the stock market as a whole. This factor depends on the environment rather than the performance of any particular company. Events favourable to an economy, political or regulatory environment like high economic growth, friendly budget, stable government etc. can fuel euphoria in the investors, resulting in a boom in the market. On the other hand, unfavourable events like war, economic crisis, communal riots, minority government etc. depress the market irrespective of certain companies performing well. However, the effect of market-specific factor is generally short-term. Despite ups and downs, price of a stock in the long run gets stabilized based on the stock specific factors. Therefore, a prudent advice to all investors is to analyse and invest and not speculate in shares.

What are Bid and Ask prices?

The 'Bid' is the buyer's price. It is this price that you need to know when you have to sell a stock. Bid is the rate/price at which there is a ready buyer for the stock, which you intend to sell. The 'Ask' (or offer) is what you need to know when you're buying i.e. this is the rate/ price at which there is seller ready to sell his stock. The seller will sell his stock if he gets the quoted "Ask' price.

What is a share market Index?

A share market Index shows how a specified portfolio of share prices is moving in order to give an indication of market trends. It is a basket of securities and the average price movement of the basket of securities indicates the index movement, whether upwards or downwards. BSE Sensex is one index. The BSE SENSEX is a free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange. The 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since January 1, 1986, the SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the SENSEX is taken as 100 on April 1, 1979, and its base year as 1978-79. On 25 July, 2001 BSE launched DOLLEX-30, a dollar-linked version of SENSEX.

What is a Depository?

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. A Depository can be compared with a bank, which holds the funds for depositors. There are many similarities in Banks and Depositories.

- While the Bank holds funds in an account, depositories hold securities in an account.
- While Bank transfers funds between accounts on the instruction of the account holder, Depository transfers securities between accounts on the instruction of the account holder.
- While the bank facilitates transfers without having to handle money, Depository facilitates transfers of ownership without having to handle securities. Banks keep safe money, depositories keep safe securities.

In India, we have two depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

What is a Depository Participant?

After depository, we have another entity called **Depository Participant**. Depository provides its services to investors through its agents called depository participants (DPs). These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs. Please note that accounts are always no frills at Depositories. This means an investor can have an account with depository without any balance.

What is a Custodian?

There is one more entity about which you must know. It is called Custodian. A Custodian is basically an organisation, which helps register and safeguard the securities of its clients. Besides safeguarding securities, a custodian also keeps track of corporate actions on behalf of its clients. The functions of custodians are to maintain client's securities account, Collecting the benefits or rights accruing to the client in respect of securities, keeping the client informed of the actions taken or to be taken by the issue of securities, having a bearing on the benefits or rights accruing to the client.

Securities Basics

What are Securities?

Security is a broader term in comparison to share market. The definition of 'Securities' as per the Securities Contracts Regulation Act (SCRA), 1956, includes instruments such as shares, bonds, scrips, stocks or other marketable securities of similar nature in or of any incorporate company or body corporate, government securities, derivatives of securities, units of collective investment scheme, interest and rights in securities, security receipt or any other instruments so declared by the Central Government. Securities Markets is a place where buyers and sellers of securities can enter into transactions to purchase and sell shares, bonds, debentures etc. Further, it performs an important role of enabling corporates, entrepreneurs to raise resources for their companies and business ventures through public issues. Transfer of resources from those having idle resources (investors) to others who have a need for them (corporates) is most efficiently achieved through the securities market. Stated formally, securities markets provide channels for reallocation of savings to investments and entrepreneurship. Savings are linked to investments by a variety of intermediaries, through a range of financial products, called 'Securities'.

How security market is regulated in India?

The securities markets need regulation because there is absense of perfect competition and markets are prone to manipulation. It is the duty of the regulator to ensure
that the market participants behave in a desired manner so that securities market continues to be a major source of finance for corporate and government and the interest of investors are protected. In India, the responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). The Securities and Exchange Board of India (SEBI) is the regulatory statutory authority in India established under Section 3 of SEBI Act, 1992. SEBI Act, 1992 .The statutory powers of SEBI are:

1. Protecting the interests of investors in securities
2. Promoting the development of the securities market

3. Regulating the securities market.
4. Regulating the business in stock exchanges and any other securities markets
5. Registering and regulating the working of stock brokers, sub–brokers etc.
6. Promoting and regulating self-regulatory organizations
7. Prohibiting fraudulent and unfair trade practices
8. Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, intermediaries, self – regulatory organizations, mutual funds and other persons associated with the securities market.

Debt Capital and Debt Instruments

Debentures or bonds are debt instruments which *pay interest over their life time* and are used by companies to raise medium or long term debt capital. If an investor prefers fixed income, he / she may invest in these instruments which may give him / her higher rate of interest than bank fixed deposit.

- In the Indian securities markets, the term '**bond**' is used for debt instruments issued by the Central and State governments and public sector organizations and the term '**debenture**' is used for instruments issued by private corporate sector.

The Debt Instruments may be Corporate Debt or Government Debt. Corporate debt instruments are generally called Debentures while Government debt instruments are generally called Bonds, but

Bonds can be issued by companies and local governance bodies too.

Debenture

A debenture is one of the capital market instruments which is used to raise medium or long term funds from public. A debenture is essentially a debt instrument that acknowledges a loan to the company and is executed under the common seal of the company. The debenture document, called Debenture deed contains provisions as to payment, of interest and the repayment of principal amount and giving a charge on the assets of a such a company, which may give security for the payment over the some or all the assets of the company. Issue of Debentures is one of the most common methods of raising the funds available to the company. It is an important source of finance.

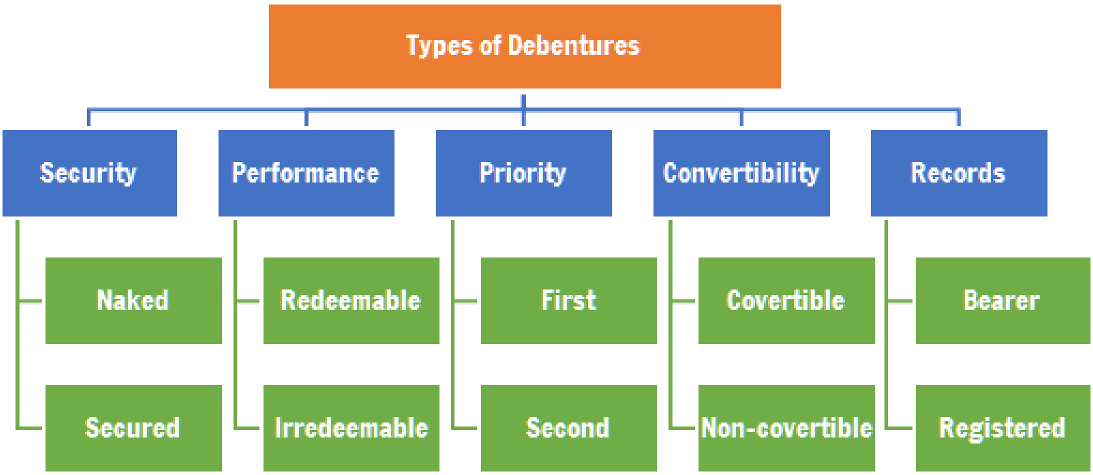
Salient Features of Debentures

The most salient features of Debentures are as follows:

- A debenture acknowledges a debt
- It is in the form of certificate issued under the seal of the company (called Debenture Deed). It usually shows the amount & date of repayment of the loan.
- It has a rate of interest & date of interest payment.
- Debentures can be secured against the assets of the company or may be unsecured.
- Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures.
- The interest paid to them is a charge against profit in the company's financial statements.

Types of Debentures

The debentures can be divided into various types on the basis of security, performance, priority, convertibility and Records as shown in the below graphics:



What are naked debentures and secured debentures?

- **Naked Debentures:** These *Debentures are not secured against any assets of the Company*. In case of winding of the company, debentures holders holding unsecured debentures treated as unsecured creditors.
- **Secured Debentures:** These Debentures are secured by a charge on the assets of the company. These debentures are secured either on particular assets called fixed charge or on the general assets of the company called floating charge. The debentures holder has a right to recover outstanding loan & interest out of such charge assets. These debentures are issued by the company under an agreement which is called "Mortgage Deed". Such mortgage is registered with Register of Companies.

What are Redeemable and Irredeemable debentures?

- **Redeemable Debentures:** The debentures are redeemed by repayment of the amount of debentures after a specified date, as per terms & conditions issued.
- **Irredeemable Debentures:** In this case the issuing company does not fix any date by which debentures should be redeemed & the debentures holder cannot demand repayment of the sum of debenture from the company so long as it is going concern.

What are first debentures and second debentures ?

- **First debentures:** This type of debentures are repaid before the repayment of other debentures.
- **Second debentures:** These debentures are paid after payment of first debentures.

What are convertible debentures and non-convertible Debentures?

- **Convertible debentures:** Holders of such debentures are given option to convert the debentures fully or partly into ***equity shares or preference shares or new debentures*** after a specified time.
- **Nonconvertible debentures:** The holders of this type of debentures do not have any right to convert them into equity shares etc.

What are bearer debentures and registered debentures?

- **Bearer debentures:** Just like bearer cheques these debentures can be transferred freely. Payment of interest is made on productions of coupons attached with debentures.
- **Registered debentures:** These are transferred only by transfer deed. The complete particulars in regard to such debentures are entered into register & the interest is paid only to those whose name appears in the register.

What are at par, at premium and at discount issue of Debentures?

Debentures can, be issued in three ways.

- **At par:**Debenture is said to have been issued at par when the amount collected for it is equal to the nominal value of debentures. e.g. the issue of debentures of Rs. 100/- for Rs. 100/-
- **At Discount:**Debenture is said to have been issued at discount when the amount collected is less than the nominal value, for e.g., issue of debentures of Rs. 100/- for Rs. 95/-. The difference of Rs. 5/- is the discount and is called discount on issue of Debentures. *This discount on issue of debentures is a capital loss.*
- **At Premium:**When the price charged is more than its nominal value, a debentures is said to be issued at a premium. e.g., issue of debentures of Rs. 100 each for Rs. 120, the excess amount over the nominal value i.e., Rs. 20 is the premium on issue of debentures. Premium received on issue of debentures is a capital gain. *Please note that this Premium on issue of debentures cannot be utilised for distribution of dividend.* Premium on debentures is shown under the head Reserves & Surplus on the liability side of the Balance Sheet.

What is Issue of Debentures for Cash?

Debentures may be issued for cash at a par, at a discount or at a premium. When amount is payable in instalments entries will be similar to the issue of shares. Any premium or discount on issue of debentures is usually adjusted at the time of making allotment. Premium payable on redemption of debentures is also adjusted at the time of issue of debentures.

What is Issue of debentures for non-cash consideration?

Debentures may be issued for consideration other than cash such as acquisition of business, or assets. It should be noted that ouch debentures may be issue at par or at a premium or at a discount.

What is Issue of debentures as a collateral security?

Debentures can be issued as collateral security against a loan or overdraft from bank or other financial institution. Collateral Security means an additional or parallel security.

What is Redemption of Debentures?

Debentures may be redeemed (repaid) a) at a par b) at a premium or c) at a discount.

- **Redeemable at par:**When debentures are to be redeemed at their face value they are said to be redeemable at par.
- **Redeemable at a premium:**When debentures are to be redeemed at an amount higher than their face value they said to be redeemable at a premium. Premium payable on redemption of debentures is a capital loss for the company. Such premium even though payable on redemption must be provided as a liability at a time of issue of debentures.
- **Redeemable at a discount:**When debentures are to be redeemed at an amount lower than their face value, they are said to be redeemable at a discount such discount is a capital profit for the company.

How debentures are different from bonds?

Bonds and Debentures, both are similar and holders of both of them are creditors to the company. Both bonds and debentures can be secured or unsecured. Generally, the bonds issued by the companies are secured by their assets. But there are unsecured bonds as well. The bonds issued by municipalities or government companies etc. are normally not secured by any assets.

Both bonds and debentures get priority over shares when company is liquidated. However, if the bonds are secured, they get priority over unsecured debentures.

What is Convertibility in Debentures?

Convertibility in debentures denotes conversion of a debenture to equity shares. On this basis they are of four types as follows:

- **Partly Convertible Debentures (PCD):**A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion. This is normally decided at the time of subscription.
- **Fully convertible Debentures (FCD):**These are fully convertible into Equity shares at the issuer's notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.
- **Optionally Convertible Debentures (OCD):**The investor has the option to either convert these debentures into shares at price decided by the issuer/agreed upon at the time of issue.
- **Non Convertible Debentures (NCD):**Non-convertible debentures , which are simply regular debentures, cannot be converted into equity shares of the liable company. They are debentures without the convertibility feature attached to them. As a result, they usually carry higher interest rates than their convertible counterparts. Thus, these instruments retain the debt character and can not be converted in to equity shares

What is difference between Debentures and Shares

The key difference between a share and a debenture is that while share represents part of ownership of a company, debenture acknowledges loan or debt to the company.

Shares	Debentures
Share capital is an ownership capital.	Debentures capital is credit to the company.
A shareholder is the owner of the company.	A debenture holder is the creditor of the company
Share capital is not returnable in the life time of the company. However, the redeemable preference shares are refunded during the life-time of the company.	Debenture capital returnable during the lifetime of the company. The exception is the irredeemable debentures which are not redeemable during the life-time of the company.

Shares	Debentures
Equity Shareholders enjoy the voting rights.	Debentures holders do not have the voting rights.
Dividend is payable on shares & it is an appropriation of profits	Interest on debentures is payable at a fixed rate on specified date irrespective of profits of the company.
Dividend depends on the profit of the company	Interest is paid on debentures & it is a charge on the revenue of the company.
Shares are unsecured.	Debentures are generally secured.
In the event of winding up of the company shareholders are the last person in re-fund of their capital.	Debenture holder being the creditors are paid prior to the shareholders. If secured they have priority even over the unsecured creditors.

G-Secs

Government securities (G-Secs) are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years). Since it is sovereign borrowing, it is free from risk of default (credit risk). The investors can subscribe to these bonds through RBI or buy it in stock exchange.

Hybrid Instruments

The Hybrid Instruments are a combination of ownership and loan instruments. Examples are Preference Shares, Cumulative Preference Shares and Cumulative Convertible Preference Shares. Preference shares are also known as Preferred Stock. The Preference share entitle the investors to receive dividend at a fixed rate. This is the major difference between the equity share holder and preference share holder that the later gets dividend at a fixzed rate. This dividend had to be paid to the investor before dividend can be paid to equity shareholders. In the event of liquidation of the company, the claim to the company's surplus will be higher pf the holders of Prefernce shares than that of the equity holders, but however, below the claims of the company's creditors, bondholders / debenture holders. This means that if a company is liquidated, the payment will be done in the following order:

Creditor's →Debenture / Bond Holders →Preference share holder's → Equity Share Holders

General Knowledge Today

Banking & Finance-7: Insurance Industry, NBFCs

Target 2016: Integrated IAS General Studies
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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

IRDA Functions, Insurance Ombudsman, Employee's State Insurance Corporation, Underwriting, Types of NBFCs and their regulators, Difference between NBFC and Banks, Infrastruture Debt Fund, Deposit Taking by NBFCs

Part-I : Insurance Industry

Insurance is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

There are different kinds of insurance. Like Auto insurance, Health Insurance, Fire insurance to protect against varied risks. Mainly however, insurance is divided into two broad Categories:

- Life Insurance
- General Insurance

History of Life Insurance

The technique of pooling of resources to be re-distributed in times of calamities and emergencies like fire, floods, famine and epidemics is not new in India. This concept of insurance finds mention in the writings of Manu's Manusmiriti, Yagnavalkya's Dharmasastra and Kautilya's Arthasastra. Insurance records in the form of Marine trade loans and carrier's contracts exist dating ancient times. Over time, the concept of Insurance evolved in India drawing heavily from other countries, particularly England.

Timeline of Life Insurance Companies

- 1818: establishment of the Oriental Life Insurance Company in Calcutta. This company failed in 1834.
- 1829: the Madras Equitable started transacting life insurance business in the Madras Presidency.
- 1870: British Insurance Act enacted, Industry back then was dominated by foreign insurance offices which did good business in India.
- 1914: the Government of India started publishing returns of Insurance Companies in India.
- 1912: The Indian Life Assurance Companies Act, the first statutory measure to regulate life business was enacted.
- 1928: Indian Insurance Companies Act was enacted. This act enabled the Government to collect statistical information about both life and non-life business transacted in India by Indian and foreign insurers including provident insurance societies.
- 1938: Insurance Act, 1938 amended previous act and consolidated it with comprehensive provisions for effective control over the activities of insurers.
- 1950: The Insurance Amendment Act abolished Principal Agencies. However, due to fierce competition and allegations of unfair trade practices, The Government of India, decided to nationalize insurance business.
- 1956 Insurance sector nationalized and Life Insurance Corporation came into existence.

Life Insurance Corporation

The LIC absorbed 154 Indian, 16 non-Indian insurers as also 75 provident societies—245 Indian and foreign insurers in all. The LIC had monopoly in the insurance sector in India till the late 90s when the Insurance sector was reopened to the private sector.

History of General Insurance in India

Industrial Revolution in the west and the consequent growth of sea-faring trade and commerce in the 17th century gave rise to the concept of General Insurance.

Timeline of General Insurance Cos.

- 1850: General Insurance has its roots in the establishment of Triton Insurance Company Ltd., in Calcutta by the British.
- 1907: Indian Mercantile Insurance Ltd, was set up and was the first company to transact all classes of general insurance business.
- 1957: the General Insurance Council, a wing of the Insurance Associaton of India was formed. It framed a code of conduct for ensuring fair conduct and sound business practices.
- 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins.

- 1972 *General Insurance Business (Nationalization) Act* was passed and with it, general insurance business was nationalized with effect from 1st January, 1973. 107 insurers were grouped into four companies, namely:
    - National Insurance Company Ltd.,
    - The New India Assurance Company Ltd.,
    - The Oriental Insurance Company Ltd and
    - The United India Insurance Company Ltd.
- 1971: The General Insurance Corporation of India was incorporated as a company, it commence business on January 1st 1973.
- 1990s: The process of re-opening of the sector had began and the last decade and more has seen it been opened up substantially.
- 1993: the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective of Malhotra committee was to complement the reforms initiated in the financial sector. The committee submitted its report in 1994 and recommended that the private sector be permitted to enter the insurance industry, preferably in a joint venture with Indian partners.
- 1999: Following the recommendations of the Malhotra Committee report, in 1999, the

Insurance Regulatory and Development Authority (IRDA) was constituted.

- 2000: IRDA opened up the market with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%.
- 2000: Subsidiaries of the General Insurance Corporation of India were restructured as independent companies and GIC was converted into a national re-insurer.
- 2002: Parliament passed a bill de-linking the four subsidiaries from GIC.

Structure of Insurance Industry in India

Today there are 27 general insurance companies including the ECGC and Agriculture Insurance Corporation of India and 24 life insurance companies operating in the country.

The insurance sector is a 72 Billion USD industry and is growing at a speedy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP.

A well-developed and evolved insurance sector is a boon for economic development of the country as it provides long-term funds for infrastructure development at the same time strengthening the risk taking ability of the country. The insurance sector went from being unregulated to completely regulated and then being partly deregulated.

IRDA: The Insurance Industry Regulator

The autonomous, apex and statutory body which regulates and develops the insurance industry in India is the Insurance Regulatory and Development Authority (IrDA). It is a statutory body constituted by IrDA act 1999, which was passed on the recommendation of the Malhotra Committee report of 1994. IrDA began functioning in April 2000. This agency operates from its headquarters at Hyderabad, where it was shifted from Delhi in 2001.

Functions of IRDA:

- Protect the rights of policy holders
- Provide registration certification to life insurance companies
- Renew, Modify, Cancel or Suspend this registration certificate as and when appropriate.
- Promoting efficiency in the conduct of insurance business;
- Promoting and regulating professional organisations connected with the insurance and re-insurance business
- Regulating investment of funds by insurance companies;
- Adjudication of disputes between insurers and intermediaries or insurance intermediaries;

Organizational structure or Composition of IrDA

IRDA is a ten member body consisting of:

- A Chairman (Currently T.S. Vijayan)
    - Five whole-time members,

- Four part-time members,

All members are appointed by the Government of India.

Insurance Ombudsman

The Insurance Ombudsman is created by Government of India for individual policyholders to have their complaints settled out of the courts in an impartial, efficient and cost-effective way.

There are 12 Insurance Ombudsman in different locations in India that an insured person can approach. Usually complaints are lodged with the ombudsman having jurisdiction over the location of the insurance company office that the insured person has a complaint against.

- Insured persons can approach the Ombudsman with complaint if:
- They have first approached their insurance company with the complaint and the company has not resolved it.
- Not resolved it to the insured person's satisfaction or
- Not responded to it at all for 30 days
- An insured person's complaint pertains to any policy you have taken in his/her capacity as an individual and
- The value of the claim including expenses claimed is not above Rs 20 lakh

A complaint to the Ombudsman can be about:

- Any partial or total repudiation of claims by an insurer
- Any dispute about premium paid or payable in terms of the policy
- Any dispute on the legal construction of the policies as far as it relates to claims
- Delay in settlement of claims
- Non-issue of any insurance document to you after you pay your premium
- The settlement process

The Ombudsman acts as counsellor and mediator and arrives at a fair recommendation based on the facts of the dispute.

Integrated Grievance Management System

IRDA has launched the Integrated Grievance Management System (IGMS). Apart from creating a central repository of industry-wide insurance grievance data, IGMS is a grievance redress monitoring tool for IRDA. Policyholders who have grievances should register their complaints with the Grievance Redress Channel of the Insurance Company first. If policyholders are not able to access the insurance company directly for any reason, IGMS provides a gateway to register complaints with insurance companies.

- Complaints are registered with insurance companies first and only if need be, be escalated them to IRDA (Consumer Affairs Department). IGMS is a comprehensive solution which not only has the ability to provide a centralised and online access to the policyholder but complete access and control to IRDA for monitoring market conduct issues of which policyholder grievances are the main indicators.

- IGMS has the ability to classify different complaint types based on pre-defined rules. The system has the ability to assign, store and track unique complaint IDs. It also sends intimations to various stakeholders as required, within the workflow. The system has defined target Turnaround Times (TATs) and measures the actual TATs on all complaints. IGMS sets up alerts for pending tasks nearing the laid down Turnaround Time. The system automatically triggers activities at the appropriate time through rule based workflows.

A complaint registered through IGMS will flow to the insurer's system as well as the IRDA repository. Updating of status will be mirrored in the IRDA system. IGMS enables generation of reports on all criteria like ageing, status, nature of complaint and any other parameter that is defined. Thus IGMS provides a standard platform to all insurers to resolve policyholder grievances and provides IRDA with a tool to monitor the effectiveness of the grievance redress system of insurers.

Insurance Repository

An Insurance Repository is a facility to help policy holders buy and keep insurance policies in digital/electronic form, rather than as a paper documents.

