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Management of Financial Institutions

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Lesson No. 1

MFI 308
MANAGEMENT OF FINANCIAL INSTITUTIONS
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FINANCIAL INSTITUTIONS IN INDIA

STRUCTURE

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1.0 OBJECTIVES

After going through this lesson, you will be able to understand and analyze the role and performance of Indian financial institutions. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand:

- Role of financial institutions in saving and investment
- Relationship between financial institutions and economic development
- Deficiencies of financial institutions

1.1 INTRODUCTION

A well-integrated structure of financial institutions in India, comprising 11 institutions at the national-level and 46 institutions at the state-level, provide a variety of financial products and services to cater to the varied needs of industrial sector. The national-level institutions known as All-India Financial Institutions (AIFIs) comprise six All-India Development Banks (AIDBs), two Specialized Financial Institutions (SFIs) and three Investment Institutions. At the state level, there are 18 State Financial Corporation's (SFCs) and 28 State Industrial Development Corporations (SIDCs). The AIDBs are Industrial Development Bank of India (IDBI), IFCI Ltd., ICICI Ltd., Industrial Investment Bank of India Ltd., (IIBI), Infrastructure Development Finance Company Ltd., (IDFC) and Small Industries Development Bank of India (SIDBI) (the category of AIDBs has been expanded to include IDFC). The SFIs comprise Export-Import Bank of India (Exim Bank) and National Bank for Agriculture and Rural Development (NABARD). Hitherto, SFIs included three institutions viz. IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Company Ltd. and Tourism Finance Corporation of India Ltd. However, due to tiny nature of their operations, these institutions have been excluded from the category of SFIs.

The Investment Institutions are Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and Unit Trust of India (UTI). For the purpose of the analysis, the above

Institutions together with SFCs and SIDCs are grouped as All Financial Institutions (AFIs).

Of the AIDBs, IDBI, IFCI, ICICI and IIBI provide financial assistance to medium and large industries whereas IDFC and SIDBI cater to the financial needs of the infrastructure sector and small-scale sector, respectively. AIDBs also undertake promotional and developmental activities. Among the SFIs, while Exim Bank's operations comprise financing of projects, products and service exports, building export competitiveness, import financing for exports, foreign trade guarantee programme, export and consultancy services, NABARD acts as an apex development bank for promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas. Among the investment institutions, LIC deals in life insurance business, while GIC, along with its subsidiaries, provides general insurance cover. LIC and GIC deploy their funds in accordance with the Government guidelines. UTI mobilizes savings of small investors through sale of units and channelizes them into corporate investments mainly by way of secondary capital market operations. Besides, the investment institutions also extend assistance to industry through loans and by way of underwriting/direct subscription to equities and debentures. At the state level, SFCs provide assistance mainly to small and medium enterprises and SIDCs cater to medium and large-scale industries in their respective states. Apart from providing financial assistance, SFCs and SIDCs also undertake promotional and developmental activities.

With the increasing integration of Indian economy with the global economy, the financing requirements of corporate sector have undergone tremendous change, and accordingly, financing institutions in India have re-oriented their policies and product range with much sharper customer focus to suit the varied needs of the corporate. With a view to leverage new opportunities thrown open by the developments in the economy, the financial institutions have set up several subsidiaries/ associate institutions offering a wide range of new products and services covering areas such as commercial banking, consumer finance, investor and custodial services, broking, venture capital financing, infrastructure financing, registrar and transfer services, credit rating and E-commerce.

1.2 OPERATIONAL PERFORMANCE

During 2000-01, financial assistance sanctioned and disbursed by AFIs increased by 19% and 11.1% to Rs. 12,93,378 million and Rs.8,10,470 million, respectively, as compared to growth in sanctions and disbursements of 26.5% and 19.1% in 1999-2000, respectively. Up to end-March 2001, aggregate sanctions and disbursements amounted to Rs.77,29,037 million and Rs.54,34,528 million, respectively (Table 1).

Table 1 - Assistance Sanctioned and Disbursed by FIs

(Rs. million)

Year	**Sanctions Rate(%)**	**Growth**	**Disbursements**	**Growth** Rate (%)
1980-81	29269.0		18479.0	
1981-82	32774.0	12.0	23520.0	27.3
1982-83	33585.0	2.5	24684.0	4.9
1983-84	41664.0	24.1	31384.0	27.1
1984-85	55487.0	33.2	36177.0	15.3
1985-86	65291.0	17.7	49400.0	36.6
1986-87	81184.0	24.3	57091.0	15.6
1987-88	95545.0	17.7	70610.0	23.7
1988-89	112867.0	18.1	77008.0	9.1
1989-90	144593.0	28.1	96397.0	25.2
1990-91	191961.0	32.8	128101.0	32.9
1991-92	223148.0	16.2	162729.0	27.0
1992-93	331933.0	48.8	231525.0	42.3
1993-94	409870.0	23.5	266243.0	15.0
1994-95	578324.0	41.1	335772.0	26.1
1995-96	599363.6	3.6	386979.7	15.3
1996-97	520336.2	-13.2	450205.8	16.3
1997-98	764273.3	46.9	558651.3	24.1
1998-99	859095.5	12.4	612629.4	9.7
1999-2000	1086881.2	26.5	729416.7	19.1
2000-01	1293377.9	19.0	810470.3	11.1

At the disaggregated level, AIFIs' sanctions and disbursements increased by 15.9% and 8.6% to Rs. 12,50,158 million and Rs.7,79,393 million, respectively as compared to growth in sanctions and disbursements of 28.3% and 21.2% in 1999-2000, respectively. Within AIFIs, AIDBs' sanctions and disbursements grew by 17.3% (22.9%) and 9.7% (17.6%), respectively. During 2000-01, investment institutions recorded a growth of 15% and 2.6% in sanctions and disbursements, as compared to 64.1% and 39.9%, respectively in 1999-2000. Sanctions by specialized financial institutions, however, declined by 14.7% as against a growth of 41.2% in the previous year, whereas disbursements recorded a growth of 8.4% (25%). AIDBs accounted for the bulk of the sanctions 78.9% (80%) and disbursements 74.7% (75.6%) during the year. The share of specialized financial institutions in total sanctions and disbursements was 2.9% (4.1%) and 4.3% (4.4%) respectively, while that of investment institutions stood at 14.8% (15.3%) and 17.2% (18.6%), respectively. Sanctions and disbursements by state-level institutions viz., SFCs and SIDCs together increased by 26.8% and 6.7% to Rs.48,700 million and Rs.36,694 million, respectively, as against decline in sanctions and disbursements of 7.4% and 9.5% in 1999- 2000, respectively. SFCs and SIDCs together accounted for 3.8% and 4.5% of total sanctions and disbursements during the year.

1.3 ROLE OF FINANCIAL INSTITUTIONS

Financial institutions obtain funds by issuing financial claims against themselves to market participants, and then investing those funds; the investments made by financial institutions their assets- can be in loans and/or securities. These investments are referred to as direct investments. Market participants who hold the financial claims issued by financial institutions are said to have made indirect investments. We can elaborate this further by understanding that financial institutions are business organizations that act as mobilizes and depositories of savings, and as purveyors of credit or finance. They also provide various financial services to the community. They differ from non-financial (industrial and commercial) business organizations in respect of their dealings, i.e., while the former deal in financial assets such as deposits, loans, securities, and so on, the latter deal in real assets such as machinery, equipment, stocks of goods, real estate, and so on.

You should not think that the distinction between the financial sector and the "real sector" is something ephemeral or unproductive about finance. At the same time, it means that the role of financial sector should not be over emphasized. The activities of different financial institutions may be either specialized or they may overlap; quite often they overlap. Yet you need to classify financial institutions and this is done on the basis of their primary activity or the degree of their specialization with relation to savers or borrowers with whom they customarily deal or the manner of their creation.

Self Check Exercise (True/False)

1. The role of financial institutions in microfinance is limited to providing loans to microfinance institutions.
2. Technology and innovation are not essential aspects of the role of financial institutions in microfinance.

1.4 FINANCIAL SYSTEM, FINANCIAL INSTITUTIONS AND ECONOMIC DEVELOPMENT

With the quickened pace of economic development under the impetus of the five years plans, the most striking change in the Indian economy has been the intimation of an industrial revolution and the reemergence of small-scale industries. Further during the past decade, there has been depending as well as widening of the entrepreneurial structure as well as the small-scale industry structure. Not only have been established small industries increased their installed capacity and output, but a wide range of new small industries has also come into being. During the last two decades, there is a boom of entrepreneurial activities in the country. Thus, in the field of capital and product goods industries, enterprises manufacturing such item as machine tools electrical and engineering equipment chemical etc. Which provide the foundation for a self-sustained growth of the economy have been set up. Amongst the consumer goods industries small units producing such item as bicycle, sewing machines plastic product etc are for going ahead.

There far-reaching developments and the scale and scope of operation of entrepreneurs particularly in small-scale industries have brought to the fore the importance to the provision of administrative and institutional assistance at various levels.

Over the years, financial institutions are playing a key role in providing finance and counseling to the entrepreneurs to start new ventures as well as modernize diversify and even rehabilitate sick enterprises. In the context we shall discuss the scale and scope of operation of various development banks which have been rendering financial assistance, directly or indirectly to entrepreneurs and their various ventures.