The Finance Minister of India recently announced the setting of insurance repository system.Like Share Depositories or Mutual Fund Transfer Agencies, Insurance Repositories, will hold electronic records of insurance policies issued to individuals and such policies are called "electronic policies" or "e-Policies".

In 2013, IRDA has issued licences to five entities to act as Insurance depositories, these companies will maintain data of insurance policies in electronic form for insurers and will open e-Insurance accounts for policyholders.

- Central Insurance Repository Limited (CIRL)
- NSDL Database Management Limited
- SHCIL Projects Limited
- Karvy Insurance repository Limited
- CAMS Repository Services Limited

Benefits of Insurance Repositories

- Policies stored in the electronic form, don't run the risk of losing the physical documents.
- It becomes easier to track one's policies as the details will be available at one place. Insured person won't have to go to different offices anymore.
- Less paperwork. With the repository as the single point of service, updating details will

become easier, faster and more reliable.

Privatization of Life Insurance in India

In 1993 RN Malhotra Committee was appointed by the Government of India to lay down a road map for privatisation of the life insurance sector. The committee submitted its report in 1994, but it took another six years before the enabling legislation was passed in 2000.

In the same year, insurance regulator – Insurance Regulatory and Development Authority IRDA—started issuing licenses to private life insurers. All insurance companies in India have to comply with the regulations laid out by IRDA. Today, life Insurance is the fastest growing sector in India since 2000 as Government allowed Private players and FDI up to 26% and then Cabinet approved a proposal to increase it to 49%. Apart from Life Insurance Corporation of the Public sector, there are 23 other private sector life insurers, most of them joint ventures between Indian and global insurance groups.

Some famous brand names in the Life Insurance Business in India are:

Aviva India, AEGON Religare, Bajaj Allianz, HDFC Life, ICICI Prudential, IDBI Federal Life Insurance, IndiaFirst Life Insurance Company, ING Life India, LIC, Max Life, Peerless Group, Reliance, SBI Life, Sun Life Financial etc.

Foreign Direct Investment (FDI) Policy in Insurance Sector

- As of now, the maximum participation in an Indian insurance company is restricted to 26.0% of its equity / ordinary share capital with the balance being funded by Indian promoter entities.
- 26% cap on foreign investments in the insurance sector also applies to intermediaries such as brokers, third party administrators and surveyors.
- Insurance brokers are entities which arrange insurance contracts with insurers or reinsurers on behalf of their clients.
- The Indian government has supported an increase in the FDI limit, which requires a change in the Insurance Act.
- In 2005 the Union budget had recommended that the ceiling on foreign holding be increased to 49.0%.
- A change in the Insurance Act requires a passage of the bill in both houses of Parliament.
- The Indian government tabled the bill in the Upper House of Parliament in August 2010 and again in 2014 but did not pass.
- IRDA has set up a committee to study the option of allowing 100 percent FDI in insurance intermediaries, third-party administrators, surveyors and loss assessors. But action on this, too, would have to wait.

Types of Life Insurance

Term Insurance Policies

This kind of policy secures the immediate needs of nominees or beneficiaries in the event of sudden or unfortunate demise of the policy holder. The policy holder does not get any monetary benefit at the end of the policy term except for the tax benefits. In the event of death of the policy holder, the sum assured is paid to his or her beneficiaries.

Money-back Policies

Under such a policy the policy holder receives a fixed amount at specific intervals throughout the duration of the policy. In the event of the unfortunate death of the policy holder, the full sum assured is paid to the beneficiaries.

Unit-linked Investment Policies (ULIP)

A ULIP is a product offered by insurance companies gives investors the benefits of both insurance and investment under a single integrated plan, unlike a pure insurance policy which only provides financial cover without the added advantage of an investment.

The money collected by the insurance provider is utilized to form a pool of fund which is used to invest in various markets instruments (debt and equity) in varying proportions just like it is done for mutual funds.

Pension Policies

These are retirement planning investment schemes where the sum assured or the monthly pay-out after retirement entirely depends on the capital invested, the investment timeframe, and the age at which one wishes to retire.

Health Insurance In India

Health insurance is the issuance that essentially coves all types of medical expenses. A health insurance policy is a contract between insurance and individual or group in which insurer agrees to provide specified health insurance cover in exchange of a regular "premium".

Since 1986 the health insurance industry has grown significantly due to liberalisation and general awareness. By 2010, more than 25% of India's population had access to some form of health insurance.

The General Insuance Corporation and IRDA have even launched an awareness campaign for all segments of population to improve awareness and reduce procrastination for buying health insurance.

Policies available under the health insurance cover both individuals and families.

Aspects of Health Insurance

Tax Deductions

- Under section 80D of the income tax act, the insured person who takes out the policy can claim for tax deduction for the amount invested.

Payment Options

- Direct payment / Cashless facility: here, the person does not need to pay the hospital as the insurer takes care of the all the treatment bills.
- Reimbursement at the end of the hospital stay : after staying for the duration of the treatment, the patient can take a reimbursement

Cost and Duration

Policy price range: Insurance companies offer health insurance from a sum insured of Rs. 5000/- for micro-insurance policies to a higher sum insured of Rs. 50 lacs and above. The common insurance policies for health insurance are usually available from Rs. 1 lac to Rs. 5 lacs.

Duration: Health insurance policies offered by non-life insurance companies usually last for a period of one year. Life insurance companies offer policies for a period of several years.

Types of Policies

Hospitalization Policy : Under such policies the insurer pays the total or partial amount of the insured person's hospital bills.

Hospital Daily Cash Benefit Policy : Under this type of schemes daily ash benefits are offered to the policyholder in terms of a fixed amount for each day of hospitalisation

Critical Illness Benefit : In the event of having critical illness, this policy is designed to mitigate expenses.

Employee's State Insurance Corporation

Functioning under the aegis of Ministry of Labour and Employment and Incorporated under the ESI Act of 1948, the ESIC is a self-financing health insurance and social security scheme for all indian workers earning less than 15000 per month as wages.

It is a contributory insurance scheme in which employer contributes 4.75% and employee contributes 1.75% of a total 6.5% of the wages earned. In return, the insured per on and their family are entitled to different types of befenits, both medical and cash. In addition to insured workers, poor families eligible under the Rashtriya Swasthya Bima Yojana can also avail facilities in ESI hospitals and dispensaries.

Recently there has been an increase in the role of information technology in ESI, with the introduction of Pehchan smart cards under the corporation's '**Project Panchdeep**', India's largest e-governance project.

Future of Insurance Sector

The future looks good for in Insurance sector. The sector has a strong potential to grow from US$ 72 billion in 2012 to US$ 280 billion by 2020. India's favorable regulatory environment which guarantees stability and fair play will be the primary driver for this growth. Foreign investors want to tap into the sector's massive potential.

Since the government liberalized the insurance sector in 2000 by opening the doors for private participation, the Indian insurance sector has gotten stronger.

Competition has provided the consumer with an unforeseen range of products, providers and enhanced service levels. The health of the insurance sector reflects a country's economy. Insurance sector generates long-term funds for infrastructure development and also increases a country's risk-taking capacity.

India's economic growth since the turn of the century is viewed as a significant development in the global economy. This view is helped in no small part by a booming insurance industry.

Select Terms related to Insurance Sector

Actuary

Actuary is a business professional who analyzes probabilities of risk and risk management including calculation of premiums, dividends and other applicable insurance industry standards.

Annuity

Annuity refers to a contract providing income for a specified period of time, or duration of life for a person or persons.

Collateralized Mortgage Obligations (CMOs)

CMOs are a type of mortgage-backed security (MBS) with separate pools of pass-through security mortgages that contain varying classes of holders and maturities (tranches) with the advantage of predictable cash flow patterns.

Policy Lapse

Policy lapse refers to termination of a policy due to failure to pay the required renewal premium.

Micro Insurance

A micro-insurance policy is a general or life insurance ploy with a sum assured of ₹ 50000 or less. IRDA has created this special category under the micro-insurance regulations, 2005, to promote insurance coverage among the economically vulnerable sections of society.

Morbidity Risk

Morbidity Risk is the potential for a person to experience illness, injury, or other physical or psychological impairment, whether temporary or permanent. Morbidity risk excludes the potential for an individual's death, but includes the potential for an illness or injury that results in death.

Mortgage Insurance

Mortgage Insurance is a form of life insurance coverage payable to a third party lender/mortgagee upon the death of the insured/mortgagor for loss of loan payments.

Package Policy

When two or more distinct policies combined into a single contract, it is known as Package Policy.

Premium

Premium is the money charged for the insurance coverage reflecting expectation of loss.

Underwriter

Underwriter is a person who identifies, examines and classifies the degree of risk represented by a proposed insured in order to determine whether or not coverage should be provided and, if so, at what rate.

Underwriting

Underwriting is the process by which an insurance company examines risk and determines whether the insurer will accept the risk or not, classifies those accepted and determines the appropriate rate for coverage provided.

Part-II: Non-Banking Financial Companies

NBFCs or Non Banking Financial Companies are those companies which provide banking services without meeting the legal definition of a bank. A NBFC is incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934.

The NBFCs do the business of loans and advances, acquisition of shares, stock, bonds, debentures, securities issued by Government. They also deal in other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business.

However, the companies cannot be NBFCs if their primary business is related to agriculture activity, industrial activity, sale/purchase/construction of immovable property.

Usually, the 50-50 test is used as an anchor to register an NBFC with RBI. 50-50 Test means that the companies at least 50% assets are financial assets and its income from financial assets is more than 50% of the gross income.

Regulation of NBFCs

Non-Banking Financial Companies are regulated by different regulators in India such as RBI, Irda, SEBI, National Housing Bank and Department of Company Affairs. RBI regulates the companies which deal in lending, accepting deposits, financial leasing, hire purchase and acquisition of shares / stocks etc. The companies that take up activities like stock broking, merchant banking etc. are regulated by SEBI while the Nidhi and Chitfund companies are regulated by Department of Company Affairs. Housing finance companies are regulated by National Housing Bank.

Category of Companies	Regulator
Chit Funds	Respective State Governments
Insurance companies	IRDA
Housing Finance Companies	NHB
Venture Capital Fund /	SEBI
Merchant Banking companies	SEBI
Stock broking companies	SEBI
Nidhi Companies	Ministry of corporate affairs, Government of India

NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI but they need to register with respective regulators. For example:

- Venture Capital Fund/Merchant Banking companies/Stock broking companies are registered with SEBI
- Insurance Company needs to hold a certificate of registration with IRDA
- Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982
- Housing Finance Companies regulated by National Housing Bank.

Difference between NBFC and Banks

The major differences between NBFCs and Banks are as follows:

- NBFC cannot accept demand deposits (they can accept term deposits)
- NBFCs do not form part of the payment and settlement system
- NBFCs cannot issue cheques drawn on themselves
- Deposits with NBFCs are not covered by Deposit Insurance.

Different Categories of NBFCs

All NBFCs are either deposit taking or Non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND). The NBFCs which have asset size of Rs.100 Crore or more are known as Systematically Important NBFC. They have been classified so because they can have bearing on financial stability of the country. The Non-deposit taking NBFCs are denoted as NBFC-NDSI. Under these two broad categories, the different NBFCs are as follows:

Asset Finance Company(AFC)

The main business of these companies is to finance the assets such as machines, automobiles, generators, material equipments, industrial machines etc.

Investment Company (IC)

The main business of these companies is to deal in securities.

Loan Companies (LC)

The main business of such companies is to make loans and advances (not for assets but for other purposes such as working capital finance etc.)

Infrastructure Finance Company (IFC)

A company which has net owned funds of at least Rs. 300 Crore and has deployed 75% of its total assets in Infrastructure loans is called IFC provided it has credit rating of A or above and has a CRAR of 15%.

Systemically Important Core Investment Company (CIC-ND-SI)

A systematically important NBFC (assets Rs. 100 crore and above) which has deployed at least 90% of its assets in the form of investment in shares or debt instruments or loans in group companies is called CIC-ND-SI. Out of the 90%, 60% should be invested in equity shares or those instruments which can be compulsorily converted into equity shares. Such companies do accept public funds.

Infrastructure Debt Fund (IDF-NBFC)

A debt fund means an investment pool in which core holdings are fixed income investments. The Infrastructure Debt Funds are meant to infuse funds into the infrastructure sector. The importance of these funds lies in the fact that the infrastructure funding is not only different but also difficult in comparison to other types of funding because of its huge requirement, long gestation period and long term requirements.

In India, an IDF can be **set up either as a trust or as a company**. **If the IDF is set up as a trust,** it would be a mutual fund, regulated by SEBI. Such funds would be called **IDF-MF.** The mutual fund would issue rupee-denominated units of five years' maturity to raise funds for the infrastructure projects.

If the IDF is set up as a company, it would be an NBFC; it will be regulated by the RBI. The IDF guidelines of the RBI came in September 2011. According to these guidelines, such companies would be called **IDF-NBFC.**

An IDF-NBFC is a non-deposit taking NBFC that has Net Owned Fund of Rs 300 crores or more and which invests only in Public Private Partnerships (PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI)

NBFC-MFI is a non-deposit taking NBFC which has at least 85% of its assets in the form of m microfinance. Such microfinance should be in the form of loan given to those who have annual income of Rs. 60,000 in rural areas and Rs. 120,000 in urban areas. Such loans should not exceed Rs. 50000 and its tenure should not be less than 24 months. Further, the loan has to be given without collateral. Loan repayment is done on weekly, fortnightly or monthly installments at the choice of the borrower.

Non-Banking Financial Company – Factors (NBFC-Factors)

Factoring business refers to the acquisition of receivables by way of assignment of such receivables or financing, there against either by way of loans or advances or by creation of security interest over such receivables but does not include normal lending by a bank against the security of receivables etc. An NBFC-Factoring company should have a minimum Net Owned Fund (NOF) of Rs. 5 Crore and its financial assets in the factoring business should constitute at least 75 percent of its total assets and its income derived from factoring business should not be less than 75 percent of its gross income. Systemically important NBFCs.

Deposit Taking by NBFCs

- All NBFCs are not allowed to take deposits. Only those NBFCs which have specific authorization from RBI are allowed to accept/hold public deposits. NBFCs cannot take demand deposits. They can accept only term deposits with a tenure of minimum 12 months.
- The NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.
- NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors. NBFCs (except certain AFCs) should have minimum investment grade credit rating.
- The deposits with NBFCs are not insured under Deposit Insurance Scheme.
- NBFCs cannot accept deposits from NRIs except deposits by debit to NRO account of NRI provided such amount does not represent inward remittance or transfer from NRE/FCNR (B) account. However, the existing NRI deposits can be renewed.
- An unrated NBFC, except certain Asset Finance companies (AFC), cannot accept public deposits.
- There is no Ombudsman for hearing complaints against NBFCs. However, all NBFCs have in place a Grievance Redressal Officer, whose name and contact details have to be mandatorily displayed in the premises of the NBFCs.

Other Important Information

Residuary Non-Banking Company

Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits.

Do Multi-Level Marketing companies, Chit funds come under the purview of RBI?

No, Multi-Level Marketing companies, Direct Selling Companies, Online Selling Companies don't fall under the purview of RBI. Activities of these companies fall under the regulatory/administrative domain of respective state government.

What are Unincorporated Bodies (UIBs)?

Unincorporated bodies (UIBs) include an individual, a firm or an unincorporated association of individuals, which accept deposits. In terms of provision of section 45S of RBI act, accepting such deposit is illegal. The state government has to play a proactive role in arresting the illegal activities of such entities to protect interests of depositors/investors.

General Knowledge Today

Banking & Finance-8: Terms and Concepts

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Contents

This document is mainly for Preliminary examination and covers the topics objectively. This content is also useful for some of you who might be appearing in Banking Examinations as well.

Prelims MCQ Topics

Asset Liability Mismatch, Letter of Credit, ADR, IDR, GDR, Arbitrage, Mezzanine Financing, Baby Bond, Bear & Bull, Bonus Shares & Rights Share, Circular trading, Employee Stock Option, External Commercial Borrowings, Gilt fund, Green shoe option, Hedging, Insider trading, Market capitalization, Net Asset Value (NAV), Offer For Sale (OFS), Stagflation, Underwriting, Anchor Tenant.

Various Risks associated with Banking Business

There are various kinds of risks associated with the banking such as credit risk, interest rate risk, foreign exchange rate risk, liquidity risk, equity price risk, commodity price risk, legal risk, regulatory risk, reputation risk, operational risk etc. They can be broadly converged into three categories viz. Credit Risk, Market Risk and Operational Risk. They have been briefly discussed below:

Credit Risk

Credit risk is risk of loss arising from a borrower who does not make payments as promised. This event would be called "Default" and the person/ company/ entity would be called "Defaulter". Due to this, credit risk is also known as "Default Risk".

Market Risk

Market risk is the possible losses due to movement in the market prices. There are four standard market risk factors viz. stock prices, interest rates, foreign exchange rates, and commodity prices. Apart from there are associated market risks as follows:

- Equity risk, the risk that stock prices and/or the implied volatility will change.
- Interest rate risk, the risk that interest rates and/or the implied volatility will change.
- Currency risk, the risk that foreign exchange rates and/or the implied volatility will change.
- Commodity risk, the risk that commodity prices (e.g. corn, copper, crude oil) and/or implied volatility will change.

Operation Risk

Operational Risk refers to the risk of loss from inadequate or failed internal processes, people, systems or external events including

- Incompetent management
- Improper planning
- Staff fraud
- Noncompliance
- Programming errors
- System Failure
- Increased competition
- Deficiency in loan documentations.

What are different approaches for risk assets calculation?

Banks have several approaches for risks assets calculations. They have been summarized in the below table:

Credit Risk	Standard Approach, Foundation Internal rating Based approach, Advance approach. Internal rating Based
Market Risk	Standard Approach (comprising maturity method & duration method), Internal risk based approach
Operational, Risk	Basic Indicator Approach, Standard Approach, Advance measurement Approach

Internal rating and external rating approaches

Standardized Approach / External Rating Approach

Under this approach the banks are required to use ratings from External Credit Rating Agencies to quantify required capital for credit risk. The Banks have to follow it without any discretion to modify. The Reserve Bank of India has identified 4 external domestic agencies for this approach. They are CRISIL, ICRA, Care and Fitch.

Apart from this, there are international agencies such as Moody's, Fitch, Standard and Poor's etc.

Internal rating based Approach

This is basically an alternative to standardized approach. The Banks do the internal assessment of the Counterparties and exposures. Banks need RBI's nod to do this.

Different credit rating agencies in India

The Credit rating market taken a definite shape in India after the SEBI made it mandatory for any debenture that has maturity of more than 18 months maturity. There are four domestic credit ratings in India for standardized approach for credit risk calculation. They have been discussed below:

CRISIL

CRISIL is India's first credit rating agency, incorporated in 1987 and was promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions.

It commenced operations from 1988 onwards. In 1995, in partnership will National Stock Exchange, CRISIL developed **CRISIL500 Equity Index**. In 1996, it made a strategic alliance with the Standard & Poor's (S&P) Ratings Group and in the following year Standard & Poor's (S&P) Ratings Group acquired 9.68% shares in it.

In services Industry, the CRISIL in 1998 set up the Indian Index Services Ltd as a joint venture with the NSE and in 1999, it developed a Risk Assessment Model (RAM) which became a banking industry standard. S&P acquired the majority stake in the company in 2005 and so today CRISIL is a S&P company.

ICRA

India's second credit rating agency is ICRA (Investment Information and Credit Rating Agency) which was set up in 1991. It was promoted by Industrial Finance Corporation of India (IFCI), other leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency. Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA Limited is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

CARE

The third Credit rating Agency in India was CARE, that started working in 1993. It was mainly promoted by the IDBI.

ONICRA

Later another Credit rating agency ONICRA was established which now Onicra Credit Rating Agency Of India Ltd. This is a private sector agency set up by Onida Finance. Today it has a niche market and provides assessment, grading and rating models for individuals & MSMES (micro, small and medium enterprises.

Prompt Corrective Action

Prompt Corrective Action is a system of RBI under which it can initiate a corrective action in case of a bank which is found to be having low capital adequacy or high Non-performing Assets. These are called Trigger Points. RBI takes such action when Capital Adequacy Ratio goes down to less than 9% and Non-Performing Assets go up to more than 10%. Further, if return on assets us below 0.25%; this also serves as a trigger point to Prompt Corrective Action.

Asset Liability Mismatch

Asset Liability Mismatch or ALM is considered to be a comprehensive and dynamical framework for measurement, monitoring and managing the market risk of the Banks. Asset Liability Mismatch arises in the following situation:

- The Primary source of funds for the banks is deposits, and most deposts have a short- to medium-term maturities, thus need to be paid back to the investor in 3-5 years. In comparison, the banks usually provide loans for a longer period to borrowers. Out of them, the home loans and Infrastructure projects loans are of longest maturity. So when a bank provides the long term loans from much shorter maturity funds, the situation is called asset-liability mismatch.
- ALM creates Risk and Risk has to be managed. This is calledAsset Liability Management.

What are Consequences of the Asset Liability Mismatch?

The Interest rate risks (due to fluctuation) and Liquidity Risk (due to long maturity of loans) are two typical consequences of Asset Liability Mismatch.

- **Interest Rate Risk:**The banks would require to reprice the deposits faster than the loans and during this process if the bank has to pay a higher rate, the adjustment is difficult.

- **Liquidity Risk:**The banks would have to repay the depositors when their funds mature. But when they repay, the cannot recall their loans. In this situation, bank would require the new deposits. This may create a acute situation if there are no deposits available. In some cases, the bank may also need to be paying higher interests on new deposits.

Asset Liability Management

Asset Liability Management is basically management of the structure of the balance sheet (which comprises the assets and liabilities) in such a way that interest gain is maximized and risk is minimized. Most of the banks have an elaborate institutional arrangement to manage the Asset liability Mismatch. They manage the above as follows:

- Pricing large percentage of loans at variable (Floating Rate Regime) interest rates which actually move in tandem with the markets.
- Pricing the fixed interest rate loans at ahuge markup, this is usually done so that borrower is enticed to go for floating rate regime.

The above two generally take care of the Asset liability mismatch situation.

Letter of Credit

A letter of credit (L/C) is a type of "documentary credit" or a "non-fund based credit". It is a document issued by a bank or financial institution at the request of a buyer whereby the bank or financial institution gives assurance of payment to a seller if the terms and conditions specified in the document are fulfilled. This means that Letter of Credit is a promise made by Bank to pay to exporter / seller on behalf of importer / buyer. The seller receives the payment only when all the requirements specified in the L/C are met including the documents, delivery dates, product specification, etc.

Thus, a Letter of Credit has three parties:

- Buyer / Importer: Also known as Opener, as he opens the credit
- Bank / Financial Institution: Also known as Issuer, as it opens the letter of credit
- Seller / Exporter : Also known as beneficiary as credit is opened in favour of him.