It has been argued that men, materials, and money are crucial inputs in production activities. The human capital and physical capital can be bought and developed with money. The human capital and physical capital can be bought and developed with money. In a sense, therefore, money, credit, and finance are the lifeblood of the economic system. Given the real resources and suitable attitudes, a well-developed financial system can contribute significantly to the acceleration of economic development through three routes. First, technical progress is endogenous; human and physical capitals are its important sources and any increase in them requires higher saving and investment, which the financial system helps to achieve. Second, the financial system contributes to growth not only via technical progress but also in its own right. Economic development greatly depends on the rate of capital formation. The relationship between capital and output is strong, direct, and monotonic (the position which is sometimes referred to as "capital fundamentalism"). Now, the capital formation depends on whether finance is made available in time, in adequate quantity, and on favourable terms-all of which a good financial system achieves. Third, it also enlarges markets over space and time; it enhances the efficiency of the function of medium of exchange and thereby helps in economic development.

We can conclude from the above that in order to understand the importance of the financial system in economic development, we need to know its impact on the saving and investment processes. The following theories have analyzed this impact:

(a) The Classical Prior Saving Theory,

(b) Credit Creation or Forced Saving or Inflationary Financing Theory,

(c) Financial Repression Theory,

(d) Financial Liberalization Theory.

The Prior Saving Theory regards saving as a prerequisite of investment, and stresses the need for policies to mobilize savings voluntarily for investment and growth. The financial system has both the scale and structure effect on saving and investment. It increases the rate of growth (volume) of saving and investment, and makes their composition, allocation, and utilization more optimal and efficient. It activates saving or reduces idle saving; it also reduces un fruitful investment and the cost of transferring saving to investment. How is this achieved? In any economy, in a given period of time, there are some people whose current expenditures is less than their current incomes, while there are others whose current expenditures exceed their current incomes. In well-known terminology, the former are called the ultimate savers or surplus- -spending-units, and the latter are called the ultimate investors or the deficit-spending- units. -

Modern economies are characterized (a) by the ever-expanding nature of business organizations such as joint-stock companies or corporations, (b) by the ever-increasing scale of production, (c) by the separation of savers and investors, and (d) by the differences in the attitudes of savers (cautious, conservative, and usually averse to taking risks) and investors (dynamic and risk takers).In these conditions, which Samuelson calls the dichotomy of saving and investment, it is necessary to connect the savers with the investors. Otherwise, savings would be wasted or hoarded for want of investment opportunities, and investment plans will have to be abandoned for want of savings. The function of a financial system is to establish a bridge between the savers and investors and thereby help the mobilization of savings to enable the fructification of investment ideas into realities.

A financial system helps to increase output by moving the economic system towards the existing production frontier. This is done by transforming a given total amount of wealth into more productive forms. It induces people to hold fewer saving in the form of precious metals, real estate land, consumer durables, and currency, and to replace these assets by bonds, shares, units, etc.

The saving is said to be "institution-elastic" i.e., easy access, nearness, better return, and other favourable features offered by a well- developed financial system lead to increased saving.

A financial system helps to increase the volume of investment also. It becomes possible for the deficit spending units to undertake more investment because it would enable them to command more capital. As Schumpeter has said, without the transfer of purchasing power to an entrepreneur, he cannot become the entrepreneur. Further, it encourages investment activity by reducing the cost of finance and risk. This is done by providing insurance services and hedging opportunities, and by making financial services such as remittance, discounting, acceptance and guarantees available. Finally, it not only encourages greater investment but also raises the level of resource allocation efficiency among different investment channels. It helps to sort out and rank investment projects by sponsoring, encouraging, and selectively supporting business units or borrowers through more systematic and expert project appraisal, feasibility studies, monitoring, and by generally keeping a watch over the execution and management of projects.

The contribution of a financial system to growth goes beyond increasing prior-saving- based investment. There are two strands of thought in this regard. According to the first one, as emphasized by Kalecki and Schumpeter, financial system plays a positive and catalytic role by creating and providing finance or credit in anticipation of savings. This, to a certain extent, ensures the independence of investment from saving in a given period of time. The investment financed through created credit generates the appropriate level of income. This in turn leads to an amount of savings, which is equal to the investment already undertaken. The First Five Year Plan in India echoed this view when it stated that judicious credit creation in production and availability of genuine savings has also a part to play in the process of economic development. It is assumed here that the investment out of created credit results in prompt income generation. Otherwise, there will be sustained inflation rather than sustained growth. The second strand of thought propounded by Keynes and Tobin argues that investment, and not saving, is the constraint on growth, and that investment determines saving and not the other way round. The monetary expansion and the repressive policies result in a number of saving and growth promoting forces: (a) if resources are unemployed, they increase aggregate demand, output, and saving; (b) if resources are fully employed, they generate inflation which lowers the real rate of return on financial investments. This in turn, induces portfolio shifts in such a manner that wealth holders now invest more in real, physical capital, thereby increasing output and saving; (c) inflation changes income distribution in favour of profit earners (who have a high propensity to save) rather than wage earners (who have a low propensity to save), and thereby increases saving; and (d) inflation imposes tax on real money balances and thereby transfers resources to the government for financing investment. The extent of contribution of the financial sector to saving, investment, and growth is said to depend upon its being free or repressed (regulated). One school of thought argues that financial repression and the low/ negative real interest rates which go along with it encourage people (i) to hold their saving in unproductive real assets, (ii) to be rent -seekers because of non-market allocation of investible funds, (iii) to be indulgent which lowers the rate of saving, (iv) to misallocate resources and attain inefficient investment profile, and (v) to promote capital intensive industrial structure inconsistent with the factor-endowment of developing countries. Financial liberalization or deregulation corrects these ill effects and leads to financial as