Types of Letter of Credit

There are several types of Letter of Credit on the basis of various levels of security they grant to the beneficiary (seller/exporter).

Irrevocable Letter of Credit

An irrevocable Letter of Credit cannot be modified or cancelled without the agreement of all the three parties.

Revocable Letter of Credit

A revocable letter of credit may be modified or even cancelled by the issuing bank at any time and without notice to the beneficiary. Such L/Cs are rare now a days as they give maximum flexibility to the buyers but involve risk to the seller.

Confirmed Irrevocable Letter of Credit

In a confirmed Irrevocable L/C, another bank (called Confirming Bank) is yet more party which obliges itself to honour the L/C in same manner as issuing bank. Such L/C is used to back up the credit standing of the issuing bank and to mitigate the risk in foreign trade by replacing foreign bank risk by domestic bank risk.

Unconfirmed Irrevocable Letter of Credit

In Unconfirmed Irrevocable Letter of Credit, a seller's domestic bank (called advisory bank) acts as agent of the issuing bank but without assuming any responsibility towards the beneficiary. The role of advisory bank here is limited to taking care of the authenticity of the issuing bank and documentary credit.

Revolving Letter of Credit

A revolving Letter of Credit is used in the case of regular business transactions between the buyer and the seller. The L/C is issued only once but remains valid for a stated period of time for a number of transactions without issuing another L/C. The Revolving L/C can be either revocable or irrevocable.

A Letter of Credit ensures the seller that his payment will be made as long as the services are performed (dispatch of goods in case of foreign trade). Thus, Letter of Credit serves as a guarantee to the seller that he or she will be paid as agreed. Letter of Credit is an instrument of trade financing.

Glossary of Terms

American Depository Receipts (ADR)

American Depository Receipt is a certificate issued in the United States declaring ownership of shares of a foreign company. The original securities are lodged in Bank/ Custodian abroad, and the American Depository Receipts (ADRs) are traded in the US for all intents and purposes as if they were a domestic stock. An ADR dividend is paid in US dollars, so it provides a way for American investors to buy foreign securities without having to go abroad, and without having to switch in and out of foreign currencies.

Appreciation and depreciation of currency

Appreciation refers to rise in the value of one currency in terms of another, while depreciation is reverse. For example, when value of 1 Dollar changes from Rs. 60 to Rs. 64; it will be appreciation of dollar while depreciation of Rupee.

Arbitrage

Arbitrage consists of purchasing a commodity or security in one market for immediate sale in another market to make profit.

Arbitration

An alternative dispute resolution mechanism for resolving disputes.

Asset based securitization

This refers to the process in which the securities are collaterised by assets mortgaged against loans, assets leased out, trade receivables, or assets sold on hire purchase basis or installment contracts on personal property.

Authorized Capital

The amount of capital that a company has been authorized to raise by way of equity and preference shares, as mentioned in the Articles of Association / Memorandum of Association of the company.

Baby Bond

This term is used in United States. It refers to a bond with a face value of less than $1000 usually in $100 denominations.

Badla

Badla is a term is used in stock markets. It refers to carrying forward of transactions from one settlement period to another without effective delivery. This is permitted only in specified securities and is done at the making up price which is usually the closing price of the last day of settlement.

Bancassurance

It's a phenomenon whereby a bank sells insurance product via cross selling.

Bankers acceptance

A short-term credit investment created by a non-financial firm and guaranteed by a bank to make payment. Acceptances are traded at discounts from face value in the secondary market.

Basis Point

Basis point in banking / finance refers to one hundredth of a percentage point. This term is frequently used in terms of interest rates and monetary policy rates of RBI. For example, when RBI reduces a rate such as Bank Rate from a rate such as 5.25% to 5.33% the change would be eight basis points.

Bear & Bull

In terms of share markets, a Bear is an investor / broker or any other market player who expects the market price of shares to decline. The term also refers to the one who has sold shares which he does not possess, in the hope of buying them back at a lower price, when the market price of the shares come down in the near future.

- A <u>Bear Market</u> is a weak or falling market characterized by the abundance of sellers.
- If there is a false signal in the markets that the rising prices of a stock would reverse and sink, but actually it does not happen; then it is called a <u>Bear Trap</u>.

On the other hand, a market player who believes prices will rise and would, therefore, purchase a financial instrument with a view to selling it at a higher price is called Bull. A Bull Market refers to a rising market with abundance of buyers and relatively few sellers.

Bid Price and Ask Price

In auctions markets, a bid price is an offer to buy; while ask price is an offer to sale. The difference between the bid price and the ask price is called Bid-Ask spread.

Blue Chip

Blue chip companies refer to the companies which have best rated shares with the highest status as investment based on return, yield, safety, marketability and liquidity.

Bonus Shares

Profit making companies may desire to convert their profit into share capital. This can be done by issue of bonus shares. Issue of Bonus shares is also called as conversion of profit into share capital or capitalization of profits. Bonus can be of two types:

- Making partly paid shares into fully paid by declaring bonus without requiring shareholders to pay for the same.
- Issue of fully paid equity shares as bonus shares to the existing equity shareholders

Rights Share

A company can issue additional shares at any time by passing an ordinary resolution at its General Meeting. However such additional shares must be first offered to the existing equity shareholders in the proportion of the shares already held by them. Such additional shares are called "Rights Shares". Rights shares should be within the limits of the authorized capital. If not so, then the authorized capital must be increased first suitably. The issue of Rights Shares is to be made after two years from the formation of the company or after one year from the first allotment of shares.

Book building process

In share Markets, the Book Building is basically a process used in IPOs for efficient price discovery. It is a mechanism where, during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date.

In India, the Price discovery through book building process is more popular than a normal issue. In the case of Price discovery through book building process, the price at which securities will be allotted is not known, while in case of offer of shares through normal public issue, price is known in advance to investor. Under Book Building, investors bid for shares at the floor price or above and after the closure of the book building process the price is determined for allotment of shares.

Market Boom

A condition of the market denoting increased activity with rising prices and higher volume of business resulting from greater demand of securities. It is a state where enlarged business, both investment and speculative, has been taking place for a sufficiently reasonable period of time.

Bubble

A speculative sharp rise in share prices which like the bubble is expected to suddenly burst.

Bulldog Bond

This term is used in UK. It refers to a bond denominated in sterling but issued by a non British borrower.

Buoyancy

Buoyancy refers to the rising trend in prices.

Butterfly spread

An option strategy involving the simultaneous sale of an at the money straddle and purchase of an out of the money strangle. Potential gains will be seen if the underlying remains stable while the risk is limited should the underlying move dramatically. It's also the simultaneous buying and selling of call options at different exercise prices or at different expiry dates.

Call option and Put option

An option agreement that gives an investor the right, but not the obligation, to buy an instrument at a known price by a specified date. For this privilege, the investor pays a premium, usually a fraction of the price of the underlying security.

In put option, the investor the right, but not the obligation, to sell an instrument at a known price by a specified date.

Circular trading

Circular trading is a fraudulent trading scheme where sell or buy orders are entered by a person who knows that the same number of shares at the same time and for the same price either have been or will be entered. These trades do not represent a real change in the beneficial ownership of the security. These trades are entered with the intention of raising or depressing the prices of securities.

Circuit Breaker

A system to curb excessive speculation in the stock market, applied by the Stock Exchange authorities, when the index spurts or plunges by more than a specified per cent. Trading is then suspended for some time to let the market cool down.

Common stock

Common stock refers to the units of ownership of a public company or bank. Holders of common stock typically have voting rights and receive dividends, but there is no guarantee of dividend payment.

Correction

Correction refers to temporary reversal of trend in share or commodity prices. This could be a reaction (a decrease following a consistent rise in prices) or a rally (an increase following a consistent fall in prices).

Coupon Rate

Coupon rate refers to the interest rate stated on the face of a money market instrument or bond. The interest paid on a bond expressed as a percentage of the face value. If the instrument carries a fixed coupon, the interest is paid on an annual or semi-annual basis.

Cumulative Convertible Preference Shares

A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

Cumulative Preference Shares

A type of preference shares on which dividend accumulates if not paid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

Current Ratio

Current ratio measures a company's current assets relative to its current liabilities. This gives an indication of its abilities to meet short-term liabilities; the higher the ratio, the more liquid the company.

Debentures

Debt instruments bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on a particular date on redemption of the debentures.

Depository

A depository is like a bank wherein the deposits are securities (viz. shares, debentures, bonds, government securities, units etc.) in electronic form. A Depository can be compared with a bank, which holds the funds for depositors. There are many similarities in Banks and Depositories.

- While the Bank holds funds in an account, depositories hold securities in an account.
- While Bank transfers funds between accounts on the instruction of the account holder, Depository transfers securities between accounts on the instruction of the account holder.
- While the bank facilitates transfers without having to handle money, Depository facilitates transfers of ownership without having to handle securities. Banks keep safe money, depositories keep safe securities.

In India, we have two depositories viz. National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

Depository Participant

After depository, we have another entity called Depository Participant. Depository provides its services to investors through its agents called depository participants (DPs). These agents are appointed by the depository with the approval of SEBI. According to SEBI regulations, amongst others, three categories of entities, i.e. Banks, Financial Institutions and SEBI registered trading members can become DPs. Please note that accounts are always no frills at Depositories. This means an investor can have an account with depository without any balance.

Demutualization

Process of transition from "mutually-owned" association to a company "owned by shareholders". In other words, transformation of the legal structure from a mutual form to a business corporation form and privatisation of the corporations so constituted, is referred to as demutualization.

Depository participant (DP)

An agent of the depository through which it interfaces with the investor. A DP can offer depository services only after it gets proper registration from SEBI.

Derivative Market

Markets such as futures and option markets that are developed to satisfy specific needs arising in traditional markets. These markets provide the same basic functions as forward markets, but trading usually takes place on standardized contracts.

Dividend

Dividend is the share in the company's profit after tax, paid to the shareholders, usually once or twice a year. Dividend payments do not distribute the entire net profit of a company, a part or substantial part of which is held back as reserves for the company's expansion. Dividend is declared on the face value or par value of a share, and not on its market price.

Dutch Auction

Dutch auction refers to an auction in which the auctioneer's prices fall rather than rise. In such an auction, the first person to bid wins whatever it is that the auctioneer is selling. The system is used in the Dutch flower markets and also, occasionally, as a method of selling securities.

Employee Stock Option

"Employee stock option" means the option given to the whole-time directors, officers or employees of a company which gives such directors, officers or employees, the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price.

Electronic fund transfer (EFT)

EFT refers to a system which utilizes computer and electronic components in order to transfer money or financial assets. EFT is information based and intangible.

Employee Stock Purchase Scheme (ESPS)

"Employee stock purchase scheme (ESPS)" means a scheme under which the company offers shares to employees as part of a public issue or otherwise.

Equity

Equity refers to the ownership interest in a company of holders of its common and preferred stock.

Exchange Rate Risk

The risk that adverse movements in exchange rates lead to capital losses in assets or revaluation of liabilities.

Exchange-traded derivative

A derivative which is listed and traded at an organized market-place. Derivatives exchanges generally provide standardised contracts and central clearing facilities for participants.

External Commercial Borrowings

In India External Commercial Borrowings are defined to include commercial bank loans, buyers' credit, suppliers' credit, securitized instruments such as Floating Rate Notes and Fixed Rate Bonds, etc., credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial Institutions such as International Finance Corporation (Washington), ADB, AFIC, CDC etc. ECBs are being permitted by the Government as a source of Finance for Indian corporates for expansion of existing capacity as well as for fresh investment.

Face Value

Face Value is the nominal or stated amount (in Rs.) assigned to a security by the issuer. For shares, it is the original cost of the stock shown on the certificate; for bonds, it is the amount paid to the holder at maturity. Face Value is also known as the par value or simply par. For an equity share, the face value is usually a very small amount (Rs. 5, Rs. 10) and does not have much bearing on the price

of the share, which may quote higher in the market, at Rs. 100 or Rs. 1000 or any other price. For a debt security, face value is the amount repaid to the investor when the bond matures (usually, Government securities and corporate bonds have a face value of Rs. 100). The price at which the security trades depends on the fluctuations in the interest rates in the economy.

Premium and Discount

Securities are generally issued in denominations of 5, 10 or 100. This is known as the Face Value or Par Value of the security as discussed earlier. When a security is sold above its face value, it is said to be issued at a Premium and if it is sold at less than its face value, then it is said to be issued at a Discount.

Forward Contract

An agreement for the future delivery of the underlying commodity or security at a specified price at the end of a designated period of time. Unlike a future contract, a forward contract is traded over the counter and its terms are negotiated individually. There is no clearing house for forward contracts, and the secondary market may be non-existent or thin.

Fortune 500

Since 1958, Fortune Magazine has published a list of five hundred largest American Industrial Corporations, ranked according to size of sales. These are called Fortune 500 companies.

Gilt fund

Fund that invests exclusively in government securities.

Gilt Edged

A term used to describe a bond, generally issued by the Government or issued with a Government Guarantee so much so that there are no doubts about the ability of the issuer to pay regular interest and the principal amount to the bond holders.

Global Depository Receipts

Any instrument in the form of a depository receipt or certificate created by the Overseas Depository Bank outside India and issued to non-resident investors against the issue of ordinary shares or Foreign Currency Convertible Bonds of issuing company.

Green shoe option

Green Shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post- listing price stabilizing mechanism in accordance with the specific provisions in DIP Guidelines, which is granted to a company to be exercised through a stabilising Agent.

Hedging

Hedging refers to a simultaneous sale and purchase to avoid loss.

Hypothecation

Hypothecation refers to pledging assets against a loan. The ownership of the asset or the income from the asset is not transferred, except that in default of repayment of loan the asset may be sold to realize its value. Brokers will accept shares as collateral for loans to finance purchase of shares or to cover short sales.

Indian Depository Receipt

A receipt, evidencing an underlying foreign security, issued in India by a foreign company which has entered into an agreement with the issuer and depository, custodian and depository or underwriters and depository, in accordance with the terms of prospectus or letter of offer, as may be prescribed.

Insider trading

Practice of corporate agents buying or selling their corporation's securities without disclosing to the public significant information which is known to them but which has not yet affected the price.

Institutionalization

The gradual domination of financial markets by institutional investors, as opposed to individual investors. This process has occurred throughout the industrialized world.

Interest Rate Risk

The risk that movements in the interest rates may lead to a change in expected return.

Liquid Assets

Liquid assets refer to cash or easily encashable assets to meet any request for redemption.

Market capitalization

The market value of a quoted company, which is calculated by multiplying its current share price

(market price) by the number of shares in issue, is called as market capitalization. For example, if a company A has 150 million shares in issue and current market price is Rs. 100. The market capitalization of company A is Rs. 15000 million.

Maturity Date

The date on which a loan, bond, or debenture becomes due for payment. The amount an investor receives when a security is redeemed at maturity is called Maturity value.

Merchant Banks

A bank who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management. In other words, merchant bank provides capital to companies in the form of share ownership instead of loans.

Further, the banks which deal in converting and trading foreign exchange to facilitate international trade and development are also known as Merchant banks. These banks finance trade between companies which are based in different countries. They ease the way of doing business in other countries.

MIBOR

Mumbai Interbank Bid and Offer rates. Calculated by the average of the interbank offer rates based on quotations at nearly 30 major banks.

Money Market Mutual Funds

MMMF are instruments of money markets.

Mortgage Trust

Mortgage is a unit trust which invests in mortgage loans. Effectively the unit trust invests money in real estate and receives an interest return with security over the property which has been purchased. The interest which is charged on mortgage trust loans is normally higher than that other sources of finance like banks so that the investor usually receives a very competitive rate or return.

Mortgage backed securities

Securities backed by mortgage loans, including pass-through securities, modified pass-through securities, mortgage-backed bonds, and mortgage pay-through securities.

Moral Hazard

In terms of banking and finance, moral hazard is the risk arising from morally incorrect actions of a party. For example, risk arising when party does not enter into a contract in good faith and possibly provided misleading information about its assets, liabilities or credit capacity.

NASDAQ

NASDAQ refers to National Association of Security Dealers Automated Quotations. This is a United States organization that provides a computerized information network through which brokers, banks and other investment professionals can obtain up to the minute price quotations on securities traded over the counter.

Negotiated Dealing System (NDS)

Electronic platform for facilitating dealing in Government Securities and Money Market Instruments, introduced by RBI.

Net Liquid Assets

Net Liquid Assets is Cash and readily marketable securities minus current liabilities of a company. This figure gives information about a company's ability to meet its current debt obligations.

Net Asset Value (NAV)

Net Asset Value refers to the current market worth of a mutual fund's share. A fund's net asset value is calculated by taking the fund's total assets, securities, cash and any accrued earnings, deducting liabilities, and dividing the remainder by the number of units outstanding.

In context with investment, the NAV of an investment scheme is a number which represents the value in rupees per fund unit as on a particular date of the assets of the fund less liability and outstanding expenses.

Thus, if the NAV in more than the face value, it means our money has appreciated and vice-versa.

NAV is only the value that a fund's assets would realise, less liabilities, in case the fund was liquidated

as on the particular date to which NAV relates. But there is no uniformity in accounting policies of the various funds and hence one cannot compare one fund with another.

Non deliverable swap

Similar to a non deliverable forward, the only difference being that settlement for both parties is done through a major currency.

Offer For Sale (OFS)

OFS refers to an offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document.

OTC (Over the Counter)

A financial transaction that is not made on an organized exchange. Generally the parties must negotiate all the details of each transaction or agree to use simplifying market conventions.

Penny Stocks

This term is used in United States. It refers to very low priced stocks– sometimes selling at a few pennies per share sometimes for a dollar or two- in speculative companies.

Price Earnings Ratio

The ratio of the market price of the share to earnings per share. This measure is used by investment experts to compare the relative merits of a number of securities.

Price rigging

When persons acting in concert with each other collude to artificially increase or decrease the prices of a security, the process is called price rigging.

Samurai Bonds

Foreign bonds offered in the Japanese Bond Market.

Stagflation

The combination of sluggish economic growth, high unemployment and high inflation.

Underwriting

An agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.

Underwriter

One who does underwriting. A financial organization that handles sales of new securities which a company or municipality wishes to sell in order to raise money. Typically the underwriters will guarantee subscription to securities say, an issue of equity from the company at a stated price, and are under an obligation to purchase securities upto the amount they have underwritten, should the public not subscribe for the issue.

Venture Capital

Professional moneys co-invested with the entrepreneur usually to fund an early stage, more risky venture. Offsetting the high risk is the promise of higher return that the investor takes. A venture capitalist not only brings in moneys as " equity capital" (i.e. without security/charge on assets) but also brings on to the table extremely valuable domain knowledge ,business contacts, brand equity, strategic advice, etc. He is a fixed interval investor, whom the entrepreneurs approach without the risk of "takeover".

Window Dressing

A manoeuvre often engaged in by companies, banks, mutual funds etc., at the end of the accounting period in order to impress stock holders who will be receiving the report showing that funds are better managed and invested than what might have been drawn up.

Yankee Bond

A bond offering in the U.S. domestic market by a non-U.S. entity registered with the SEC.

Joint Venture

Association of two or more entities (whether corporate, government, individual or otherwise) combining property and expertise to carry out a single business enterprise and having a joint proprietary interest, a joint right to control and a sharing of profits and losses.

Regardless of the scope of the undertaking, the nature of the JV must:

- be a separately identifiable entity
- have an ownership interest in such entity by each joint venture partner ("JVP"); and
- have an active management involvement or deliberate rejection of the right to such involvement by each JVP.

JVs are common and successful in several industries. For example, in the land development and construction industries, JVs are often used to obtain sufficient financing to acquire large land tracts or to undertake major building projects. JVs are also common in the manufacturing, mining, and service industries.

Credit Authorization Scheme

The Credit Authorization Scheme (CAS) was launched in 1965 and was withdrawn in 1989. Under this scheme, all commercial banks had to obtain prior approval / authorization of the RBI before granting a loan of Rs. 1 crore or more to a single borrower.

Anchor Tenant

Planned shopping mall concept was developed by Victor Gruen in 1950s. It was then only realised that the success of the mall will depend on the number and kind of large stores which will set-up their business in there. Such stores will ultimately define the financial stability of the mall as it acts as the major crowd pullers.

An Anchor Tenant, anchor store, draw tenant or key tenant is the major departmental store in the mall which becomes the reason for people to visit the mall. As the anchor store pulls the maximum traffic it is also called as the magnet store. The concept of malls caught up in Indian markets in the

last decade. India now has over 300 malls, but it is only a few of them which are running successfully. As per a report by CBRE South Asia Private Limited, the rate of success is more dependent on the anchor tenant mix than the location or size. The anchor tenants usually have their rents discounted and may also be offered cash benefits by the mall to remain in the mall or may also be offered a share in profits. Also, within a mall such stores are widely spaced to make other stores visible by getting suitable exposure as the shoppers move from one anchor to another. Mostly it is the presence of an anchor store in the vicinity that drives the traffic for satellite stores. Thus, anchor tenants are given the right to dictate the choice of satellite stores around it. This is done to not let any satellite store to open shop whose core philosophy is juxtaposed with that of the anchor.

The International Council for Shopping Centers has outlined the presence of anchors as the main characters for two kinds of malls classified on the basis of their area-regional center mall and superregional center mall. The former has only 2 or more anchors while the latter have 3 or more.

Another popular term is Shadow Anchor which means a small shopping complex gains from the presence of a magnet store in close vicinity or just next door.

Primary Credit Societies

Primary Cooperative Credit Societies are formed at village or town level. A primary credit society refers to any cooperative society other than a primary agricultural credit society. It is basically an association of members residing in a particular locality. The members can be borrowers or non-borrowers. The funds of this society are derived from the share capital of the deposits and also the loans from central cooperative banks.

According to the norms, the paid-up share capital and reserves of a Primary Credit Society should be less than Rs 1 lakh. Such as society can do banking business without being required to take a licence from the RBI. However, the Banking Laws (Amendment) Act, 2012 has permitted RBI to assume additional regulatory powers over co-operative banks. It also gives the regulator the power to withdraw freedom given to primary co-operative credit societies to operate as banks without a licence from RBI.

In the Primary Cooperative Credit Society, the borrowing powers of the members as well as of the society are fixed. It generally gives small credit for farm inputs, fodder, fertilizers, pesticides etc.

Initial Public Offering (IPO)

When an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public, it is called Initial Public Offering or IPO. An IPO paves way for listing and trading of the issuer's securities.

Pricing of IPO

When a company makes an IPO, the prior requirement would be to decide a price of the Issue / share. The question is -who will decide what should be the price? In India, there is a system of free

pricing since 1992. However, there are guidelines that the company (Issuer) will decide the price in consultation with Merchant Banker. Still there is no formula for deciding the price of an IPO. Please note that SEBI does not play any role on pricing of shares, but the company and merchant banker are required to give full disclosures of the parameters which they had considered while deciding the issue price. While deciding the prices, there are two possibilities,

- Where company and Lead Merchant Banker fix a price. This is called Fixed Price.
- Where the company and the Lead Manager (LM) stipulate a floor price or a price band and leave it to market forces to determine the final price. This is called the Price discovery through book building process.