well as economic development. However, as indicated earlier, some economists believe that financial repression is beneficial. The most recent thinking on this subject says that the empirical foundations of financial liberalization are not robust enough, and that mild, moderate, small repression is more growth promoting than either large-scale repression or complete laissez-faire.

1.5 CLASSIFICATION OF FINANCIAL INSTITUTIONS

We can classify financial institutions into banking and non-banking institutions. You know that the banking institutions have quite a few things in common with the nonbanking ones, but their distinguishing character lies in the fact that, unlike other institutions, they participate in the economy's payments mechanism, i.e., they provide transactions services, their deposit liabilities constitute a major part of the national money supply, and they can, as a whole, create deposits or credit, which is money. Banks, subject to legal reserve requirements, can advance credit by creating claims against themselves, while other institutions can lend only out of resources put at their disposal by the savers, and the latter as mere "purveyors" of credit. While the banking system in India comprises the commercial banks and co-operative banks, the examples of non-banking financial institutions are Life Insurance Corporation (LIC), Unit Trust of India (UTI), and Industrial Development Bank of India (IDBI). We shall discuss this in detail later. There are also few other ways to classify financial institution. Like they can be classified as intermediaries and no intermediaries. As we have seen earlier, intermediaries intermediate between savers and investors; they lend money as well as mobilize savings; their liabilities are towards the ultimate savers, while their assets are from the investors or borrowers.

Non--intermediary institutions do the loan business but their resources are not directly obtained from the savers. All banking institutions are intermediaries. Many nonbanking institutions also act as intermediaries and when they do so they are known as Non- Banking Financial Intermediaries (NBFI). UTI, LIC, General Insurance Corporation (GIC) is some of the NBFIs in India. Non-intermediary institutions like IDBI, Industrial Finance Corporation (IFC), and National Bank for Agriculture and Rural Development (NABARD) have come into existence because of governmental efforts to provide assistance for specific purposes, sectors, and regions. Their creation as a matter of policy has been motivated by the philosophy that the credit needs of certain borrowers might not be otherwise adequately met by the usual private institutions. Since they have been set up by the government, we can call them Non-Banking Statutory Financial Organizations (NBSFO).

Let us now shift our focus to financial markets. Financial markets are the centers or arrangements that provide facilities for buying and selling of financial claims and services. The corporations, financial institutions, individuals and governments trade in financial products in these markets either directly or through brokers and dealers on organized exchanges or off—exchanges. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers, and others who are interlinked by the laws, contracts, covenants and communication networks. Financial markets are sometimes classified as primary (direct) and secondary (indirect) markets. You all must be well aware that primary markets deal in the new financial claims or new securities and, therefore, they are also known as new issue markets. On the other hand, secondary markets deal in securities already issued or

existing or outstanding. The primary markets mobilize savings and supply fresh or additional capital to business units. Although secondary markets do not contribute directly to the supply of additional capital, they do so indirectly by rendering securities issued on the primary markets liquid. Stock markets have both primary and secondary market segments.

Very often financial markets are classified as money markets and capital markets, although there is no essential difference between the two as both perform the same function of transferring resources to the producers. This conventional distinction is based on the differences in the period of maturity of financial assets issued in these markets. While money markets deal in the short-term claims (with a period of maturity of one year or less), capital markets do so in the long-term (maturity period above one year) claims. Contrary to popular usage, the capital market is not only co-extensive with the stock market; but it is also much wider than the stock market.

Similarly, it is not always possible to include a given participant in either of the two (money and capital) markets alone. Commercial banks, for example, belong to both. While treasury bills market, call money market, and commercial bills market are examples of money market; stock market and government bonds market are examples of capital market. What are the points of difference related to financial instruments? These instruments differ from each other in respect of their investment characteristics, which of course, are interdependent and interrelated. Among the investment characteristics of financial assets or financial products, the following are important: (i) liquidity, (ii) marketability, (iii) reversibility, (iv) transferability, (v) transactions costs, (vi) risk of default or the degree of capital and income uncertainty, and a wide array of other risks, (vii) maturity period, (viii) tax status, (ix) options such as call-back or buy-back option, (x) volatility of prices, and (xi) the rate of return-nominal, effective, and real.