Listing & Delisting of Securities

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading. The term ' Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange.

Bid Price

The ' Bid' is the buyer's price. It is this price that you need to know when you have to sell a stock. Bid is the rate/price at which there is a ready buyer for the stock, which you intend to sell. The 'Ask' (or offer) is what you need to know when you're buying i.e. this is the rate/ price at which there is seller ready to sell his stock. The seller will sell his stock if he gets the quoted "Ask' price.

Debt Instruments

A shareholder, whatever might be the quantity of the shares, is a part owner of the company and entitled to all the benefits of ownership, including dividend (company's profit distributed to owners). Over the years if the company performs well, other investors would like to become owners of this performing company by buying its shares. This increase in demand for shares leads to increase in its share prices. When the prices of the share increase, the investors have option of selling their shares at a higher price than at which they purchased it. Thus investor can increase their wealth, provided they make the right choice, as the reverse is also true.

Apart from the shares, there are many other financial instruments (securities) used for raising capital. Debentures or bonds are debt instruments which pay interest over their life time and are used by companies to raise medium or long term debt capital. If an investor prefers fixed income, he / she may invest in these instruments which may give him / her higher rate of interest than bank fixed deposit.

In the Indian securities markets, the term ' bond' is used for debt instruments issued by the Central and State governments and public sector organizations and the term 'debenture' is used for instruments issued by private corporate sector.

The Debt Instruments may be Corporate Debt or Government Debt. Corporate debt instruments are generally called Debentures while Government debt instruments are generally called Bonds, but Bonds can be issued by companies and local governance bodies too.

Joint stock company

Business partnership done by separate contributions individually from a group of stakeholders. The stockholders get certificate of ownership which they can freely transfer or sell to others. Company is managed and run by an appointed Board of Directors. Shareholders can attend AGMs, get copy of annual report and also vote on account audits.

Trusts

It is an obligation where property is held by one person or persons for the benefit of the owner. The owner thus transfers his property to the trustees. It is run under a contract which defines the terms on which the trust is run. It generally has the following participants: Appointer, beneficiary, protector and settler.

Executors and administrators

They are the ones to whom the property of a dead person gets attached. Their role becomes prominent if the deceased person has left a will If person dies without making a will, an administrator will be appointed by the court. The power of an administrator is drawn from the

Probate Act while the powers of the executor are statutory. He can also be given some additional powers as per the terms of the will.

Local authorities

They are government administrative offices which are smaller in scale than a state or a province. They are like municipal corporations, zila parishads, taluka panchayats etc. They execute plans for local and economic development of local area. They have right to impose various kind so taxes and duties at a local level.

SWIFT

It stands for the Society for Worldwide Interbank Financial Telecommunication. It is a mode of exchange of messages between banks in a secure and reliable way. Under the SWIFTNet network, it also markets softwares and services to other institutions dealing in finance. SWIFTNet is an international platform which connects 8,000 financial institutions in 205 countries.

SWIFT does not accommodate funds transfer and needs a corresponding banking relationship for financial exchanges. SWIFT is a cooperative society, which works under Belgian Law and has its HQs at La Hulpe. It provides revolutionary solutions for members to allow connectivity to SWIFTNet and CBTs (computer-based terminals) which members use to manage their messages.

SWIFT services fall under three key areas: securities, treasury and derivatives, trade services and payments and finally cash management. It also comes equipped with a person to person messaging service called SWIFTNet Mail.

Automated Trading System

Automated trading stands for trading financial instruments completely on computers with zero human intervention. These are the new face of investment banks as human hands are not able to cope up with volume and speed required for these systems. Banks and other financial vendors are now switching to newer programmatic trading opportunities as their e-commerce options galore. It is enabled on all kinds or primary financial instruments and derivatives.

Electronic funds transfer (EFT)

It is a way to transfer money from one place to another via electronic means. It is one of the fastest and easiest method to transfer money and is widely in use today. The money thus transferred is instantly available on the other end. Many security and safety procedures are applied like encryption, verification and passwords etc. PayPal is the biggest EFT tool available. A variety of different transactions can be performed: sale, refund, withdrawal, deposit, cashback, inter-account transfer, payment, inquiry etc.

Digital Payment System.

Digital payments deal in electronic cash, electronic currency, digital money, digital cash etc. which are exchanged only by electronic means. This involves use of digital stored value systems. It deals with a system of debts and credits which exchanges value with other system or itself. It can at times be backed by gold to increase security and authenticity. Banks too have started to offer many services wherein a person can transfer funds, purchase stocks, etc. However, there are many incidences of fraud, technical snags etc. reported

E-banking

E-banking is the electronic management of information retrieval, storage and management. In addition, customer service is highly facilitated by e-banking as bankers can give instant information about account statements, balance or other enquiries. It also reduces the cost of doing business. Banks use IT effectively to create products and sell them. It also comprises many banking services like: email, research and development, provision of services, minimises physical interaction.

Loan to Value Ratio

LTV Ratio is a lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow or he or she will need to purchase mortgage insurance.

Mezzanine Financing

This refers to a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

General Knowledge Today

International Trade and Balance of Payment

Target 2016: Integrated IAS General Studies

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Mains Model Questions

1. "International trade theory asserts the benefits of free trade. However, in reality, many countries adopt protectionist policies." Why?
2. "Non-discrimination is one of the fundamental principles of the WTO". Discuss in the light of Most-Favoured Nation (MFN) and National Treatment.
3. What are the various trade remedies available in World Trade Organization? Discuss with examples.
4. What do you understand by Technical Barriers to Trade (TBTs)? Discuss in the light of WTO agreement on TBTs.
5. What were the reasons behind failure of the Doha Development Agenda? Discuss in the light of India's stand.
6. While keeping India's concerns in focus, discuss to what extent the Bali Package and Nairobi Package have been able to bridge the divide between developing and developed countries on WTO talks.
7. Critically examine India's Foreign Trade Policy 2015-20 while discussing its salient features.
8. What do you understand by BoP disequilibrium? Discuss the causes and methods to adjust BoP disequilibrium.
9. What are invisible exports and imports? How they affect Balance of Trade and Balance of Payment. Discuss with examples.
10. What do you understand by convertibility of Rupee? Discuss India's current policy on convertibility of Rupee on current account and capital account.

Theories of International Trade

International trade refers to exchange of capital, goods, and services across international borders. The main difference between the domestic trade and the international trade is of "cost of doing trade" because the international trade involves *border costs* such as tariffs & customs, *time costs* due to distance and border delays and *other costs* associated with cultural and economic differences between the two countries. Further, the *labour* and *capital* are more mobile within the country in comparison to cross border mobility. No country today is aloof from the international trade.

There are several theories to explain why international trade takes place. They have been explained shortly here:

Adam Smith's Theory of Absolute Differences in Cost

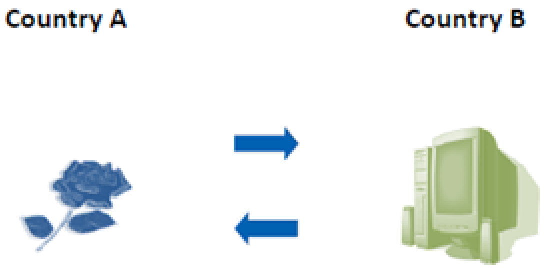
Adam Smith said that trade between two nations is based on **absolute advantage**. When one nation is more efficient than another in the production of one commodity but is less efficient than the other nation in producing a second commodity, then ***both nations can gain*** by each specializing in the production of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage.

> Adam Smith
> Adam Smith (5 June 1723 – 17 July 1790) was a Scottish moral philosopher and a pioneer of political economy. One of the key figures of the Scottish Enlightenment, Adam Smith is best known for two classic works: *The Theory of Moral Sentiments* (1759), and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). The latter, usually abbreviated as The Wealth of Nations, is considered his magnum opus and the first modern work of economics. Smith is cited as the father of modern economics and is still among the most influential thinkers in the field of economics today. In 2009, Smith was named among the "Greatest Scots" of all time, in a vote run by Scottish television channel STV. (From wikipedia)

This process helps in utilizing the resources in the most efficient way and the output of both products will rise.

Example

Suppose country A is better than country B in producing roses, and country B is better than country A in producing computers. This is because country A can produce more roses than Country B with the same number of employees per hour (read resources), while country B can produce more computers than country A under the same conditions. Then, it will be an obvious case that each country will specialize in the product that it can produce most efficiently and then trade their products: country A will export roses and import computers from B, while country B will export computers and import roses from A.



Under these circumstances, both countries would gain if each specialized in the production of product of its absolute advantage and traded with the other country*. As a result both the products would be produced and consumed in more quantities and both the nations would benefit.*

This means that the theory of Adam Smith refutes the assumption that one nation could benefit only at the expense of another nation *Adam Smith believed that all nations would gain from free trade and strongly advocated a policy of laissez-faire i.e. free trade.*

Criticism of Absolute Advantage Theory

Adam Smith's theory could not explain *why the trade takes place even when one of the trading countries* ***does not have absolute cost advantage*** in both the commodities compared to the other country. Absolute cost advantage theory can explain only a very small part of world trade such as trade between tropical zone and temperate zone or between developed countries and developing countries. Most of the world trade is between developed countries that are similar with respect to their resources and development which is not explained by absolute cost advantage.

So another theory by David Ricardo, who gave the principle of comparative cost advantage as the basis for trade, we need to discuss here briefly.

David Ricardo's Theory of Comparative Cost

As in the absolute cost advantage theory, this theory also says that international trade is solely due to differences in the productivity of labour in different countries. However, it says that the trade between countries which don't have absolute advantage can be explained by the law of *comparative advantage*. The theory is based upon some assumption such as:

- Every country has a fixed endowment of resources and all units of each particular resource are identical.
- The factors of production are perfectly mobile between alternative productions within a country.
- Factors of production are completely immobile between countries.
- Labour is the only primary input to production

- The relative ratios of labour at which the production of one good can be traded off for another differ between countries
- Countries use fixed technology
- Production is under constant cost conditions regardless of the quantity produced. Hence the supply curve for any goods is horizontal.
- There is full employment in the macro-economy.
- The economy is characterized by perfect competition in the product and market.
- There is no governmental intervention in the form of restriction to free trade.
- Transport costs are zero.
- It is a two-country, two-commodity model.

To understand this model, we suppose that there are two countries A and B producing cloth and wine. The following table gives labour hours required for the production of one unit of two commodities in the two countries.

Country	Cloth	Wine	Price Ratio
Country A	1 hour per unit	3 hours per unit	1 unit of wine: 3 units of cloth
Country B	2 hours per unit	4 hours per unit	1 Unit of wine : 2 units of cloth

The above table shows that country A has absolute cost advantage in the production of both the commodities because lesser labour hours required in the production of cloth and wine which is 1 hour per unit of cloth and 3 hours per unit of wine. This is lesser than 2 hours per unit of cloth and 4 hours per unit of wine as required in country B. *Even then trade between the two countries can be mutually advantageous so long as the difference in comparative advantage exists between the productions of two commodities.*

The example shows that country A is twice as productive as country B in cloth production whereas in wine production it is only 4/3 times as productive as the country B. Hence country A has higher comparative advantage in cloth production. Country B has comparative advantage in wine because its relative inefficiency is lesser in wine. It is half as productive in cloth while in wine the difference in labour productivity is only 1/3 minus 1/4, which is much less than ½.

The summary of Ricardo's theory is that International trade is mutually profitable *even when one of the countries can produce every commodity more cheaply than the other*.

Each country should specialize in the product in which it has a comparative advantage that is greatest relative efficiency. When trade takes place between the two countries, the terms of trade will be within the limits set by the internal price ratio before trade. For both countries to gain, the terms of trade should be somewhere between the two countries internal price ratios before trade.

Absolute Advantage

- Trade allows countries to specialize in the production of the goods that they can produce relatively MORE efficiently and import the goods that they produce relatively LESS efficiently. The exchange of these goods benefits both countries.

Comparative Advantage

- A country has a comparative advantage in producing a certain good, if the opportunity costs of producing that good in terms of other goods, is lower in that country than it is in another country

Opportunity Cost

- The opportunity cost of a certain good, e.g. roses, in terms of another goods, e.g. computers, is the number of roses that could have been produced with the resources used to produce a given number of computers. Opportunities costs differ across countries because of differences in technologies.

Heckscher-Ohlin model

Two Swedish economists, Eli Heckscher and Bertil Ohlin gave one more model of International Trade. This theory says that in reality, trade is not just determined by technological differences, but it also reflects differences in **factor endowments** across countries. For example, *Canada exports forestry products to the United States not because its workers are more efficient in forestry, but because Canada is more endowed with forests.* To explain the importance of resources in trade Heckscher and Ohlin, have developed a theory known as the "**factor proportion theory**". *This theory essentially says that countries will export products that use their abundant and low-cost factors of production, and import products that use the countries' scarce factors*.

For example, in a capital abundant country, the cost of capital will tend to be relatively low. As a consequence, the cost of production of the capital intensive product, and its price, will tend to be relatively low. The opposite will occur in a labour abundant country – wages will tend to be relatively low and the cost of the labour intensive products will be relatively low. Differences in relative prices of the two goods will lead to trade. Both countries will produce more of the good on which they have a comparative advantage.

The capital abundant country will tend to specialize in the production of the capital intensive goods and export this product, while the labour abundant country will tend to specialize in the labour intensive good and export that product. Like in the case of the Ricardian Model, also in the Heckscher and Ohlin model, it is possible that the global production of both goods may increase with trade. It is therefore possible for both trading economies to consume more of both goods than in the absence of trade and therefore, both countries gain from trade.

Trade Theory: Important Observations

Gains from Trade

There are several gains from international trade which have been mentioned the following graphics:

Gains from better utilization of resources

- Gains from specialization and from exploitation of economies of scale (producing on a larger scale)

Gains from increased competition

- Foreign competition has an effect on firms' pricing decisions. Overall, the opening up to trade reduces mark-ups of price over costs (the difference between the cost of production of a good and its selling price).

Gains from access to a broader variety of goods and services

- Consumers benefit from the access to a broader variety of goods and services. They have available not only the varieties of goods produced in their own country, but also those produced abroad.

Gains from innovation and technology transfer

- Trade enhances the incentive to innovate. The larger size of the market and competition from abroad increase the incentive of a firm to invest in research and development. Trade also favours technology transfer.

Income Redistribution by Trade

In a capital abundant country, trade induces a reallocation of resources towards the capital intensive goods – therefore more capital will be demanded and this will increase the domestic price of capital. Owners of the capital will therefore gain more because returns to capital increase. What will happen to the demand of labour in this country? – This is the relatively scarce factor, where the country has not got a comparative advantage. The demand for labour will go down and wages will go down. To sum up, in the capital abundant country, owners of capital will gain and owners of labour will lose. A consequence of these redistributive effects is likely to be that owners of the relatively abundant factor (exporters) will support trade, while owners of the relatively scarce factor will oppose free trade. It is important to bear in mind that despite income distribution effects, the country overall gains – that is gains outweigh losses. In other words, the gains from better utilization of resources (specialization), access to a broader variety of goods and increased competition, are higher than the costs derived from the redistributive effects of trade.

Adjustment Costs: One fallout of the Trade Liberalization

The adjustment costs are the result of the distributive effects of trade. Adjustment costs are the costs incurred, for example, *by displaced workers (such as in the import-competing sector) that have to look for another job.* Adjustment costs are also the costs of a firm that needs to invest in order to adjust to the new market conditions. Although these costs are unavoidable, as they are a direct consequence of the reallocation effect of trade liberalization, the size of these costs depends on a number of characteristics of the domestic market (e.g. functioning of credit and labour markets, quality of infrastructure and quality of domestic institutions). The fact that there is additional income as a result of trade means that resources are available for governments to redistribute the benefits from those who gain from trade to those who lose (e.g. supplying social safety nets or through appropriate redistributive tax systems).

Why Protectionism?

International trade theory asserts the benefits of free trade. In reality, however, many countries adopt protectionist policies. As explained above, when a country liberalizes trade, some people gain and others lose. In particular, the export sector is likely to gain from opening up to trade, while the import competing sector is likely to lose. Therefore, in most cases protectionist policies are the consequence of the lobbying activity of industries in the import-competing sectors that wish to be protected against competition from the rest of the world. There are theoretical arguments aimed at justifying the use of protection, such as the infant industry argument for protection. The argument is that the country may have a potential comparative advantage in the manufacturing sector, but the industry is too young and too little developed to compete at the international level. Although at first sight reasonable, this theory is not without drawbacks. The evidence shows that even when the protected sector did develop, it needed continued government intervention to stay in the market. In other words, infant industry protection did not led to the development of a competitive industry that eventually could face its competition in the international market. That is because the expected results would be dependent on the ability of a government to identify which industries have a potential comparative advantage.

Key Facts and Trends about Global Trade

The below trivia have been compiled from CIA Fact Book, Wikipedia and news sites. The data is of 2014 and 2015 and is subject to change.

- World's largest single country by international trade is China, followed by United States, Germany, Japan and France. In terms of International Trade, India's 2014 rank is 12.
- World's top traded commodities include Mineral fuels, oils, distillation products etc. followed by electrical / electronic equipments.
- World's top exporter is China while top importer is United States. India's world's 16th largest exporter while 8th largest importer.
- There is a strong correlation between World GDP Growth and World Trade Growth. A rise / dip in one follows rise / dip in another.
- The global trade has increased manifold in last century due to many reasons such as trade liberalization, global and regional trade agreements, reduction in trade costs etc. Further, the trade has also diversified. The share of higher technology goods has increased manifold.
- There has been a rising trend in the Foreign Value Added (FVA) Exports. These refer to intermediate goods which have the value added produced in each source country before they

are exported for their export destination.

- The influence of multinational corporations (MNCs) in global trade is ever-increasing.

World Trade Organization

The WTO is an inter-governmental organization for governments to negotiate global trade agreements and progressively liberalizing trade. Currently, WTO has 164 members. The WTO operates a system of trade rules *that apply to all its members.* The WTO is also a place for Member governments to settle their trade disputes. Its located in Geneva, Switzerland. It was established on 1 January 1995 and its official languages are English, French and Spanish.

Objectives of WTO

WTO wishes to achieve the following objectives through the multilateral trading system:

- Raise living standards
- Ensure full employment
- Ensure a large and steadily growing volume of real income and effective demand
- Expand the production of and trade in, goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development.

The Agreement also recognizes the need for "positive efforts to ensure that developing countries, and especially the least-developed among them, secure a share in the growth in international trade commensurate with their economic development".

Principle of Self Selection

WTO Member governments are generally grouped as "developed Members" or "developing Members", according to their level of development. More than two thirds of the WTO Members are developing countries. We note that there was no agreed definition of what is a "developed" or a "developing" Member in the WTO. It is up to each Member to decide if it is to be considered "developing Member" (this is known as the principle of self-selection). However, other Members can challenge the decision of a Member to be considered as a developing Member. The distinction between "developed" and "developing" Members is important because the developing Members enjoy special rights in the WTO. Some developing countries are considered least developed countries (LDCs), however, the WTO does not keep the list of LDCs. The United Nations Economic and Social Council (ECOSOC) maintains a list of the countries that are considered LDCs. Least-developed country Members (LDCs) enjoy additional rights in the WTO.

WTO Agreements

The WTO provides to its Member governments a forum for negotiating global trade rules. Negotiations in the WTO are conducted directly and exclusively by the Member governments. The WTO itself was born out of negotiations and everything it does is the result of negotiations among its Members.

The WTO agreements are essentially contracts *legally binding Member governments* to keep their trade policies within agreed limits. The WTO Agreements recognise that, in certain circumstances, Members may need to apply trade restrictions to meet certain policy objectives, such as the protection of human health or the environment. In those cases, members are allowed to depart from the basic principles, but subject to specific conditions. *Thus, the WTO rules are not absolute in nature.*

History of WTO

The history of the WTO begins with the signing of the **General Agreement on Tariffs and Trade** (GATT) in 1947. From 1948 to 1994, GATT provided the rules for the bulk of world trade and presided over periods that saw some of the highest growth rates in international trade.

Please note that the initial objective was to create an **International Trade Organization** (ITO) to handle the trade side of international economic cooperation, joining the two "Bretton Woods" institutions, the World Bank and the International Monetary Fund. The efforts to establish the ITO failed and the GATT served for several years as an organization, taking some of the functions originally intended for the ITO.

The GATT developed rules for the MTS through **eight rounds of trade negotiations**.

In the early years, the GATT trade rounds focused on reducing tariffs. Following GATT trade rounds covered not only tariffs, but also other trade barriers. During the GATT rounds, substantial liberalization for international trade in goods was achieved and fundamental rules were established on the basis of an open and non-discriminatory trading system.

GATT rounds of trade negotiations

Year	Name	Subjects Covered	Parties
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-1961	Dillon Round	Tariffs	26
1964-1967	Kennedy Round	Tariffs and anti-dumping measures. Section on trade and development.	62
1973-1979	Tokyo Round	Tariffs and non-tariff measures, "framework" agreements. Enabling Clause (development).	102
1986-1994	Uruguay Round	Creation of WTO. Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, etc.	123

During the last years of the GATT MTS was recognized as an instrument for economic and trade reforms. The eighth round, known as the Uruguay Round, was the most comprehensive round and led to the creation of the WTO and a new set of agreements (the current WTO Agreements). Negotiations under GATT lasted till the end of Uruguay Round, which lasted between 1986-1994, and GATT was replaced by the World Trade Organization in 1995.

We note here that the original GATT text (GATT 1947) is **still in effect** under the WTO framework, subject to the modifications of GATT 1994. The GATT 1947 is enshrined with some modifications in the GATT 94. The 75 existing GATT members and the European Communities became the founding members of the WTO on 1 January 1995. The Final Act concluding the Uruguay Round and officially establishing the WTO regime was signed during the April 1994 ministerial meeting at Marrakesh, Morocco, and hence is known as the Marrakesh Agreement.

Further, GATT 1994 is not the only legally binding agreement included via the Final Act at Marrakesh. There are a total of 60 agreements, annexes, decisions and understandings. These agreements are divided into 6 main parts viz.

- The Agreement Establishing the WTO
- Multilateral Agreements on Trade in Goods including the GATT 1994
- Trade Related Investment Measures (TRIMS)
- General Agreement on Trade in Services (GATS)
- Intellectual property — the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
- Dispute settlement (DSU)
- Reviews of governments' trade policies (TPRM)

Principles of WTO

The WTO Agreements are based on a number of simple and fundamental principles such as:

Non-discrimination

- Members shall not discriminate between their trading partners. This is called **Most-Favoured Nation (MFN) principle.**
- Members shall not discriminate between national and foreign like products, services or nationals. This is called **National Treatment**

More open trade

- Reducing or eliminating obstacles to trade.