Self Check Exercise

3. What is the primary function of financial institutions in microfinance?
4. What does the financial system provide to micro financial institutions?
5. Why are partnerships with financial institutions crucial for microfinance?

1.6 FUNCTIONS OF FINANCIAL INSTITUTIONS

After a detailed discussion on financial institution, it becomes easy for us to determine the functions of financial institution. Financial institutions or institutions offer various types of transformation services. They issue claims to their customers that have characteristics different from those of their own assets. For example, banks accept deposits as liability and convert them into assets such as loans. This is known as "liability-asset transformation" function. Similarly they choose and manage portfolios whose risk and return they alter by applying resources to acquire better information and to reduce or overcome transaction costs. They are able to do so through economies of scale in lending and borrowing. They provide large volumes of finance on the basis of small deposits or unit capital. This is called "size-transformation" function.

Further, they distribute risk through diversification and thereby reduce it for savers as in the case of mutual funds. This is called "risk-transformation" function. Finally they offer savers alternate forms of deposits according to their liquidity preferences, and provide borrowers with loans of requisite maturities. This is known as "maturity-transformation" function. A financial system also ensures that transactions are effected safely and swiftly on an on-going basis. It is important that both buyers and sellers of goods and services should have the confidence that instruments used to make payments will be accepted and honored by all parties. The financial system ensures the efficient functioning of the payment mechanism.

In a nutshell, financial markets can be said to perform proximate functions such as

1. Enabling economic units to exercise their time preference,
2. Separation, distribution, diversification, and reduction of risk,
3. Efficient operation of the payment mechanism,
4. Transmutation or transformation of financial claims so as to suit the preferences of both savers and borrowers,
5. Enhancing liquidity of financial claims through securities trading, and
6. Portfolio management.

1.7 DEFICIENCIES OF FINANCIAL INSTITUTIONS

Given the controversy regarding the contribution of financial sector, it is necessary to have a framework to evaluate the performance of the country's financial sector. Let us first look at the criteria formulated, in the form of questions, by Richard D. Erb, the former Deputy Managing Director of the International Monetary Fund: (i) Do institutions find the most productive investments? (ii) Do institutions revalue their assets and liabilities in response to changed circumstances? (iii) Do investors and financial institutions expect to be bailed out of mistakes and at what price? (iv) Do institutions facilitate the management of risk by making available the means to insure, hedge, and diversify risks? (v) Do institutions effectively monitor the performance of their users, and discipline those not making proper and effective use of their resources? (vi) How effective is the legal, regulatory, supervisory, and judicial structure? (vii) Do financial institutions publish consistent and transparent information? These criteria, useful as they are, do not encompass social and ethical aspects of finance which ought to be regarded as important as economic aspects. Therefore, the relevant normative criteria, organizing principles, and value premises which should guide the functioning of the financial system are :

- Finance is the most critical factor in development. The use of finance must be imbued with the virtues of austerity, self--limit, and minimization.
- Financial reforms are not merely a question of "credit limits"; they encompass issues involved in "limits of credit".
- State intervention is not the best way to achieve a fair distribution of credit.
- Financial institutions must evolve from below rather than be imposed from above.
- Financial development ought to take place at a slow and steady pace rather than in spurts and in a programmed or (time) encapsulated manner.
- There should be a replacement of large-scale by small-scale, wholesale by retail, and class by mass banking.
- The sufficing principle rather than the maximizing one should power the financial system. The functioning of different financial institutions must be on the basis of a communitarian spirit, not competition and profit motive.
- The financing of investment which results in the displacement or retrenchment of labour should be discouraged.
- The scope for financing various sectors is ultimately constrained by domestic saving. The substantial increase in the total saving in India is unlikely to take place now.
- The working of the Indian financial system should not be corporate-sector- centric. There are limits to the overall and industrial growth, and, therefore, a "ceiling" on the targeted rate of growth has to be imposed.

The only legitimate role of the financial markets is infrastructural; hence they should not exist to provide opportunities to make quick, disproportionate pecuniary gains. It is the primary markets activity of supporting new, economically and socially productive real investment, trade, and flows of goods and services, which is of foremost importance. The enthusiasm, hyperactivity, and preoccupation with the secondary markets ought to be avoided.

1.8 SUMMARY

Financial institutions provide various types of financial services. Financial intermediaries are a special group of financial institutions that obtain funds by issuing claims to market participants and use these funds to purchase financial assets. Intermediaries transform funds they acquire into assets that are more attractive to the public. By doing so, financial Intermediaries do one or more of the following: (1) provide maturity intermediation; (2) provide risk reduction via diversification at lower cost; (3) reduce the cost of contracting and information processing; or (4) provide a payments mechanism. The nature of their liabilities determines the investment strategy pursued by all financial institutions.