Transparency and predictability

- Traders and Members need to know what are the trade rules around the world (transparency) and that trade measures will not be raised arbitrarily (predictability)
- Special treatment for less developed Members: Least developed Countries face more challenges before they start benefiting from trade liberalization therefore, they have *more time to adjust to the rules,* greater flexibility and other special rights.

Trade Policy Review Mechanisms

- WTO Members also review periodically each Member's trade policies and practices under the **Trade Policy Review Mechanism** (TPRM). These reviews allow the evaluation of individual Members' trade policies and practices and their impact on the **Multilateral Trading System** (MTS).

Settlement of Disputes

- The WTO is also a place for Member governments to settle their trade disputes. The WTO's procedure for settling disputes is vital for enforcing the rules. A dispute commonly arises when a Member adopts a trade measure that one or more Members consider to be contrary to the obligations under the WTO Agreements.
- When Members are unable to agree on a solution, they can request a panel of independent experts to rule on the dispute. The procedure for settling disputes is based on the rules contained in the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)

Building Trade Capacity

- Technical assistance and capacity building are core elements of WTO's work. More than two thirds of WTO Members are developing countries. The WTO helps these Members to fully benefit of the multilateral trading system (MTS) in various ways.

- The WTO Agreements contain special provisions for developing countries, including longer periods to implement their obligations and measures to increase their trading opportunities. WTO's **Trade-Related Technical Assistance** (TRTA) activities and programmes are geared towards sustainable trade capacity-building in beneficiary countries.
- Capacity building also involves providing assistance to build the supply-side capacity and infrastructure needed in these countries to expand their trade.

We note here that ***WTO does not provide Financial Assistance*** to the LDC member countries. However, there are ways via which developed countries provide financial assistance to LDCs. Further, IMF and WTO in collaboration have launched a **Trade Integration Mechanism** (TIM) in April 2004. In this facility, funds are provided to those developing countries which suffer temporary Balance of Payment problem as a result of multilateral trade liberalization.

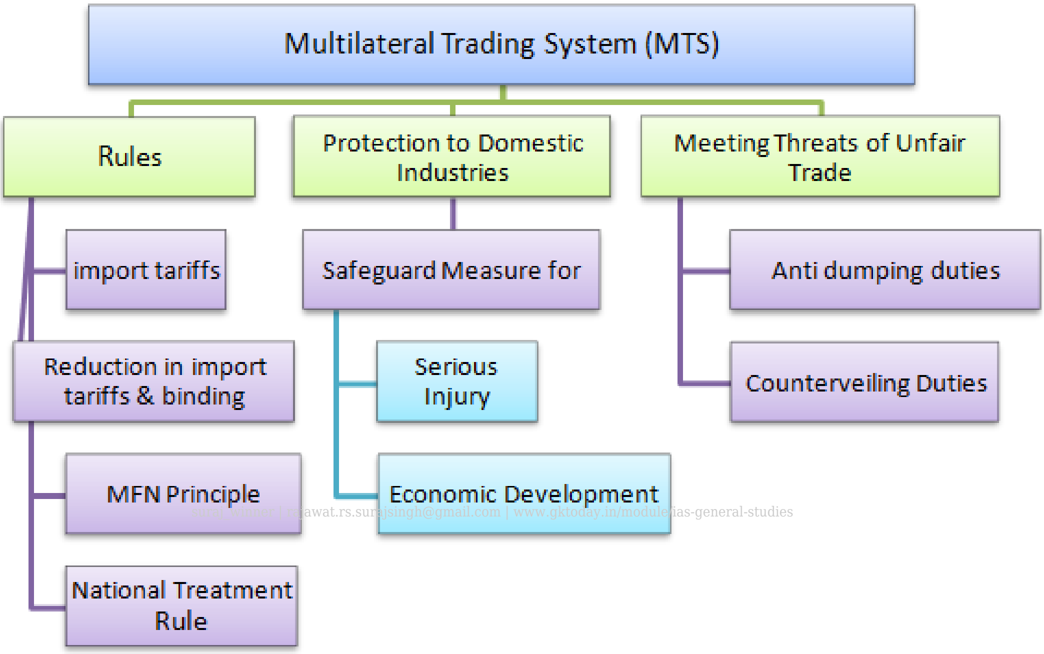
Cooperation with other International Organizations

The WTO cooperates with other international institutions to achieve greater coherence in global economic policymaking. The WTO cooperates with the International Monetary Fund and the World Bank to achieve more coherent and complementary international economic policies.

Multilateral Trading System

Multilateral Trading System is a WTO system that governs the trading among various countries.

This system has been established over the years as a result of the continuous international negotiations among the various countries. Various components of Multilateral Trading System are shown below:



Principle of Non Discrimination

Non-discrimination is a fundamental principle of the WTO. It has two components:

- The **Most-Favoured Nation** (MFN) principle: treating other WTO members equally
- The **National Treatment** Principle: treating foreigners and locals equally

These two principles apply to trade in goods, trade in services as well as trade related aspects of intellectual property rights.

Principle of Most Favored Nation

If a WTO Member grants to a country an advantage, it has to give such advantage to all WTO Members. The MFN principles ensures that every time a WTO Member lowers a trade barrier or opens up a market, it has to do so for the like goods or services from all WTO Members – without regard of the Members' economic size or level of development.

- However, there are exceptions allowed for preferential treatment of developing countries, regional free trade areas and customs unions.

Please note that under the Most-Favoured-Nation principle, should WTO Member country A agree in negotiations with state B, which needs not be a WTO Member, to reduce the tariff on the same product X to five percent, this same "tariff rate" must also apply to all other WTO Members as well. In other words, if a country gives favourable treatment to one country (Member or Non-Member) regarding a particular issue, it must handle all Members equally regarding the same issue.

Thus, the MFN principle requires to accord to all WTO Members any advantage given to any other country (Member or not of the WTO). A WTO Member could give an advantage to other WTO Members, without having to accord advantage to non- Members (only WTO Members benefit from the most favourable treatment).

Please note that the MFN status is for "like Products". The criteria for determining "likeness" are not spelled out in the WTO Agreements. Four criteria have been used in several WTO dispute settlement cases as follows:

- The physical characteristics of the products (nature, properties and quality)
- The products' end uses
- Consumers' tastes and habits
- The customs classification of the products

BENEFITS OF WTO MFN PRINCIPLE

Ensures equal access to international markets:

- The MFN principle ensures all members, including small developing members, that they will benefit from the best trading conditions provided by other members

Maximizes efficiency:

- by ensuring that each country will import from the most efficient supplier. Without the MFN principle, the importing country would impose higher tariffs or other trade barriers on the products coming from the most efficient supplier in order to protect its industry. The imposition of higher barriers would lead to inefficiencies because the most efficient firms would be punished and production would be shifted to a less efficient firm in another exporting country.

Reduces the cost of administration of trade rules:

- by requiring equal treatment among Members, the MFN principle promotes the simplification of procedures and requirements related to importation and exportation.

Minimizes costs of trade negotiations:

- countries negotiate one multilateral agreement instead of several bilateral agreements.

Exceptions to MFN:

- A member may provide preferential treatment only to some countries within a free trade area or customs union, without having to extend such better treatment to all members.
- Developed members may give "unilaterally" preferential treatment to goods imported from developing countries and least developed countries (LDCs), without having to extend such better treatment to other members.

Principle of National Treatment

Under the principle of national treatment, a WTO member should not discriminate between imports and like domestic products from a WTO member. This means that for trade in goods, the national treatment principle prohibits a WTO Member from favouring its domestic products over the imported **like products** of other Members. Please note that the national treatment applies to only internal measures, as opposed to border measures (e.g. tariffs). It covers:

- **Internal taxation** (e.g. sales, value added tax), and
- Internal laws, regulations and requirements affecting the internal sale, transportation, distribution or use of products
- The GATS and the TRIPS Agreement have similar provisions.

The objective of the National Treatment principle is to prevent countries from taking discriminatory measures on imports on the one hand, and to prevent countries from offsetting the effects of tariffs through non-tariff measures. The purpose of the national treatment rule is to **eliminate "hidden" domestic barriers** to trade by WTO Members through according imported products treatment no less favourable than that accorded to products of national origin. The adherence to this principle is important to maintain the balance of rights and obligations, and is essential for the maintenance of the multilateral trading system.

In the area of services, the national treatment principle refers to non-discrimination between, on the one hand, domestically produced services or domestic service providers and, on the other hand, imported services or foreign services providers.

Exceptions to National Treatment Principle

Please note that the following are specific exceptions to the national treatment principle (goods) *and remember them for your exam.*

- Government procurement
- Subsidies to domestic producers
- Internal maximum price control measures
- Cinematographic films

More open and predictable trade

More open and predictable trade **refers to lowering the trade barriers**. Lowering trade barriers is one of the most obvious means of encouraging trade. These trade barriers include customs duties ("tariffs"), as well as import bans or quotas. There are also several other measures that could restrict or even impede market access for goods and services.

WTO's Trade Policy Review Mechanism

The WTO's Trade Policy Review Mechanism (TPRM) was a result of the Uruguay Round. With the creation of the WTO in 1995, it was made permanent and broadened to cover also trade in services and trade- related aspects of intellectual property rights. The reviews focus on Members' domestic trade policies and practices taking into account Members' wider economic and developmental needs their policies and objectives, and the external economic environment that they face.

All WTO Members are subject to review under the TPRM. The frequency of each Member's review varies according to its share of world trade. The reviews have two broad results: they enable outsiders to understand a Member's trade policies and practices and they provide feedback to the reviewed Member.

The reviews take place in the **Trade Policy Review Body** (TPRB), which is the General Council operating under special rules and procedures, and comprises all WTO Members. The reviews are not intended to serve as a basis for the enforcement of specific obligations under the WTO Agreements, for dispute settlement procedures or to impose new commitments on Members.

Objectives

The main objectives of the TPRM are as follows:

- The smoother functioning of the MTS by achieving greater transparency and understanding of Members' trade policies and practices
- Enable the collective appreciation and evaluation of the full range of individual Members' trade policies and practices and their impact on the MTS
- Contribute to improved adherence by all Members to rules, disciplines and commitments made under the WTO Agreements

What is reviewed?

- Extent to which individual trading entities follow basic WTO principles concerning transparency of trade policies, non-discrimination in treatment of trading partners, the pattern of protection and the extent to which tariffs only are used as measures of protection in trade in goods.
- Restrictions used in trade in services, the record of adherence to the MTS and participation in dispute settlement.

TRPM for developing countries

The TPRM is a valuable tool for the development of trade policies in developing and LDC Members. Given the fact that these Members may confront with particular difficulties in adjusting their domestic policies in compliance with the WTO Agreements, a trade policy review would assist them to undertake a process of self assessment, including an examination of their participation in the WTO. Preparation for and participation in a trade policy review can be onerous for small developing countries. The WTO Secretariat may assist the Member concerned during the review process.

WTO and Regional Trade Agreements

WTO Members have the right to grant preferential treatment to their trading partners within a customs unions or a free trade area, without having to extend such better treatment to all WTO Members, subject to certain conditions. Thus, we note that this is contrary to the WTO's basic principle of non-discrimination among trading partners (MFN principle).

Enabling Clause

In 1979, as part of the Tokyo Round of the General Agreement on Tariffs and Trade (GATT), the enabling clause was adopted in order to permit trading preferences targeted at developing and least developed countries which would otherwise violate Article I of the GATT. The enabling clause permits developed countries to discriminate between different categories of trading partners (in particular, between developed, developing and least developed countries) which would otherwise violate Article I of the GATT which stipulates that no GATT contracting party must be treated worse than any other (this is known as most favoured nation treatment). In effect, this allows developed countries to give preferential treatment to poorer countries, particularly to least developed countries.

WTO rules and Balance of Payments

WTO Members retain the right to apply import restrictions to safeguard their external financial position and their balance of payments (BOPs), subject to certain conditions. These provisions require Members to progressively relax the restrictions as conditions improve and eliminate them when conditions no longer justify such maintenance.

WTO Trade Remedies

According to the WTO rules, the members can also temporarily depart from some of their basic WTO obligations in order to remedy a situation of unfair competition or a surge of imports, when these cause **injury to the domestic industry,** subject to specific requirements.

The three types of trade remedies that WTO Members are allowed to apply are as follows:

- Anti-dumping measures
- Countervailing measures and
- Safeguards measures.

These trade defence mechanisms can be used temporarily to shield vulnerable sectors from the consequences of trade liberalization in certain circumstances. *The three trade remedies allow WTO Members to impose customs duties above the bound levels.* In addition, safeguard measures may adopt the form of quantitative restrictions. The conditions applicable to the three types of trade remedies are similar, particularly in the case of anti-dumping and countervailing measures.

Anti-Dumping Measures

Dumping is a form of price discrimination, which takes place when the price of a product when exported to another country is less than the price of that same product when sold in the market of the exporting country. For example, China supplying the computer chips to European Union at a rate which is even lower than that in China itself.

Please note the following points:

- When products are exported at a dumped price, they enter the importing market with a competitive advantage **considered unfair if they cause injury to the domestic industry** producing like products. This means that in case of a dispute, it has to be proved in the WTO that the particular import caused Injury to the domestic industry.
- As a result, Members are allowed to apply anti-dumping measures to compensate for the unfair competitive advantage. The application of anti-dumping measures is subject to specific substantive and procedural requirements set forth in Article VI of the GATT and the Anti-dumping Agreement.
- A bargain sale, in the sense of ordinary trade, is not dumping.
- The country's imposition of an anti-dumping duty is determined by the dumping margin–the difference between the export price and the domestic selling price in the exporting country. By adding dumping margin to export price, the dumped price can be rendered a "fair" trade price.

Subsidies and countervailing measures

The Agreement on Subsidies and Countervailing Measures (the SCM Agreement) – addresses two separate but closely related matters

- The multilateral disciplines on the use of subsidies
- The conditions under which Members may apply countervailing measures.

Subsidies have been provided widely throughout the world as a tool for realizing government policies, in such forms as grants (normal subsidies), tax exemptions, low-interest financing, investments and export credits. There are six primary categories of subsidies, divided by purpose:

- Export subsidies,
- Subsidies contingent upon the use of domestic over imported goods,
- Industrial promotion subsidies,
- Structural adjustment subsidies,
- Regional development subsidies,
- Research and development subsidies.

By beneficiary, there are two primary categories:

- Subsidies that are not limited to specific businesses or industries (non-specific subsidies), and

- Subsidies those are limited to specific businesses and industries (specific subsidies).

Subsidies as barriers to Trade

Although governments articulate ostensibly legitimate goals for their subsidy programmes, it is widely perceived that *government subsidies may give excessive protection to domestic industries*. In such cases, subsidies act as a barrier to trade, by distorting the competitive relationships that develop naturally in a free trading system. Exports of subsidized products may injure the domestic industry producing the same product in the importing country. Similarly, subsidized products may gain artificial advantages in third-country markets and impede other countries' exports to those markets.

Because of this, for industrial goods, the WTO agreements prohibit export subsidies and subsidies contingent upon the use of domestic over imported goods, as having a particularly high trade-distorting effect. Even for subsidies that are not prohibited, it allows Member countries importing subsidized goods to enact countermeasures, such as countervailing duties if such goods damage domestic industry and certain procedural requirements are complied with. For agricultural products, it requires obligations such as reducing export subsidies and domestic supports.

Understanding Tariff

A **tariff or customs duty** is a financial charge in the form of a tax, imposed at the border on goods going from one customs territory to another. Tariffs applied to imports are usually collected by customs officials of the importing country when goods are cleared through customs for domestic consumption. Tariffs can also be imposed on exports also but the import tariffs are the most common type of tariffs and have been the main focus of attention of GATT/WTO negotiations.

There are different types of tariffs, depending on the way they are calculated. Two of the most common types of tariffs used are ad valorem tariffs and specific tariffs.

Ad valorem tariff

A tariff calculated on the basis of the value of the imported good, expressed as a percentage of such value. For example, an ad valorem tariff of 10% on an imported car worth US$ 10000 would lead to a requirement to pay US$ 1000 as customs duty.

Specific Tariff

A specific tariff is a tariff calculated on the basis of a **unit of measure**, such as weight or volume, of the imported good. For example, a tariff of Rs. 1000 per gram of Gold on imported Gold.

Impact of Tariffs

There are two main purposed of imposing tariffs by the Governments.

- To protect their domestic industries from the competition of imports.
- To collect revenue.

This means that the tariff levied on an imported product imposes costs on both, the country "exporting" the product and the country "Importing" that product and imposing the tariff. *The* *imposition of import tariffs increases the domestic price of the imported good.* This usually brings gains for domestic producers of the good and the government in the importing country, but also losses for consumers (who will buy less of the product since the price is higher) and for other domestic producers who use that good as an input.

Tariff Binding

A "bound tariff" is a tariff for which a WTO Member accepts a legal commitment not to raise it above a certain level. In the WTO, Members commit to "bind" their tariffs (during negotiations), and the "bound rate" represents the *maximum level of import duty that can be levied on a product imported into that Member*. A member is *always free to impose a tariff that is lower than the bound level*.

^^*Tariff negotiations are not only about negotiating tariff reductions, but also about negotiating tariff bindings.* Tariffs bindings provide predictability to traders by setting an upper limit on the amount of duty that can be levied on a product. In other words, traders know that the import tariff that they will have to pay for a product cannot be higher than the bound level recorded in the Schedule of concessions for that product.

For example, if assume that India is a WTO Member who made a commitment to bind its tariff on diapers at 10% ad valorem. This would imply that:

- India cannot impose a 12% ad valorem tariff on diapers imported from other WTO members.
- India can apply a 15% ad valorem tariff to a non-WTO member
- India can apply a 5% tariff that is "lower" than the bound level. However, such "lower" tariff has to be applied on an MFN basis, that is, to like diapers imported from all WTO Members

Why countries agree to reduce tariffs?

There are many implications, however major three have been discussed as below:

- It results in **enhanced market access and predictability for traders**. As tariff barriers are reduced in both developed and developing countries, increased market access opportunities will allow Members to improve welfare by expanding export volumes and revenues and through better access to their markets for imports
- The WTO rules say that the **Tariff negotiations shall be held on a reciprocal and mutually advantageous basis.** This is called **"reciprocity".** Generally, this requirement implies that negotiations for the reduction of tariffs should achieve a result that is mutually beneficial to all participants. However, the principle of reciprocity does not apply in the same manner to tariff negotiations between developed and developing country Members since it has been adapted to take account of the principle of special and differential treatment. This involves requiring from developing countries "lesser" liberalization than from developed countries in multilateral rounds of negotiations – a principle originally referred to as "non-

reciprocity" or, more recently, as "less-than-full reciprocity".

- The MFN principle plays an important role in enhancing market access for goods. With respect to tariff negotiations, the MFN rule serves to avoid concession-erosion after tariff negotiations (see example below). In addition, for developing countries and others with little bargaining power in the negotiations, the MFN principle ensures that they will benefit from the best tariff treatment resulting from the negotiations.

General elimination of quantitative restrictions

As a general rule, the WTO members cannot impose quantitative restrictions such as bans or quotas on the goods imported from or exported to another Member. While tariffs are allowed as long as they do not exceed the bound levels and are applied on a non-discriminatory basis, quantitative restrictions are generally prohibited. But there are exceptions which allow the imposition of quantitative restrictions in certain circumstances and subject to specific conditions. These exceptional rules permit the imposition of quantitative measures under limited conditions and only if they are taken on policy grounds justifiable under the GATT such as critical shortages of foodstuffs and balance of payment problems. As long as these exceptions are invoked formally in accordance with GATT provisions, they cannot be criticized as unfair trade measures.

Implications of Quantitative Restrictions

The quantitative restrictions are considered to have a greater protective effect than tariff measures and are more likely to distort free trade that is why they are prohibited. When a trading partner uses tariffs to restrict imports, it is still possible to increase exports as long as foreign products become price competitive enough to overcome the barriers created by the tariff. When a trading partner uses quantitative restrictions, however, it is impossible to export in excess of the quota no matter how price competitive foreign products may be. Thus, quantitative restrictions are considered to have such a greater distortional effect on trade than tariffs that their prohibition is one of the fundamental principles of the GATT. But also, GATT provides exceptions to this fundamental principle.

WTO: Important Agreements

There are more than different 60 agreements overseen by the WTO. Any country which is accessing to WTO must sign and ratify all WTO agreements. So, far we have discussed the main provisions related to GATT that affect the trade in goods in general. In this section, we are discussing the other main agreements as follows:

- The Agreement on Agriculture (AoA)
- Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
- Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)
- Agreement on Technical Barriers to Trade (TBT)

- Agreement on Trade Related Investment Measures
- General Agreement on Trade in Services (GATS)

Agreement on Agriculture (AoA)

The Agreement on Agriculture (AoA) was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO on January 1, 1995. It aims at reforming trade in agriculture, envisaging a fair and market-oriented system, which improves predictability and stability for both importing and exporting countries.

The Agreement allows governments to support their rural economies, but preferably through policies that **cause less trade "distortions"**.

The Agreement on Agriculture applies not only basic agricultural products (such as wheat and live animals), but also the products derived from them (such as flour and meat), as well as most processed agricultural products (e.g. chocolate and sausages). The coverage of the Agreement also includes wines, spirits and tobacco products, as well as fibres (such as cotton). Fish and fish products are not included, nor are forestry products. These products are covered by the Non-Agricultural Market Access (NAMA) negotiations of the World Trade Organization, based on the Doha Declaration of 2001. Agreement on Agriculture has three pillars.

Market access

- This rule is Tariffs Only

Domestic support

- Disciplines applicable to subsidies and other programmes granted in favour of agricultural producers

Export competition

- Disciplines on export subsidies and other methods to make exports artificially competitive

Three Pillars of Agreement on Agriculture (AoA) under WTO

Market Access – Tariff Only

The market access rule for agricultural products is "tariffs only". This means *that all non-tariff measures were to be either removed or to be replaced by tariffs*, reflecting substantially the same level of protection (this process is called "tariffication"). As per the AoA, the WTO Members committed to set tariff bindings to agricultural products and assumed reduction commitments on tariffs, which are contained in each Member's WTO Schedule of concessions on goods (Article 4).

- Different reduction commitments applied to developing and developed Members. At the same time, please note that the LDCs were not required to reduce their tariffs.

Domestic support (Subsidies)

This pillar is based upon the assumption that not all subsidies distort trade to the same extent. The Agreement distinguishes between two categories of domestic support:

- Domestic support with no, or minimal, distorting effects on trade – not subject to reduction commitments. These were kept in Green Box and Blue Box Measures.
- Domestic support with distorting effects on trade – subject to limits and reduction commitments. These were kept in Amber Box measures.