1.9 Keywords

- **Accountability:** Obligation to give answers and explanations concerning one's actions. Internal accountability exists within organizations; an example is management's responsibility to a board of directors. External accountability denotes an organization's responsibility to shareholders, lenders, and the public. The Bank monitors borrower accountability through project reviews and auditing to ensure that Bank funds are used with economy and efficiency, and in support of good governance.
- **Accounting:** Process of recording, measuring, interpreting, and communicating financial data for the purpose of decision making.
- **Audit:** The inspection of the accounting records and procedures of a business, government unit, or other reporting entity by a trained accountant for the purpose of verifying the accuracy and completeness of the records. It could be conducted by a member of the organization (internal audit) or by an outsider (independent audit).
- **Commercial Bank:** A financial institution that provides commercial banking services. A commercial bank accepts deposits, gives business loans and provides other services to businesses.
- **Central Bank:** The bank that provides financial and banking services to the government of a country and its commercial banking system and which implements the government's monetary policy.

1.10 PRACTICE QUESTIONS

Short Answer Type Questions

1. What is the Significance and Definition of Financial System?
2. What is the Importance of Financial Institutions?

Long Answer Type Questions

3. What is the Role of Financial Institutions?
4. What are the various classifications of Financial Institutions?

5. What are the functions of Financial Institutions?
6. What are the effects of Financial Institutions on saving and Investment?
7. Discuss the relationship Between Financial System, Institutions and Economic Development?

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1.12Self Check Exercise (Answer Key)

1. False, 2. False, 3. Support, 4. Facilitation, 5. Collaboration

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RESERVE BANK OF INDIA — PRIMARY FUNCTIONS

STRUCTURE

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2.10 Questions for Review
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2.12 Self Check Exercise (Answer Key)

2.0 OBJECTIVES

After going through this lesson, you will be able to understand and analyze the role and performance of RBI. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand the following:

- Organization and management of RBI
- Function and Roles of RBI
- Treasury Bills
- The Reserve Bank as Banker and Advisor to Government

2.1 INTRODUCTION

As you know, the central bank of any country is the apex institution in its banking system. It is a authority to issue currency notes and its role as a government's banker and a bankers' bank impart to it a unique position in the banking structure of a country. The Reserve Bank of India (RBI) which is the central bank of this country performs not only those functions which central banks in developed countries perform but also certainpromotional and developmental functions to help the development of the less developed financial markets and institutions. In this lesson you will study in detail about the functions of RBI and its overall role.

A study of financial institutions in India should appropriately begin with a brief discussion of the regulatory framework of the country. Since the financial markets are characterized by various degrees of imperfections, the need for regulation prudential or otherwise-even in a liberalized framework cannot be denied. The financial system deals in other people's money and, therefore, their confidence, trust and faith in it is crucially important for its smooth functioning. Financial regulation is necessary to generate, maintain and promote this trust. One reason why the public trust may be lost is that some of the savers or investors or intermediaries may imprudently take too much risk, which could engender defaults, bankruptcies, and insolvencies. Thus a regulation is needed to check imprudence in the system.

The task of efficient regulation is rendered difficult by the very nature of financial assets, which are mobile, easily transferable or negotiable; and also by the nature of financial markets which are prone to a systemic risk. The modern trading technology and the possibility of high leveraging enable market participants to take large stakes, which are disproportionate with their own investments. There are also frequent instances of dishonest, unfair, fraudulent, and unethical practices or activities of the market intermediaries or agencies such as brokers, merchant bankers, custodians, trustees, etc. The regulation becomes necessary to ensure that the investors are protected; that disclosure and access to information are adequate, timely, and equal; that the participants measure up to the rules of the market place; and that the markets are both fair and efficient. In this context, it is said that fairness and efficiency are two sides of the same coin; if the market is unfair, in the end, it is also inefficient.

The regulatory framework or apparatus for the financial sector in India broadly consists of the Ministry of Finance of the Government of India which administers the Companies Act, 1956, and the Securities Contracts (Regulation) Act, 1956; the Reserve Bank of India and the Board of Financial Supervision (BFS) under its aegis; the Securities and Exchange Board of India (SEBI), Insurance Regulatory Authority; the Governing Boards of various stock exchanges and the apex financial institutions such as the IDBI, SIDBI, NHB and NCB. Among these, the RBI and SEBI have special role and responsibility. We shall first discuss the functioning of the RBI followed by the SEBI.