The green, Blue and Amber box subsidies are discussed below:

Green Box Subsidies

Green box subsidies are those subsidies which cause no, or at most minimal, trade distorting effects or effects on production. These include the amounts spent on Government services such as research, disease control, and infrastructure and food security. This also includes the subsidies given to the farmers that directly don't affect international trade badly. Since they are permitted in WTO regime, the most developed countries have kept providing subsidies to their farmers. The Green Box contains fixed payments to producers for environmental programs, so long as the payments are

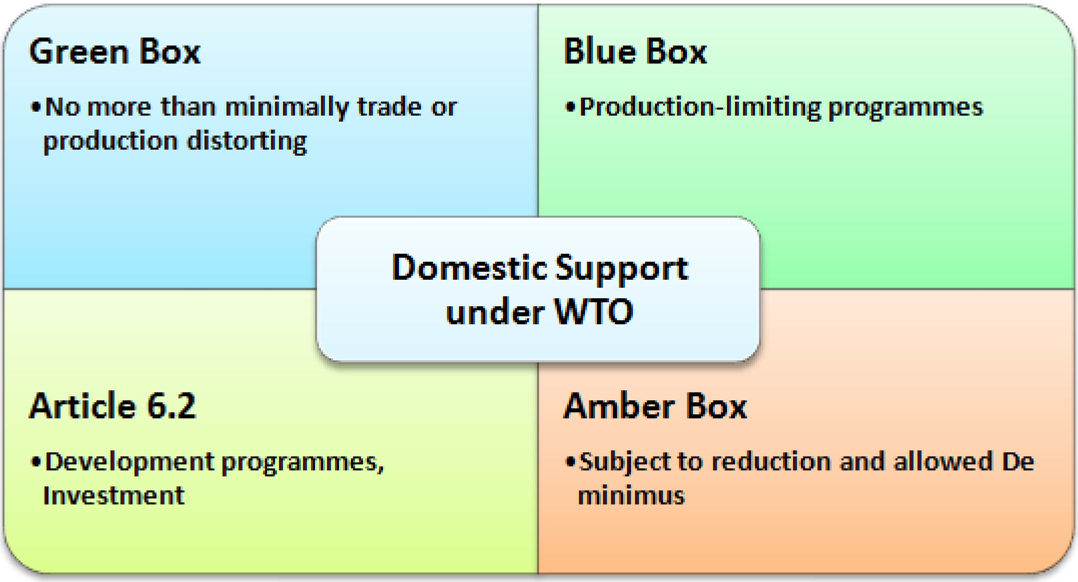
"decoupled" from current production levels.

Blue Box Subsidies

Blue Box contains direct payment subsidies which can be increased without limit, so long as payments are linked to production-limiting programs

Amber Box Subsidies

All domestic support measures considered to distort production and trade (with some exceptions) fall into the amber box The provisions accepts 5% of agricultural production for developed countries, 10% for developing countries. The Amber box subsidies with conditions designed to reduce distortion are placed in Blue Box. They include the direct payment to the farmers to reduce production. Apart from the above, there are Article 6.2 subsidies for **Development Programmes**.

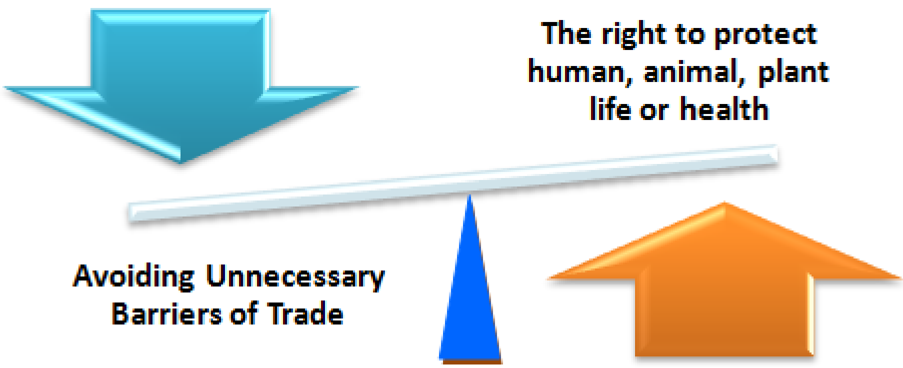


Export Competition

Export subsidies are presumed to have trade-distorting effects. They allow exporters, benefited with such subsidies, to sell below the cost of production. In that way, export subsidies reduce world prices, undercutting exporters in other countries. The Agreement on Agriculture prohibits the use of export subsidies for agricultural products, unless a Member has reserved the right to use export subsidies in its WTO Schedules of concessions.

Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)

The SPS agreement was negotiated during the Uruguay Round. Under the SPS agreement, the WTO sets constraints on member-states' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (phytosanitation) with respect to imported pests and diseases.



Sanitary and Phytosanitary measures, as well as products' technical regulations, *may result in restrictions to trade*. It is recognized that such measures may be necessary to serve legitimate objectives, such as to ensure food safety or to protect human, animal or plat life or health. However, these measures may sometimes go beyond what is needed to protect such objectives and be used to shield domestic producers from foreign competition. Some believe that the use of such types of measures for protectionist purposes is likely to increase whenever import tariffs on goods are reduced.

Sanitary and phytosanitary measures can take many forms such as requiring products to come from a disease free area, safety inspection or setting of allowable maximum levels of pesticides residues. They apply to domestically produced food or local animal and plant diseases, as well as to products coming from other countries. *Please note that under SPS agreement, burden of proof is on members to demonstrate scientifically that something is dangerous before it can be regulated. If there is no scientific proof, WTO would override the right of the country to impose such restrictions.*

Agreement on Technical Barriers to Trade (TBT)

The Agreement on Technical Barriers to Trade was last renegotiated during the Uruguay Round. TBT exists to ensure that technical regulations, standards, testing, and certification procedures do not create unnecessary obstacles to trade. The agreement prohibits technical requirements created in order to limit trade, as opposed to technical requirements created for legitimate purposes such as consumer or environmental protection. The TBT agreement is closely linked to the SPS agreement.

The TBT Agreement covers technical regulations on quality, packaging and labelling also. If a producer in country A wants to export to country B, it will be obliged to satisfy the technical requirements that apply in country B, with all the financial consequences this entails. Having many different regulations and standards involves significant costs for producers and exporters. In addition, in the absence of international disciplines, a risk remains that TBT measures could be used as an excuse for protectionism.

The TBT Agreement recognizes that no Member shall be prevented from taking measures necessary to fulfil a legitimate objective, including the protection of human, animal or plant life or health, the protection of the environment or the prevention of deceptive practices. WTO Members may protect other legitimate objectives (e.g. ensure quality of products), provided they comply with the TBT Agreement.

Agreement on Trade-Related Investment Measures (TRIMS)

Agreement on Trade Related Investment Measures (TRIMS), resulting from the Uruguay Round, recognizes that certain investment measures may cause restrictive effects on international trade in goods. Policies such as local content requirements and trade balancing rules that have traditionally been used to both promote the interests of domestic industries and combat restrictive business practices were major focus.

The main obligation contained in Agreement is that Members shall not apply any trade-related investment measure that is inconsistent with Article III (national treatment) or Article XI (general elimination of quantitative restrictions) of the GATT. The following have been explicitly Prohibited by the TRIMs Agreement:

- **Local content requirement:** Measures requiring the purchase or use by an enterprise of domestic products.
- **Trade balancing requirements:** Measures requiring that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports
- **Foreign exchange restrictions:** Measures restricting the importation by restrcting access to foreign exchange
- **Domestic sales requirements:** Measures restricting the export in proportion of volume or value of its local production.

Please note that Developing countries are permitted to retain TRIMs by virtue of the economic development needs of developing countries.

Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)

Today, the intangible assets are becoming increasingly important. These assets which are the result of human intellectual creative activity such as invention, design, know-how, and artistic creation are known as "intellectual property."

Among the forms of intellectual property specifically entitled to legal protection are *inventions, trademarks, designs, literary works, layout-designs of integrated circuits and trade secrets*. As the volume of trade in goods and services involving intellectual property has increased greatly in recent years, the importance of the protection of intellectual property for the world economy has grown enormously. Inappropriate and insufficient protection of intellectual property can distort free trade.

In the developing countries, the protection of intellectual property rights has been often insufficient. Developing countries often limit protection to a very narrow subject area, or provide protection for only a short period of time, or lack strict enforcement. In contrast, the developed countries have problematic intellectual property regimes that, for example, openly discriminated against foreign nations, provide excessive protection or otherwise have regimes so different from those employed by the rest of the world that its effect is discriminatory.

The WTO sought to establish an appropriate framework for the protection of intellectual property in order to bring greater order to international trade. A number of international treaties already form a common legal framework for the protection of intellectual property, including the **Paris Convention** (1883) and covers patents, trademarks and other industrial property rights, the **Berne Convention** (1886) and covers copyrights.

Recently, however, as countries pay more attention to the trade related aspects of this subject, they have frequently placed intellectual property protection on the agenda of trade negotiations. Countries recognized that as many governments as possible should take part in framing an international agreement establishing standards for the trade aspects protecting intellectual property. As a result, GATT negotiators instituted negotiations on the Trade-Related Aspects of Intellectual Property Rights (TRIPS) one of the most important new areas included in the Uruguay Round negotiations. A final consensus on the TRIPS Agreement was reached in Marrakesh in April 1994 and took effect on 1 January 1995.

Some important Notes on TRIPS are as follows:

- TRIPS covers all legally-recognized intellectual property rights (copyright and related rights, patents, industrial designs, trademarks, geographical indications, layout-designs of integrated circuits and undisclosed information)
- The TRIPS Agreement incorporates and improves upon protection levels of the Paris Convention (industrial property rights) and the Berne Convention (copyright).
- In the area of copyrights and related rights, the TRIPS Agreement specifies the protection of computer programmes (protected as literary works under the Berne Convention) and rental rights.
- The TRIPS Agreement contains provisions governing the protection of trademarks, geographical indications, industrial designs, layout-designs of integrated circuits, and undisclosed information. It also contains rules on anti-competitive practices in contractual licenses.
- Developed countries were given a transition period of one year from the date of entry into force of the WTO Agreement; developing countries and transformation countries were given five years (until January 2000); and least-developed countries were given 11 years (until January 2006).
- TRIPS Agreement is to date the most comprehensive multilateral agreement on intellectual property (IP).
- The TRIPS Agreement is based on the main conventions of the World Intellectual Property Organization (WIPO). Most of the provisions of these conventions have been incorporated into the TRIPS. The TRIPS Agreement includes however, a number of additional obligations where the pre-existing conventions are silent or inadequate.

General Agreement on Trade in Services (GATS)

The General Agreement on Trade in Services (GATS) requires most-favoured-nation Treatment, market access commitments and national treatment. GATS was agreed upon at the end of the Uruguay Round negotiations with the participation of all Member nations including developing countries. The GATS covers a wide range of service industries such as financial services, transport and shipping, communications, construction, and distribution. The GATS distinguishes between four modes of supplying services: cross-border trade, consumption abroad, commercial presence, and presence of natural persons. They have been defined as follows:

Mode 1: Cross-border supply

- Cross-border supply is defined to cover services flows from the territory of one Member into the territory of another Member
- Example: Banking or architectural services transmitted via telecommunications or mail

Mode 2: Consumption abroad

- Consumption abroad refers to situations where a service consumer (e.g. tourist or patient) moves into another Member's territory to obtain a service
- Example : Various kinds of tourism activities

Mode 3: Commercial presence

- Commercial presence implies that a service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a service
- Example: Domestic subsidiaries of foreign insurance companies or hotel chains

Mode 4: Presence of a natural person

- Presence of natural persons consists of persons of one Member entering the territory of another Member to supply a service
- Movement of skilled persons such as accountants, doctors or teachers

WTO Negotiations

There are more or less 60 agreements which are administered by the WTO. However, there are six agreements which made the foundation of this multilateral organization as follows:

- The Agreement on Agriculture (AoA)
- Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)
- Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)
- Agreement on Technical Barriers to Trade (TBT)
- Agreement on Trade Related Investment Measures (TRIMS)
- General Agreement on Trade in Services (GATS)

The above agreements more or less make various provisions for removing the trade and non-trade barriers, protection of domestic industries, protraction of farmers, protection of intellectual property etc. These agreements were finalized in the Uruguay round of trade negotiations that led to conclusion of the GATT agreements and establishment of WTO. To take the trade negotiations to further level, the negotiations had started in 2001 at the Doha round.

Doha Round

To take the trade negotiations to further level, Doha Development Round or Doha Development Agenda (DDA) commenced in November 2001. The overall objective is to lower trade barriers around the world, which would help facilitate the increase of global trade. The Uruguay round had already included many agreements on vital issues such as trade in agriculture and trade in services. *The agenda in Doha Round was to expand the agriculture and services talks to allow trade-offs and thus achieve greater trade liberalization.* The main negotiating issues and the *key elements from India's perspective* in the Doha Round are as follows:

Agriculture

Substantial and effective reductions in **Overall Trade-Distorting Domestic Support** (OTDS) by developed countries;

Self designation of an appropriate number of **Special Products** (SPs);

An operational and effective **Special Safeguard Mechanism** (SSM); and

Tariff simplification and tariff capping of developed country tariffs.

Non-agricultural Market Access (NAMA)

- NAMA covers *manufacturing products, fuels and mining products, fish and fish products, and forestry products*. These products are not covered by the Agreement on Agriculture or the negotiations on services. The Doha Talks require adequate and appropriate flexibilities for protecting economically vulnerable industries; participation in sectoral initiatives on a non-mandatory and good faith basis without prejudgement of the final outcome. The special and differential treatment for developing countries must be substantial.
- Non tariff barrier (NTB) textual proposals with wide support such as the Horizontal Mechanism must be taken up on a more serious note.

Services

- The qualitative improvement in the revised offers especially on crosses border supply and movement of natural persons.

TRIPS

- Establishing a clear linkage between the TRIPS Agreement and the Convention on Bio-diversity (CBD) by incorporating specific disclosure norms for patent applications; and

Enhanced protection for geographical indications (GIs) other than wines and spirits.

Why Doha Talks failed?

The Doha round of talks failed because of the divide between the developed and developing countries on WTO, IMF and World Bank.

- The key argument of the developing countries was that the current rules and regulations are more in favour of the developed or industrialised countries; and the developed countries don't come forward for trade concessions for the developing countries. The developing countries set the market conditions as per their own needs.
- On the other hand, the developed countries and blocks such as EU argue that the developing economies don't comply with their demands for *near zero-tariffs in agriculture and services.*

During most of the Doha talk rounds, the developed countries pressurized the developing countries to *open their markets further* via a so called **Trade Facilitation Agreement** (TFA). On the other hand, the developing countries pressurized the developed countries to bring more transparency to rules and regulations in the global financial bodies; and for removing or raising the cap on food and agricultural subsidies (this also known as "aggregate measure of support", or AMS). The issue got politicised in both the blocks.

Further, the developing countries also could not make some credible union {G-33 had not strong coherence} to put their cause and lacked a coherent strategy. Summarily, the Doha Round talks failed because of the following:

- Inability of the participating countries to achieve an agreement in the key areas of agricultural subsidies and tariffs.
- Developing countries have sought an agreement from developed countries on cutting back farm subsidies as well as tariffs.
- Developing countries seeking bigger cuts on industrial tariffs to have more market access.

Analysing India's Stand during Doha Round

India along with G-33 group of developing countries wanted right for food stockholding for food security purposes. India took very extreme position from the beginning and wanted substantial and effective reductions in overall trade-distorting domestic support (OTDS) of the US and EU. Later, India softened its stand on both the key issues viz. Trade Facilitation Agreement (TFA) and subsidy on procurement, stocking and distribution of food grain during the Bali conference.

- TFA, as mentioned above is prime interest to developed countries, which want hassle-free access to markets in countries like India. The concerns of India as well as G-33 countries are to address the food security problem. The Doha talks had collapsed mainly due to food production- and stocking-related disputes. India is willing to bargain on this front to secure developed countries' consent for removing or raising the cap on food and agricultural subsidies.

- India cannot go ahead with caps on food and agricultural subsidies particularly when the Food security act is in implementation. This implies that India can face retributive tariffs from developed countries.

This is why India softened its stand and ready to accept middle path which can *exempt the developing countries to carry on with the food subsidies.* On Trade Facilitation Agreement (TFA) front, the trade talks involve the removal of red tape (Custom Raj) from cross border transactions i.e. harmonize the custom clearance norms and introduce the sweeping changes in domestic procedures. The talks also involve expansion of infrastructure at entry points. For the developing countries, these are hard to meet demands without external assistance.

Ninth Ministerial Conference 2013 and Bali Package

The Ninth Ministerial Conference of WTO was held in Bali, Indonesia on 3–7 December 2013. The key issues discussed in this meet included Trade facilitation, **Agriculture negotiations**, Cotton, Least-developed countries, Monitoring mechanism, Small and vulnerable economies, Yemen's accession, E-commerce, Non-violation in intellectual property etc. The outcome of this package was the first agreement reached through the WTO called **Bali Package**. But there were unresolved issues in this Bali Package also, which are discussed below:

- Under Bali package, the WTO agreed to allow developing countries to provide subsidy on food crops without any punitive action via a so called *Peace Clause*, which offered four years of immunity against penalties imposed for breaching the farm subsidy cap of 10 per cent under the WTO Agreement on Agriculture (AoA). However, India rejected this clause in want of a permanent solution to its food security act.
- Developing countries sought an end to the export subsidies given to farmers by the developed countries which give them edge in exports. United States came up with a new US Farm Bill 2014 to ensure that there would be no cut in export subsidies.
- Developing countries and LDCs wanted special safeguards and changing of rules related to public stockholding for food security.

Overall, the developing countries said that the developed ones just are rallying behind the Trade Facilitation Agreement to get the markets opened up in developing countries to their goods and services; without providing permanent solutions to their problems. They wanted an agreement on special safeguard measures (SSM) to protect farmers against import surges.

SSM is a tool that allows developing countries to raise tariffs temporarily to deal with surges in agricultural imports or price falls. Developing and developed nations are at loggerheads over the 'trigger factor' that allows a developing country to raise tariff on imports and the level of tariff that can be imposed.

10th Ministerial Conference and Nairobi Package

The Tenth Ministerial Conference of the WTO was held in Nairobi, Kenya during 15-19 December 2015. This was the first such meeting to be hosted by an African nation. The agenda of this meeting was to take forward issues that were unresolved during last ministerial conference in Bali in 2013.

The Nairobi Package

After five days negotiations, a "*Nairobi Package*" was defined which contained a series of six ministerial decisions on agriculture, cotton and issues related to LDCs. These include a commitment to abolish export subsidies for farm exports". As per this package:

- Developed countries such as United States will need to eliminate the farm export subsidies immediately, except on a handful of agriculture products. The developing countries were allowed to end these export subsidies by 2018.
- The Developing countries were given flexibility to cover marketing and transport costs for agriculture exports until the end of 2023. Additional time was given to the poorest and food importing countries. This simply implied that India will not be able to offer export subsidies for sugar and other farm products after eight years.
- No final decision was taken on public stock-holding as well as Special Safeguard Mechanisms (SSM).
- The countries struck a deal on IT trade whereby, they would eliminate the tariffs on 201 IT products per year. The idea is to make all IT products duty-free by 2019.

India's Concerns with Nairobi Package and Current Status

India wanted public food procurement to be exempted from subsidy reduction deals under WTO norms, which say public stockholding must not exceed 10 per cent of the value of food grains produced. India's argument was that it should have permanent freedom instead of a temporary peace clause to use its food reserves to feed its poor without the threat of violating any international obligations. This issue remains unresolved so far. Further, India wanted to get the Doha Development Agenda reaffirmed. Towards this, India also had given a written submission to Director General WTP and chair of 10th ministerial conference. But WTO seemed to leave it where it was and move on. This was a setback for India.

India's International Trade

Prior to 1947, India's trade was a typical colonial trade, in which we used to supply raw materials to our colonial master and imported the manufactured goods. So, naturally the industrialization at home was not permitted. The indigenous handicrafts suffered because of the competition from the British manufactured products as well as British traders located in India as well as abroad.

The colonial pattern of trade was to be changed after independence.

- The first major challenge was the increase in the production capacity of the country. So, this led to import of the heavy plants and machinery which was called the "developmental Imports".
- To maintain the productive capacity of the country, the objects such as machines were imported and this was called "maintenance imports".

The above two similar kinds of imports were vital for a developing country like ours which just embarked on the path of the economic development.

Apart from that, India needed to import lots of food grains in the beginning. Since, the food grain production in the country was so less to fulfil needs. The import of food grains was also necessary to contain the inflation in these consumer goods.

India when became independent was heavily dependent upon the imports. The higher imports and negligible exports mean a **pressure on the balance of trade**. The result is pressure on the economy. So, there was need to encourage the exports. ***The imports were inelastic***, and to fight with the pressure of the foreign debt, the country needed to boost its exports.

Balance of Trade

Balance of Trade is the difference between the monetary value of exports and imports of output in an economy over a certain period. A positive balance is known as a trade surplus if it consists of exporting more than is imported; it is also known as favourable trade balance. A negative balance is referred to as a trade deficit.

Factors that can affect the balance of trade include:

- The cost of production (Land, Labour, Capital, Taxes, Incentives, etc.) in the exporting and importing countries
- The cost and availability of raw materials, intermediate goods and other inputs;
- Exchange rate movements;
- Multilateral, bilateral and unilateral taxes or restrictions on trade;
- Non-tariff barriers such as environmental, health or safety standards;
- The availability of adequate foreign exchange with which to pay for imports; and
- Prices of goods manufactured at home (influenced by the responsiveness of supply)
- The stage in business cycle such as recession, boom, stagnation etc.

Historical Trends in Trade Balance

In 1949-50, India's exports were worth Rs. 485 Crore and the imports were worth Rs. 617 Crore.

Thus, the country started with negative trade balance of Rs. 132 Crore. Both exports and imports increased and the trade deficit also increased. India has a continuous trade deficit *except only two years viz. 1972-73 & 1976-77* in which there were more exports than imports and a positive trade balance.

Post liberalization, the devaluation of Rupee and convertibility of Indian Rupee in current account tried to create a favourable environment but in the subsequent years, the trade deficit increased.

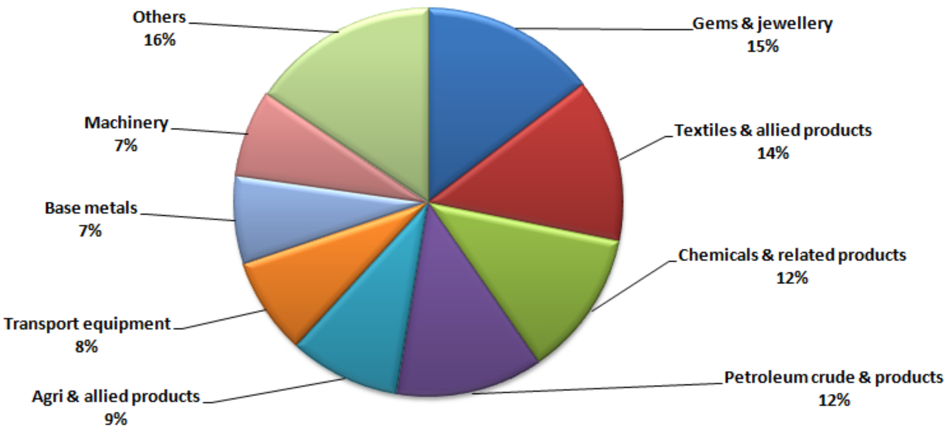
India's Merchandise Trade: Key Facts

During the current financial year (April-January), India's total export was $217.7 billion while total import during the same period was $324.5 billion. In 2015-16, both imports and exports have been *on declining trend mainly due to global slowdown*. The trade deficit stands at $106.8 billion. Some important current facts are as follows:

- The merchandise trade (trade in commodities) had a 13.9% share in India's GDP in 1991-92. It stood at 27% in 2004-05, and further went up to 41% in 2013-14. In 2014-15, merchandise trade is 37.1% of GDP.
- In 2013, India's exports share in world merchandise exports was 1.7 per cent. The objective of taking it to a respectable figure of at least 4% of world trade in next five years still seems to be a distant dream. We note here that China's share in world trade is around 11%.
- Gujarat and Maharashtra are two export dominating states of India.
- China and UAE are India's largest trade partners.

Composition of India's merchandise export Basket

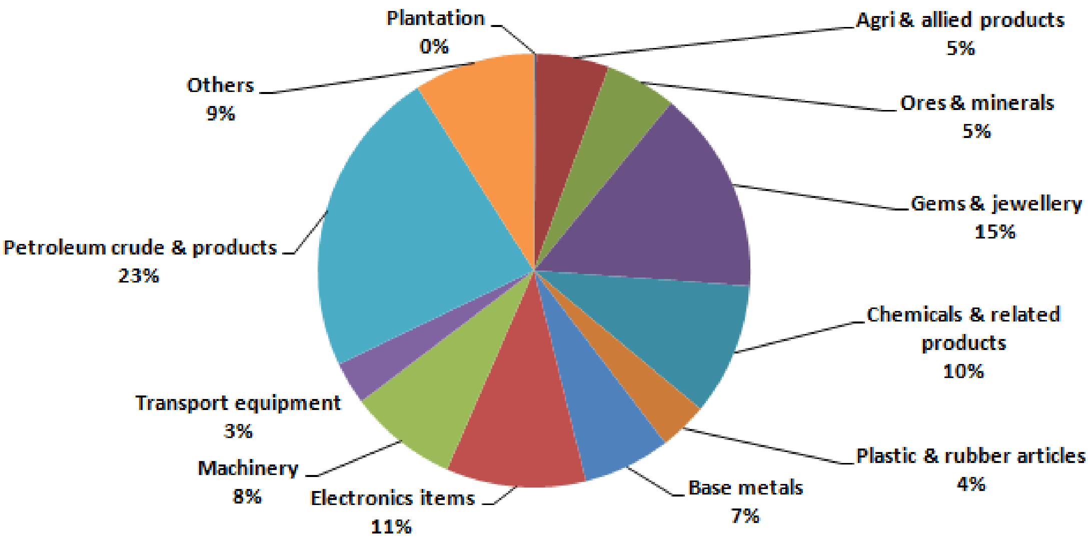
The merchandise exports of India are broadly classified into four categories viz. manufactured goods, Ores & minerals, Farm Products, Crude Oil and Petroleum products. We note here that manufactured goods are backbone of India's Merchandise exports. In Merchandise exports too, the share of Gems and Jewellery is maximum.



Composition of India's Export Basket 2015-16

India's Merchandise Imports Basket

Around one fourth of India's imports are POL (Petrol, Oil and Lubricants) products. Food is a small fraction in the imports and out of the total 3.5%, 2% is occupied by vegetable oils which are India's largest agricultural import item.



India's Merchandise Import Basket April - December 2015 {Source Economic Survey 2015-16}

Foreign Trade Policy 2015-20

Export promotion being a constant endeavour of the government, export performance is constantly monitored and export strategy and export policies are formulated. In the Foreign Trade Policy for the years 2015-20 announced in April 2015, the Government spelt out a framework for increasing exports of goods and services as well as generation of employment and increasing value addition in the country, in line with the 'Make in India' and "Digital India" programme.

Salient Features

Objective

The policy seeks to make India a bigger player in global trade by doubling the overseas sales to $900 billion by 2019-20, while integrating the foreign trade with "Make in India" and "Digital India Programme".

MEIS and SEIS schemes

Five existing schemes to promote merchandize exports have been merged into a single *Merchandise Exports from India Scheme* (MEIS). In this scheme, the incentives are to be provided in the form of duty scrips as % of FOB {free on board} value of exports. One scheme for services exports called *Served from India Scheme* (SFIS) have been replaced in one scheme called *Service Exports from India Scheme (SEIS).* The benefits of this scheme will be only for India based service providers and will be based on net foreign exchange earned. The benefits of MEIS and SEIS have been extended to the SEZ units also.

Transferable Duty Scrips

A scrip literally means a "chit" and refers to a form of credit. The Duty free scrips are provided to the exporters under various export promotion schemes of the government s. Under these schemes, the exporters get incentives at a certain percentage of the export value and these incentives can also be used to reimburse duties on imported inputs. The scrips may be *transferable or non-transferable*. If they are transferable the holder of these scrips can sell them in market at discount. If the scrips are non-transferable, they come with actual user condition and the holder can use it to import inputs or capital goods duty free.

The foreign Trade Policy 2015 makes all duty free scrips freely transferable. These scrips can be used for payment of custom duty, excise duty and service tax also.

Status Holders

Merchant as well as Manufacturer Exporters, Service Providers, Export Oriented Units (EOUs) and Units located in Special Economic Zones (SEZs), Agri. Export Zones (AEZs), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio-Technology Parks (BTPs) are recognized as various status holders as **follows:**

Status	Business in million US dollars
One Star Export House	3
Two Star Export House	25

Status	Business in million US dollars
Three Star Export House	100
Four Star Export House	500
Five Star Export House	2000

A status holder is eligible for many benefits such as self declaration during custom clearances; exception from some documents and receipts various incentives. In the foreign Trade Policy 2015-20, the government says promises to reduce transaction costs of the status holders.

Make in India

To integrate the FTP with Make in India, the government has reduced export obligation for capital goods purchased from Indian suppliers under the EPCG {Export Promotion of Capital Goods} scheme. The exporters who export with high level of domestic content get higher level rewards.

Trade facilitation and ease of doing business

The policy calls for online filing of documents/ applications and paperless trade in 24×7 environments; online inter-ministerial consultations and simplification of procedures/processes, digitisation and e-governance

Other measures include

- Measures to facilitate & encourage export of defence goods
- e-Commerce Exports: Benefits of foreign trade policy to export of items up to Rs. 25,000 per consignment
- Benefit available to handloom products, books / periodicals, leather footwear, toys and customized fashion garments
- New initiatives for EOUs {Export Oriented Units}, EHTPs {Electronic Hardware Technology Parks} and STPs {Software Technology Parks}. They can share infrastructure & inter-unit transfer of goods allowed.

Prohibited Items

India's Foreign Trade Policy prohibits the following:

- Import & Exports trade in "arms and related material " with Iraq
- Any defense related equipment from North Korea
- Any content which might enhance the nuclear energy adventures of Iran
- Import of Charcoal from Somalia. We note here that UNSC Resolution 2036 had banned all exports from Somalia and India honours this resolution. Charcoal exports from Somalia are a significant revenue source for Al-Shabaab.

Merchandise Export from India Scheme

The six different schemes of the earlier FTP (Focus Product Scheme, Market Linked Focus Product

Scheme, Focus Market Scheme, Agriculture Infrastructure Incentive Scrip, Vishesh Krishi and Gram Udyog Yojana and Incremental Export Incentive Scheme) which had varying sector-specific or actual user only conditions attached to their use have been merged into a single scheme, namely the Merchandise Export from India Scheme (MEIS). Notified goods exported to notified markets will be incentivized on realized FOB value of exports. For the purpose of granting incentibes, the countries have been grouped into three categories as follows:

- Category A: traditional markets
- Category B: emerging & focus markets
- Category C: other markets

Government has expanded the coverage of the MEIS on 29 October 2015 by adding 110 new items. The incentive rate/country coverage of 2228 items has been enhanced.

Service Export from India Scheme

The Served from India Scheme (SFIS) has been replaced with the Service Export from India Scheme (SEIS). The SEIS applies to 'service providers located in India' instead of 'Indian service providers'. Thus, it provides for incentives to all service providers of notified services who are providing services from India, regardless of the constitution or profile of the service provider. The rates of incentivization under the SEIS are based on net foreign exchange earned. The incentive issued as duty credit scrip, will no longer carry an actual user condition and will no longer be restricted to usage for specified types of goods but be freely transferable and usable for all types of goods and service tax debits on procurement of services/goods.

Comment on FTP-2015-20

The new foreign trade policy aims to double India's exports to $900 billion by 2020. To achieve this target, the exports need to grow at about 14% every year. This growth is a function of global recovery, which seems to be distant at present. However, the policy must be lauded for its recognition that exports cannot be made competitive just by throwing sops for exporters. The government has made the duty free scrips freely transferable as per the global norms. This would be used by exporters to pay indirect taxes and duties and will be available to SEZs too. Further, the Export obligation under the Export Promotion Capital Goods Scheme has also been reduced, ostensibly to give a boost to "Make in India". All these are efforts towards making exports more competitive. What India needs to do is to raise the share of manufacturing in its economy and promote exports of manufactured goods. Towards this direction, the government needs to slash and rationalize import duties further.

Balance of Payments

Balance of Payments refers to the systematic and summary record of a country's economic and financial transactions *with the rest of the world*, over a period of time. In a layman's language, *anything that affects the financial and accounting entries of a country with respect to the rest of the world* is counted in Balance of Payments. Knowledge about BoP provides a good basis for developing an understanding of economic issues like currency crises, the impact of capital flows, economic position of a country etc.

Components of BoP

The three main components of BoP:

- Current Account
- Capital Account
- Official Reserve Transactions

The current account includes all the transactions related *to export and import of goods and services, investment income, and unilateral transfers (remittances, gifts, grants etc.).* The capital account includes all international asset transactions (FDI, FPI etc.). The official reserve transactions are conducted by central banks like RBI whenever there is BoP deficit or BoP surplus. These transactions are conducted in the form of international reserve assets, such as gold and major international currencies. The sum of the three BoP components should be zero. There is another element in BoP that is 'Errors and Omissions', which is the balancing item reflecting our inability to record all international transactions accurately.

BoP = Current Account + Capital Account + Official Reserve Transactions + Errors and Omissions = 0

Generally, when the joint of sum of current account and capital account of BoP is negative, it is referred as 'BoP deficit'. When the term 'BoP deficit' is used, we leave aside the official reserve transactions. Similarly, 'BoP surplus' means there is surplus in the joint sum of current account and capital account of BoP. Whenever we use the terms BoP Equilibrium and BoP Disequilibrium, we consider only current account and capital account.

Autonomous and Accommodating Transactions

All the included transactions under current account and capital account are called as autonomous transactions because they are done with business or profit motives without considering the status of BoP (whether it is surplus or deficit). Autonomous transactions are also called as 'above the line' items in BoP. The accommodating transactions are determined by the net consequences of autonomous transactions, that is, they depend on the status of BoP. These accommodating transactions are also called as 'below the line' items in BoP. Examples of accommodating transactions are official reserve transactions.

Current Account Transactions

Current Account transactions include all transactions of export and import of goods and services, investment income, and unilateral transfers. If the sum of all these transactions is negative then it is called as **current account deficit (CAD)** whereas if the sum is positive it is called **current account surplus**.

Exports and imports of goods (visible trade)

When we export goods, we credit money to the current account. When we import goods, we debit money from the current account. The difference between export and import is called **merchandise Trade Balance**. If exports are more than imports there will be trade surplus and if imports are more than exports there will be **trade deficit**. Except for two years in the 1970s, India has a trade deficit consistently.

Export and Import of Services (invisible trade)

When we export services, we again credit money to the current account. When we import the services, we debit money from the current account. Now, export of services has two meanings. One is that we provide service to the foreign nationals in their own land and another is that foreigners come to our country and we provide service to them here. Both have same meaning. Like in tourism, the tourists come to India and *whatever we earn from their tourism activity is also deemed to be a service export*. But since we cannot see this export taking place, we call it **Invisible Export.** India is slowly becoming a service oriented economy, so invisible exports are slated to play very important role in the years to come. Following are examples of Invisible exports and imports:

- Money spent on travel by tourists
- Tuition paid to universities by international students
- Banking, Insurance, Consulting services in foreign land
- Royalties and license fee paid for use of copyright or patent

Please note that Outsourcing is basically getting service from abroad. So, it is a service import or invisible import, which would be a debit entry in the current account. Even if you outsource goods, it would mean import of goods.

Investment income

Investment income includes any income made from investing abroad, profits from business activities of subsidiaries located abroad, interest received from investment and loans abroad, and dividends from owing shares in overseas companies. If we receive interest, dividends and other incomes from abroad, it will be a credit entry in the current account. Similarly, if we pay the interest, dividends and other expenditures to abroad, it will be debit entry from the current account.

Unilateral transfers

Unilateral transfers include foreign aid, personal gifts sent to friends and relatives abroad, donations, charitable donations, and international remittances, withdrawal/redemption of NRI deposits locally etc. Whenever there is inward remittance, it will be credited to the current account and outward remittances will be debited from the current account. The same is valid for pensions also. If a foreigner living in India is getting pension from his own country here, it would be credited to current account and vice versa.

Capital Accounts Transactions

The capital account transactions include all transactions which alter the assets or liabilities, including contingent liabilities, outside India of persons resident in India. Similarly, it includes transactions which alter assets and liabilities in India of persons resident outside the India. The assets and liabilities include securities, immovable properties, foreign currency, lending or borrowing in foreign currency or rupees, intangible assets, trade credits etc. Current Account items can be categorised based on maturity as short term or long term flows, based on instrument type as debt or non-debt instrument. NRI deposits from part of capital accounts. Other capital account items includes leads and lags in exports, special drawing rights (SDR) allocation, funds held abroad, advances received pending issue of shares under FDI and other capital not included elsewhere (n.i.e).

Foreign Direct Investment

When foreigners purchase the Indian capital assets such as factories, machines, companies, we credit the money to the capital account. If Indians make FDI investment abroad, we debit the money from the capital account.

Portfolio Investment

When foreigners purchase the Indian securities such as stocks, bonds, CDs, money-market accounts, the money is credited to capital Account. When Indians purchase the foreign securities abroad, the money is debited from the capital Account.

Other items of Capital Account

When there is an increase in loans & trade credits to Indian residents by foreigners, the money will be credited to financial account and vice versa. Loans can be in the form of external assistance, external commercial borrowings and trade credits.

Understanding BoP Disequilibrium

The most important feature of the Balance of Payments Accounts is that *it is a double-entry system of accounts*: a credit entry in the BOP accounts has a corresponding debit entry elsewhere in the BOP accounts. This implies that for a BoP Equilibrium, the current and capital accounts must sum to zero. We can understand it very easily. The current account balance is the difference between current income and current expenditures. A current account deficit implies that expenditures exceed revenues. If expenditures exceed revenues, from where the money would come to finance that extra expenditure? This means that the country would need to finance the additional expenditure form either internal sources or external sources. When the expenditure is financed via external sources, there would be some corresponding entry in the Balance of payments. For example, the additional expenditure can be financed by any one or more than one of the following:

- Through FDI inflows
- Through portfolio inflows
- By increased loans from foreigners / reduced holdings of foreign currency / increased foreign holdings of domestic currency; by acquiring foreign currency from the government (lower reserves)
- or lastly by hoping that the foreign government forgives the debt, if it is so, it would be a unilateral flow in capital account.

The foreign funding has to be returned in the form of foreign exchange only. That is why the Foreign Currency is the backbone of a country's economic relations with other countries. In other words, the balance of payments of a country is said to be in equilibrium when the demand for foreign exchange in exactly equivalent to the supply of it. There will be a deficit in the balance of payments when the demand for foreign exchange exceeds its supply, and three will be a surplus when the supply of foreign exchange exceeds the demand. A number of factors may cause disequilibrium in the balance of payments.

Some of the causes and types of the BoP disequilibrium

Development Programmes

The direct impact of large scale development expenditures is seen in increase the purchasing power, aggregate demand and prices. This results in large scale imports. This phenomenon is common in developing countries where large scale import of capital goods needed for carrying out various development programmes and it will raisethe deficit in their balance of payments. These developmental imports cause BoP disequilibrium.

Cyclical Fluctuations

Cyclical fluctuations in the business activity bring depression, stagnant and boom stage in world trade. Whenever there is a depression/recession in foreign countries, our exports will fall due to low demand and there will be reduction in foreign exchange earnings. This will cause BoP disequilibrium. Similarly, the boom condition in foreign countries will increase our exports and our capacity to earn foreign exchange will increase.

Population growth

The high population growth of a country may lead to increased imports due to increased demand. This will naturally cause the BoP disequilibrium.

Natural factors

Natural calamities in the form of floods, no rains may affect the agricultural and industrial production of a country. Then the country will go for increased imports and reduced exports. This will cause discrepancy in the equilibrium of the BoP.

Political Factors

A country with political instability may experience large capital outflow and inadequacy of domestic investment and production.

Sustained Disequilibrium

The sustained or secular disequilibrium refers to a situation when, the BoP disequilibrium persists for long periods due to certain secular trends in the economy. It is seen in the developed countries where, the disposable income is generally very high and so the aggregate demand is also very high. But due to higher aggregate demands, the production costs are also very high. This would result in higher prices, which may result in the imports being much higher than exports.

Structural Disequilibrium

Structural Disequilibrium occurs due to changes in some sectors of the economy at home country or foreign country which may alter the demand-supply relations of exports or imports or both. The changes may include development of alternative source of supply, development of better substitutes, exhaustion of productive resources or change in transport routes and costs etc.

Adjustment of BoP

There is not much bothering if there is a surplus in the balance of payments, however, every country strives to remove or at least reduce a balance of payments deficit. There are a number of adjustments, which are done to correct the balance of payments disequilibrium. There are two categories of measures to correct the BoP disequilibrium:

Automatic Measures

The Automatic measures were useful and relevant when there was Gold Standard. Since, now the Gold Standard is not there, the whole mechanism is irrelevant, yet it works in Paper currency environment on the basis of the fact that if the market forces of demand and supply are allowed to have free play, in course of time, equilibrium will be automatically restored.

This can be understood by a simple example. Whenever there is a deficit, demand for foreign exchange exceeds its supply and this result in an increase in the exchange rate and a fall in the external value of the domestic currency. This would result in the exports of the country go cheaper and imports dearer than before. Consequently, the increase in exports and fall in imports restore the balance of payments equilibrium.

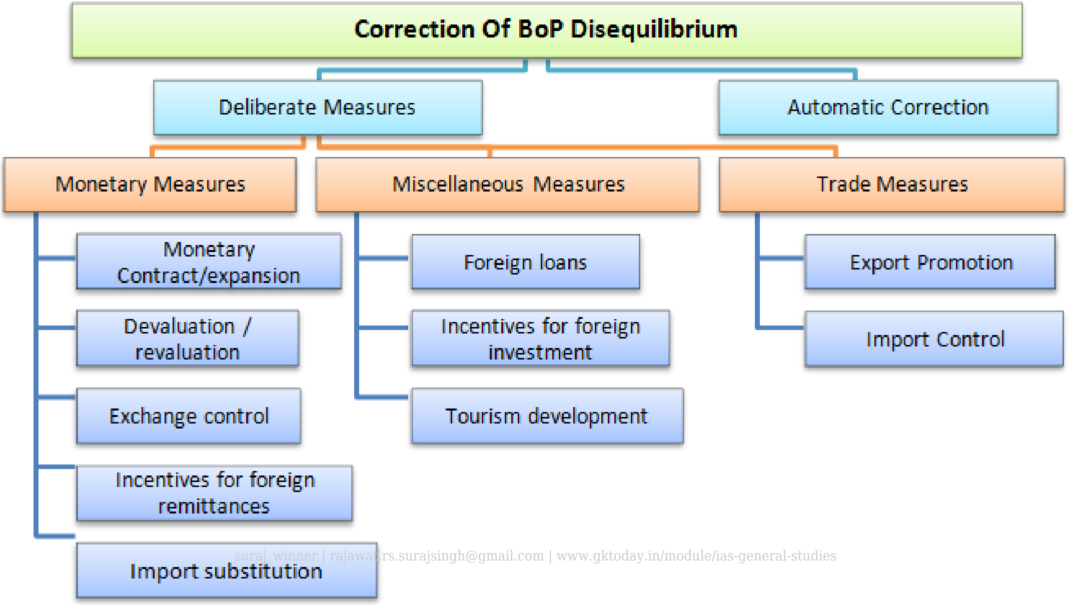
Deliberate measures

Deliberate Measures refer to the correction of disequilibrium by means of measures taken deliberately with this end in view. There are various deliberate measures such as

- Monetary measures such as Monetary Contraction, Devaluation, Exchange Control
- Trade measures : Export Promotion, Import Control

- Miscellaneous measures

These various measures have been shown in the following graphics:



Monetary Contraction

The contraction or expansion of money supply affect the level of aggregate domestic demand, domestic price level and the demand for imports and exports, and this intervention can be used to correct the disequilibrium of the BoP.

We take an example:

We assume there is a situation of balance of payments deficit. The BoP deficit means that there is an increased level of aggregate demand that have led to the increased imports. When the money supply is contracted, it would leave less money in the system and finally would reduce the purchasing power.

- The reduced purchasing power would reduce the aggregate demand.
- The reduced aggregate demand also reduced the domestic prices.
- The reduced domestic prices also reduced the demand for the imports. The fall in the domestic prices' would encourage more exports, to earn better money.
- Thus, the overall result in case of monetary contraction is that Imports decrease and Exports Increase. This results in the correction of a BoP deficit situation.

Devaluation

Devaluation is defined as a reduction of the official rate at which the currency is exchanged for another currency. The idea behind currency devaluation is to stimulate its exports and discourage imports to correct the disequilibrium. The direct impact of devaluation is that it makes the export goods cheaper and imports dearer. How? Let's understand:

We assume that Current Rate of Dollar is Rs. 55.

In this situation, an exporter in India would realize Rs. 5500 for an export worth 100 Dollars.

We assume that the **Rupee is devalued** and now a Dollar becomes of Rs. 65

In this situation, the same exporter would realize Rs. 6500. The result is that Export earnings would increase and export of good would become cheaper.

We again assume that there is an importer who needs to make a payment of $ 100 to a party sitting abroad.

At Rs. 55, this importer would need Rs. 5500 to make payment.

At Rs. 65, this importer would need Rs. 6500 to make payment. The result is the import becomes dearer. So, most commonly, the Currency devaluation takes place to correct the BoP deficit.