2.2 ORGANISATION AND MANAGEMENT OF RBI

The Reserve Bank of India was established on April 1, 1935, under the Reserve Bank of India Act, 1934. The main functions of the Bank are to act as the note-issuing authority. Banker's Bank, Banker to the government and to promote the growth of the economy within the framework of the general economic policy of the government, consistent with the need to maintain price stability. The Bank also performs a wide range of promotional functions to support the pace of economic development. The Reserve Bank is the controller of foreign exchange. It is the watchdog of the entire financial system. The Bank is the sponsor bank of a wide variety of top-ranking banks and institutions such as SBI, IDBI, NABARD and NHB. The Bank sits on the board of all banks and it counsels the Central and State Government and all public sector institutions on monetary and money matters. No central bank, even in the developed world, is saddled with such onerous responsibilities and functions.

The RBI, as the central bank of the country, is the centre of the Indian Financial and Monetary System. As the apex institution, it has been guiding, monitoring, regulating, controlling, and promoting the destiny of the IFS since its inception. It is quite young compared with such central banks as the Bank of England, Risk bank of Sweden, and the Federal Reserve Board-of the US. However, it is perhaps the oldest among the central banks in the developing countries. It started functioning from April 1, 1935 on the terms of the Reserve Bank of India Act, 1934. It was a private shareholders' institution till January 1949, after which it became a state-owned institution under the Reserve Bank (Transfer to Public Ownership) of India Act, 1948. This act empowers the central government, in consultation with the Governor of the Bank, to issue such directions to it, as they might consider necessary in the public interest. Further, the Governor and all the Deputy Governors of the Bank are appointed by the Central Government.

The Bank is managed by a Central Board of Directors, four Local Boards of Directors, and a committee of the Central Board of Directors. The functions of the Local Boards are to advise the Central Board on matters referred to them; they are also required to perform duties as are delegated to them. The final control of the Bank vests in the Central Board, which comprises the Governor, four Deputy Governors, and fifteen Directors nominated by the central government. The committee of the Central Board consists of the Governor, the Deputy Governors, and such other Directors as may be present at a given meeting. The internal organizational set-up of the Bank has been modified and expanded from time to time in order to cope with the increasing volume and range of the Bank's activities. The underlying principle of the internal organization is functional specialization with adequate coordination. In order to perform its various functions, the Bank has been divided and sub-divided into a large number of departments.

The pattern of central banking in India was initially based on the Bank of England. England had a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's function as 'a lender of last resort' was on the condition that the banks maintain stable cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate.

The effectiveness of open market operations however depends on the member banks' dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

2.3 FUNCTIONS OF RBI

The RBI functions within the framework of a mixed economic system. With regard to framing various policies, it is necessary to maintain close and continuous collaboration between the government and the RBI. In the event of a difference of opinion or conflict, the government view or position can always be expected to prevail.

The Preamble of the RBI Act, 1934 states that "Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in (India) and generally to operate the currency and credit system of the country to its advantage".

To elaborate, the main functions of the RBI are:

- To maintain financial, stability and ensure sound financial institution so that monetary stability can be safely pursued and economic units can conduct their business with confidence.
- To maintain stable payments system so that financial transactions can be safely and efficiently executed.
- To promote the development of financial infrastructure of markets and systems, and to enable it to operate efficiently i.e., to play a leading role in developing a sound financial system so that it can discharge its regulatory function efficiently.
- To ensure that credit allocation by the financial system broadly reflects the

national economic priorities and societal concerns.

- To regulate the overall volume of money and credit in the economy with a view to ensure a reasonable degree of price stability.

Self Check Exercise

1.What is the primary function of RBI in microfinance?

2. How does RBI contribute to the stability of microfinancial institutions?

2.4 ROLE OF RBI

In view of the Bank's close contacts and intimate knowledge of the financial markets, it is in a position to advise the Central and State Governments on the Quantum, timing and terms of issue of new loans. While formulating the borrowing program for the year, the Government and the Bank take into account a number of considerations such as the amount of Central and State loans maturing for redemption during the year, the estimate of available resources (based on the estimated growth in deposits with the banks, premium income of insurance companies and accretions to provident funds) and the absorptive capacity of the market.

In India, banks, insurance companies and provident funds are statutorily required to invest a portion of their liabilities, premium income or accretions, as the case may be, in Government and other approved securities, which ensure a captive market for these securities, facilitating the easy absorption of new issues. The Bank tries to ensure that over a reasonably long period it will be neither a net purchaser of securities from the market nor a net seller so that the loans raised are absorbed by the market outside the Bank to the maximum extent.