Exchange Control

This is yet another popular measure of correcting the BoP deficit. Under the exchange control, the government via the RBI assumes complete control over the foreign exchange reserves and earnings of the country. The recipients of foreign exchange, like exporters, are required to surrender foreign exchange to the government/central bank in exchange for domestic currency. By virtue of its control over the use of foreign exchange, the government can control imports and also increase its foreign currency reserves.

Export Promotion

This may include the reduction and abolition of the export duties, providing export subsidy, encouraging export production and export marketing by giving monetary, fiscal, physical and institutional incentives and facilities.

Import Control:

'This may be done by improving or enhancing import duties, restricting imports through import quotas, licensing and even prohibiting altogether the import of certain inessential items.

Miscellaneous Measures

Other measures are promotion of tourism to attract foreigners and providing incentives to enhance inward remittances.

What is the best way to fund the Current Account Deficit (CAD)?

One of the best ways to fund the CAD is through non-debt creating and long-term inflows such as FDI. Volatile inflows like portfolio investment also referred as hot money can threaten the stability of the economy.

India's Balance of Payments

The account book of the Balance of Payments comprises four accounts viz. Current Account, Capital Account, Errors and Omissions, and Change in Foreign Exchange Reserves.

Current Account

Under current account of the BoP, transactions are classified into merchandise (exports and imports) and invisibles. Invisible transactions are further classified into three categories.

1. Services comprising travel, transportation, insurance, government not included elsewhere (GNIE), and miscellaneous. Miscellaneous services include communication, construction, financial, software, news agency, royalties, management, and business services.
2. The second component of invisibles is income.
3. Transfers (grants, gifts, remittances, etc.) which do not have any quid pro quo form the third category of invisibles.

They have been defined as follows:

- Travel' represents all expenditure by foreign tourists in India on the receipts side and all expenditure by Indian tourists abroad on payments side. Travel receipts largely depend on the arrival of foreign tourists in India during a given time period.
- Transportation' records receipts and payments on account of the carriage of goods and natural persons as well as other distributive services (such as port charges, bunker fuel, stevedoring, cabotage, warehousing) performed on merchandise trade.

- Insurance' consists of insurance on exports/imports, premium on life and non-life policies and reinsurance premium from foreign insurance companies.
- 'Government not included elsewhere (GNIE)' represent remittances towards maintenance of foreign embassies, diplomatic missions and international/ regional institutions, while payments record the remittances on account of maintenance of embassies and diplomatic missions abroad.
- 'Miscellaneous Services' encompass communication services, construction services, financial services, software services, news agency services, royalties, copyright and license fees and business services.
- 'Investment Income' represents the servicing of capital transactions (both debt and non-debt). These transactions are in the form of interest, dividend, and profit for servicing of capital transactions. Interest payments represent servicing of debt liabilities, while the dividend and profit payments reflect the servicing of non-debt (foreign direct investment and portfolio investment) liabilities. Investment income payments move in tandem with India's external liabilities, while investment income receipts get linked to India's external assets including foreign exchange reserves. In accordance with the Balance of Payment Manual, Fifth Edition,

'compensation of employees' has been shown under the head, "income" with effect from 1997-98.

- 'Transfers' represent one-sided transactions, i.e., transactions that do not have any quid pro quo, such as grants, gifts and migrants' transfers by way of remittances for family maintenance, repatriation of savings and transfer of financial and real resources linked to change in resident status of migrants. Official transfer receipts record grants, donations and other assistance received by the Government from bilateral and multilateral institutions. Similar transfers by Indian Government to other countries are recorded under official transfer payments.

India's Capital Account

Under capital account, capital inflows can be classified by instrument (debt or equity) and maturity (short or long-term). The main components of capital account include foreign investment, loans, and banking capital. Foreign investment comprising foreign direct investment (FDI) and portfolio investment consisting of Foreign Institutional Investor (FIIs) investment and American depository receipts /global depository receipts (ADRs/GDRs) represents non-debt liabilities. Loans (external assistance, external commercial borrowings [ECB], and trade credit) and banking capital including non-resident Indian (NRI) deposits are debt liabilities.

Overview of the India's BoP position

After the global financial crises in 2008, most of the emerging economies like India were faced shocks form the policies of the advanced countries. The situation got amplified with the low external demand and increased the domestic demand with large scale dependence on oil imports. This had led to the widening of CAD during 2011-12 and it countered till the first quarter of the 2013-14. The policy measures adopted by the government in 2013-14 along with increased financing through capital flows helped to reserve accretion. This has continued in the fiscal year of 2014-15. The overall BoP during 2014-15 showed an improvement over the 2013-14. The lower current account deficit (which is 1.3% of GDP in 2014-15) is on account of contraction in trade deficit and surplus of invisibles along with sizeable increase in the net capital flows has enable the country to build-up of reserves. The higher capital inflows were in access of the financing requirement of the CAD. At the end of March 2015, the level of foreign exchange reserves was US$ 341.6 billion. The moderation of trade deficit was mainly due to the fall of global prices of crude petroleum. Considering the situation, the government had decontrolled the prices of high speed diesel in October 2014 and lifted the restrictions on gold imports in November 2014. Other observations on current account are: Service sector is dominated by software exports;high net transfers are mainly due to surplus in remittances.

Balance of Payments	(US$ Billion)	
	2013-14	2014-15
Trade deficit	147.6	144.2
Net invisibles	115.2	116.7
Current account deficit	32.4	27.5
Capital flows (excluding change in foreign exchange reserves)	48.7	89.5

The net invisibles work as cushion to neutralize the Trade deficit of the country. We should note here that from 1951 till 1990-91, the Net Invisibles of the country was always positive. It was for the first time in 1990-91, that the Net invisibles of the country went to a negative zone with a deficit of Rs. 433 Crore. In 1990-91, there was a large net outflow of the investments from the country, and the total BoP of the country went to Rs. 17367 Crore. This was the nadir of the Balance of Payments problem in India. It was followed by Economic Liberalization and the BoP corrected for a few years.

India's BoP Crisis of 1990s

From 1947 till 1956-57, the *India had a current account surplus.* By the end of the first plan, the Trade deficit was Rs. 542 Crore and Net Invisibles was Rs. 500 Crore, thus giving a BoP deficit in Current Account worth Rs. 42 Crore. From this time onwards, the trade deficit increased from 3.8% of the GDP at market prices to 4.5% of GDP. Due to this, the government imposed the exchange controls. This was the first BoP crisis, ever India faced, after independence.

Second BOP crisis

In 1965, when India was at war with Pakistan, the US responded by suspension of aid and refusal to renew its **PL-480** agreement on a long term basis. The idea of US as well as World Bank was to induce India to adopt a new agricultural policy and devalue the rupee. Thus, the Rupee was devalued by 36.5% in June 1966. This was followed by a substantial rationalization of the tariffs and export subsidies in an expectation of inflow of the foreign aid. The BoP improved, but not because of inflow of foreign aid but because of the decline in imports.

After the 1966-67, the BoP of India remained comfortable till 1970s. The first oil shock of 1973-74 was absorbed by the Indian Economy due to buoyant exports. After that there was an expansion of the international trade.

Crisis of 1990-91

When we usually discuss about the BoP crisis in India, we refer to that one of 1990-91. This crisis had its origin from the fiscal year 1979-80 onwards. By the end of the 6th plan, India's BoP deficit (Current account) rose to Rs. 11384 crore. It was the mid of 1980s when the BoP issue occupied the centre position in India's macroeconomic management policy. The second Oil shock of 1979 was more severe and the value of the imports of India became almost double between 1978-78 and 1981-82. From 1980 to 1983, there was global recession and India's exports suffered during this time. The trade deficit was not been offset by the flow of the funds under net invisibles. Apart from the external assistance, India had to meet its colossal deficit in the current account through the *withdrawal of SDR and borrowing from IMF under the extended facility arrangement.* A large part of the accumulated foreign exchange fund was used to offset the BoP.

During the 7th plan, between 1985-86 and 1989-90, India's trade deficit amounted to Rs. 54, 204 Crore. The net invisible was Rs. 13157 Crore and India's BoP was Rs. 41047 Crore. India was under a sever BoP crisis. In 1991, India found itself in her worst payment crisis since 1947. The things became worse by the 1990-91 Gulf war, which was accompanied by double digit inflation.

India's credit rating got downgraded. The country was on the verge of defaulting on its international commitments and was denied access to the external commercial credit markets. In October 1990, a Net Outflow of NRI deposits started and continued till 1991.

The only option left to fulfil its international commitments was to borrow against the security of India's Gold Reserves as collateral. The prime Minister of the country's caretaker government was Chandrashekhar and Finance Minister was Yashwant Sinha. *The immediate response of this Caretaker government was to secure an emergency loan of $2.2 billion from the International Monetary Fund by pledging 67 tons of India's gold reserves as collateral.* This triggered the wave of the national sentiments against the rulers of the country. India was called a "Caged Tiger". On 21 May 1991, Rajiv Gandhi was assassinated in an election rally and this triggered a nationwide sympathy wave securing victory of the Congress. The new Prime Minister was P V Narsimha Rao. P V Narsimha Rao was Minister of Planning in the Rajiv Gandhi Government and had been Deputy Chairman of the Planning Commission. He along with Finance Minister Manmohan Singh started several reforms which are collectively called "Liberalization". This process brought the country back on the track and after that India's Foreign Currency reserves have never touched such a "brutal" low.

In 1991, the following measures were taken:

- In 1991, Rupee was once again devaluated.
- Due to the currency devaluation the Indian Rupee fell from 17.50 per dollar in 1991 to 45 per dollar in 1992.
- The Value of Rupee was devaluated 23%.
- Industries were Delicensed.
- Import tariffs were lowered and import restrictions were dismantled.
- Indian Economy was opened for foreign investments.

- Market Determined exchange rate system was introduced. This was initiated with LERMS

Correction of BoP crisis

Liberalized Exchange Rate Management System

In the Union Budget 1992-93, a new system named LERMS was started. The LERMS was introduced from March 1, 1992 and under this, a system of double exchange rates was adopted. Under LERMS, the exporters could sell 60% of their foreign exchange earning to the authorized Foreign Exchange dealers in the open market at the open market exchange rate while the remaining 40% was to be sold compulsorily to RBI at the exchange rates decided by RBI.

Another important feature of LERMS was that the Government was providing the foreign exchange only for most essential imports. For less important imports, the importers had to arrange themselves from the open market.

Thus, we see that LERMS was introduced with twin objectives of building up the Foreign Exchange Reserves and discourage imports. At that time, the government was successful in achieving both of these objectives.

Rangarajan Panel for correcting BoP

The Report of the High Level Committee on Balance of Payments, of which Dr. Rangarajan was the Chairman, was submitted in June 1993. The important recommendations of this panel were as follows:

- A realistic exchange rate and a gradual relaxation of the restrictions on the current account should go hand in hand.
- ***Current account deficit of 1.6% of GDP should be treated as a ceiling.***
- Government should be cautious of extending concessions or facilities to the Foreign Investors. The concessions were more to the foreign investors than to the domestic players.
- All external debts should be pursued on a prioritized on the basis of the Use on which the debt is to be put.
- No approval should be accorded for a commercial loan which has a maturity of less than 5 years.
- There should be efforts so that Debt flows can be replaced by the equity flows.
- *RBI should target a level of reserves that took into account liabilities that may arise for debt servicing, in addition to imports of three months.*

Convertibility of Rupee

The convertibility of a currency such as Rupee has different meanings in different times. In existing standards, it means that *the country's currency becomes convertible in foreign exchange and vice versa* ***in the market***. The definition should be seen in historical aspect of foreign currency regulation in India.

Almost at the same when India got independence, the **Foreign Exchange Regulation Act 1947** was enacted with the object of regulating certain dealings in foreign exchange and the import and export of currency and bullion. The focus of this act was on dealings in Foreign exchange and payments which directly affect foreign exchange resources. This act was later replaced by the **Foreign Exchange Regulation, Act, 1973,** which we call **FERA.** Later FERA was laid to rest and its successor is now FEMA.

Those were the days of restriction on foreign exchange. No one could keep foreign exchange without the knowledge and due permission of RBI. The exchange control consisted of restrictions on the purchase and sale of foreign exchange by general public and payments to and from non-residents. There were also restrictions on the import and export of Indian currency, foreign currency and bullion.

In those times, the exchange rates used to be different than what they are today. Today we have a market determined exchange rate system, but during those times, **RBI used to dictate its Official Exchange Rate** on which Indian currency could be converted into foreign currency and vice versa. All transactions in foreign exchange were governed by this official rate of exchange. This means that Rupee was inconvertible at the market rate. An importer who wanted to import from abroad was supposed to buy dollars at the RBI dictated rates. Similarly, an exporter who just got dollars was supposed to sell them to RBI appointed Authorize agents at RBI decided rate. This was the *inconvertibility of Rupee*.

The major implications of these restrictions were:

- All foreign exchange earned and received by any person in India were required to be sold to RBI authorised dealers.
- This means that all foreign exchange earned or received could be converted and utilised only according to the priorities fixed by the Government.

Partial Convertibility of Rupee on Current Account

After the BoP crisis of 1990-91 and change in the central Government, the LERMS was introduced as a first measure towards making foreign exchange a free commodity. By LERMS, the exporters of goods and services and those who are recipients of remittances from abroad could sell the part of their foreign exchange receipts at market determined rates. Similarly, those who need to import goods and services or undertake travel abroad could buy foreign exchange to meet such needs, at market determined rates from the authorised dealers, subject to their transactions being eligible under the liberalised exchange control system.

But this was not for all exports and imports but in respect of some priority imports and transactions, provisions were made in the scheme for making available foreign exchange at the official rate by the

Reserve Bank of India. Thus, when LERMs was introduced, there were two exchange rates in India:

- Official Rate for select items of exports and imports
- Market Rate for all others.

The Government said that now onwards, anyone who deals in **current account** means international trade of goods and services will be able to convert them to Indian Rupees as follows:

- 40 % of the receipts at Official rate
- 60% of the receipts at Market Rate

This means that only part of the current account receipts were made convertible at market rates and that is why it was called **Partial Convertibility of Rupee on Current Account.** The imports of materials other than petroleum, oil products, fertilizers, defence and life-saving drugs and equipment always had to be effected against market determined rates.

We see that practically, all the receipts of foreign exchange were required to be surrendered to authorised dealers. The only difference was that of the 60% of it could be converted at the free market rate quoted by authorised dealers. The Partial convertibility of Rupee is known as *Dual exchange system*. At that time, India's current account was showing large deficit so it was risky to introduce the full convertibility of Rupee.

The major objective of the partial convertibility of Rupee was to "*make the foreign exchange available at a low price for essential imports so that the prices of the essentials are not pushed up by the high market price of the foreign exchange*".

Full convertibility of Rupee on Current Account

When Partial convertibility of Rupee on current account was introduced 1992, government had announced its intention to introduce the full convertibility on the current account in 3 to 5 years. The full convertibility means no RBI dictated rates and there is a unified market determined exchange rate regime. Encouraged with the success of the LERMS, the government introduced the **full convertibility of Rupee in Trade account**(*means only merchandise trade no service trade)*from March 1993 onwards. With this the dual exchange rate system got automatically abolished and LERMS was now based upon the open market exchange. The full convertibility of Rupee was followed by stability in the Rupee Rate in the next many months coming up.

The above full convertibility was introduced on Trade account. The Government wanted to introduce the Full convertibility of Rupee on Current account (means invisible also included). In August 1994, the Government of India declared full convertibility of Rupee on Current account with announcing some relaxations as per requirements of the Article VIII of the IMF. These were:

- Repatriation of the income earned by the NRIs and overseas corporate bodies of NRIs in a Phased manner in 3 years period.

- The ceiling for providing foreign exchange for foreign tours, education, medical treatment, gifts and services was made just an indicative. Above this ceiling, foreign exchange could be obtained for payments, while making a reference to RBI.
- While the Principal amount on the NRNR (Non Resident Non Repatriable) Accounts was non repatriable, the interest was made repatriable.

Capital Account Convertibility

Please note that the concept of Capital Account Convertibility was coined by RBI and CAC is now almost synonymous with the SS Tarapore Committee. Capital account is made up of both the short-term and long-term capital transactions such as investments in financial and non-financial assets. The Capital Transaction may be Capital outflow or capital inflow.

Capital account convertibility (CAC) or a floating exchange rate means the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. This means that capital account convertibility allows anyone to freely move from local currency into foreign currency and back.

Convertibility on the capital account is usually introduced after a certain period of introducing the Current account convertibility. The most important effect of introducing the capital account

convertibility is that it *encourages the inflow of the foreign capital, because under certain conditions, the foreign investors are enabled to repatriate their investments, wherever they want.* But the risk is that it may accelerate the flight of the capital from the country if things are unfavourable. For example, an Indian can sell property here and take the Capital outside. This is why; it is generally introduced after experimenting with the convertibility on current account.

- Presently, India has current account convertibility. This means one can import and export goods or receive or make payments for services rendered. However, investments and borrowings are restricted.

Tarapore Committee on Capital Account Convertibility

CAC is considered to be one of the major features of a developed economy. CAC helps attract foreign investment and offers foreign investors a lot of comfort as they can re-convert local currency into foreign currency anytime they want to and take their money away. Capital account convertibility also makes it easier for domestic companies to tap foreign markets. But, jumping into capital account convertibility game without considering the downside of the step can harm the economy. The Committee on Capital Account Convertibility (CAC) or Tarapore Committee was constituted by the Reserve Bank of India for suggesting a roadmap on full convertibility of Rupee on Capital Account. The committee submitted its report in May 1997. The committee observed that there is no clear definition of CAC. The CAC as per the standards – refers to the freedom to convert the local financial assets into foreign financial assets or vice versa at the market determined rates of exchange. Here is what this committee observed:

- ***The Capital Control must stay here.***Capital controls can be useful in insulating the economy of the country from the volatile capital flows during the transitional periods and also in providing time to the authorities, so that they can pursue discretionary domestic policies to strengthen the initial conditions.
- The Capital Account Convertibility, if the Government wants, can be introduced for a 3 year period viz. 1997-98, 1998-99 and 1999-2000. However, there are some pre conditions as follows:
- First bring you Gross fiscal deficit to GDP ratio from 4.5 per cent in 1997-98 to 3.5% in 1999-2000.
- Create a consolidated sinking fund which can meet the government's debt repayment needs. It can be financed by increased in RBI's profit transfer to the govt. and disinvestment proceeds.
- Bring the Inflation rate between an average 3-5 per cent for the 3-year period 1997-2000.
- Bring down the Gross NPAs of the public sector banking system from the present 13.7% to 5% by 2000. At the same time, average effective CRR needs to be brought down from the current 9.3% to 3%.
- RBI should have a Monitoring Exchange Rate Band of plus minus 5% around a neutral Real Effective Exchange Rate.
- External sector policies should be designed to increase current receipts to GDP ratio and bring down the debt servicing ratio from 25% to 20%
- Four indicators should be used for evaluating adequacy of foreign exchange reserves to safeguard against any contingency. Plus, a minimum net foreign asset to currency ratio of 40 per cent should be prescribed by law in the RBI Act.

We see that the Tarapore committee came up with some *not from this world* recommendations. It was not a good idea to ignore the prerequisites so CAC was not translated into reality.

However, some partial convertibility of Rupee on Capital Account was introduced later. Today we have **Partial convertibility of Rupee on Capital Account.**

The Second Tarapore Committee on Capital Account Convertibility

Reserve Bank of India appointed the second Tarapore committee to set out the framework for fuller Capital Account Convertibility. The committee was established by RBI in consultation with the Government to revisit the subject of fuller capital account convertibility in the context of the progress in economic reforms, the stability of the external and financial sectors, accelerated growth and global integration. The report of this committee was made public by RBI on 1st September 2006. In this report, the committee suggested 3 phases of adopting the full convertibility of rupee in capital account.

1. First Phase in 2006-7
2. Second phase in 2007-09
3. Third Phase by 2011.

Following were some important recommendations of this committee:

- The ceiling for External Commercial Borrowings (ECB) should be raised for automatic approval.
- NRI should be allowed to invest in capital markets
- NRI deposits should be given tax benefits.
- Improvement of the Banking regulation.
- FII (Foreign Institutional Investors) should be prohibited from investing fresh money raised to participatory notes.
- Existing PN holders should be given an exit route to phase out completely the PN notes.

It means at present the rupee are fully convertible on the current account, but only partially convertible on the capital account.

Is there any role of RBI in Foreign Exchange or not?

Officially, the Indian rupee has a market-determined exchange rate. So, the way via which RBI affects the exchange rates in India is **"Trade".** RBI is very active in currency market and is capable to impact effective exchange rates effectively by its volume of lifting and releasing the foreign currency from and to the market. ***The impact of RBI on trade is so much that currency regime in India is de facto controlled***. That is why we sometimes call it "**managed float**". Here we should note that the objective of RBI to intervene in the currency markets is to ensure *low volatility in exchange rates*, and not to influence the direction of the Indian rupee in relation to other currencies. Further, RBI has one more arm in its arsenal called "capital controls" in addition to intervention through active trading in currency markets.

What are Capital Controls?

Through Capital controls, the RBI controls the foreign capital inflows in the form of loans and equity in India. The current account flows arise out of transactions in goods& services are permanent in nature whereas capital account flows are dynamic in nature and are can be reversed at any time. That is why a close eye on capital flows is needed. The Capital Inflows would include the foreign borrowings by Indian corporates and businesses, NRI deposits and portfolio flows from institutional investors into the stock markets, Loans to government and short-term trade credit. The foreign

Capital inflows bring cheaper resources to finance the economy but the dark side is that they pose risks to value of the country's currency. They can put the liquidity management also in trouble. Because when huge dollars flow, they would need to be bought by Central bank and in turn Central bank would pumps local currency. If there is an abrupt reverse flow of capital, it would put the country into vulnerable condition.

Are we moving towards full Capital Account Convertibility?

Though there are certain risks associated with full capital account convertibility, we cannot avoid it for longer period as it may become counter-productive. As the country is becoming more globalised it will be difficult to maintain closed capital accounts. Capital account restrictions may create opportunities for traders to circumvent rules through under-pricing or over-pricing of trade transactions and corporates could use transfer pricing mechanism. But how early are we moving to full capital account convertibility depend on various pre-conditions like low and sustained current account deficit, fiscal-consolidation, controlled inflation, low level of NPAs, resilient financial markets, prudent supervision of financial institutions etc. Already India is making progress on these fronts. The progress can be measured by the attainment of the specific goals mentioned by the two Tarapore committees. The present low level prices of oil and large net invisibles are helping the country moving towards low level of CAD but it needs to be sustained. On inflation front, though we made some progress but it is always an area of suspect. There are other areas where the country is needed to make progress like reduction of NPAs, development of resilient financial system etc. India cannot escape the full convertibility of capital account as its economy grows further and becomes global in dimension. The country cannot afford to remain isolated for a longer period of time.