The Bank actively operates in the gilt-edged market to ensure the success of Government loan operations. For instance, the Bank grooms the market by acquiring securities nearing maturity to facilitate redemption. If maturing stocks are held by investors to the last, conditions in the money market are likely to be disturbed as most of the cash paid out seeks avenues of reinvestment, but, in practice, all the investors are not equally eager to wait for cash repayment on the redemption date and then undertake reinvestment, as they can reinvest the proceeds at times of their own choosing if these were realized earlier, the Bank, therefore, stands ready as the stock approaches maturity to buy all the stocks offered for sale at these terms. Thus, in carrying out the loan operations of the Government the Bank endeavors on the one hand to minimize the effects of such operations on the money market and Government securities market, and on the other to obtain the best possible terms for the Government concerned. The close involvement in the market by its continuous presence and the willingness to deal in the securities at process determined by it give the Bank a good degree of flexibility when it is seeking occasions for implementing a shift in policy on prices.

The timing of the issue of new loans is normally left to the Reserve Bank. The Central Government and the state Governments float market loans separately, but through the Reserve Bank. For the management of the public debt of the Government, the Bank charges a commission. In addition, the Reserve Bank also charges for all new issues both by Central and State Government loans, besides recovering brokerage and expenses incurred by the Bank on account of printing of loan notifications, telegrams, advertisements, etc.

2.5 TREASURY BILLS

You must be well aware that Treasury Bills are the main instrument of short-term borrowing by the Government, and serve as a convenient gilt-edged security for the money market. The qualities of high liquidity, absence of risk of default, and negligible capital depreciation in case of sale before maturity make them an ideal form of short-term investment

for banks and other financial institutions.

In certain countries, unlike in India, Treasury Bills are an important tool for the central bank for influencing the level of liquidity in the money market through open market operations.

Sale of Treasury Bills helps to absorb any excess liquidity in the money market and, conversely, their purchase by the central bank has the effect of relieving stringency. Since neither the Government nor the money market wishes to hold surplus cash, the central bank steps in and restores the equilibrium by selling to or purchasing from the money market Treasury Bills (and similar other securities) accordingly as the Government payments are larger than its receipts or vice versa. In this way, the Government is able to borrow cheaply to meet its immediate needs and to use its temporary surplus to buy back before maturity some of its outstanding debt.

The Reserve Bank, as the agent of the Government, issues Treasury Bills at a 'discount'. These are negotiable securities and can be rediscounted with the Bank at any time before maturity upon terms and conditions determined by it from time to time.

2.6 THE RESERVE BANK AS BANKER TO GOVERNMENT

You have been studying since childhood that The Reserve Bank is the Central Bank of India. It is the banker to the Central Government statutorily and to the State Governments by virtue of agreements entered into with them. The Bank provides a full range of banking services for these Governments such as acceptance of moneys on deposit, withdrawal of funds by cheques, receipt and collection of payments to Government and transfer of funds by various means throughout India. The Governments' main accounts are held in the Bank. A large number of branches of agency banks, sub-agency banks and Treasury agencies also undertake Government business because the Bank has branches/ offices mainly in the State capitals and a few big cities in the country. The Government revenue collected through the agency banks is remitted to the Government accounts at the Bank in due course.

Before the establishment of the Bank, the more important current financial transactions of the Indian Government were handled by the then Imperial Bank of India; the administration of the public debt was the direct responsibility of the Government although the Public Debt Offices were being managed by the Imperial Bank. Both these responsibilities in regard to Government finance were centralized in the Reserve Bank on its formation. Further, the Bank acts as the banker not only to the Government of India, but in view of the federal character of the constitution of India, also to the Governments of the States.

2.7 ADVISER TO GOVERNMENT

The Bank has ordinary banking relationship with the Government, performing deposit and lending functions. It manages the public debt on behalf of the Government. Besides, the Bank is entrusted with a wide range of statutory functions such as buying and selling of foreign exchange, administration of exchange control and provision of rural credit, the performance ofwhich.-is-_attuned to the policies of the Government in the relevant areas it maintains close coordination with the Government at all levels, especially with the Ministry of Finance, both in the day-to-day affairs and through participation in the official committees.

The fiscal operations of the Government exercise a direct and significant impact on the monetary and credit system, which the Bank is required to regulate. It follows that monetary and credit policies can be implemented more effectively if there is coordination between them and the economic policies of the Government. Hence, the Bank takes an active interest in the formulation of fiscal and other policies of the Government and tenders advice calculated to promoter the attainment of the national economic goals.

Daily operations in the gilt-edged and foreign exchange markets and close contacts with the commercial banks and other financial institutions and with the business world in general have equipped the Reserve Bank with the technical knowledge of, and practical experience in, these spheres which contribute greatly to the Bank's competence to give financial advice to Government. Like all central banks, the Bank acts as adviser to the Government not only on policies concerning banking and financial matters but also on a wide range of economic issues including those in the field of planning and resource mobilization. It has of course a special responsibility in respect of policies and measures concerning new loans, agricultural finance, co-operative organization, industrial finance and legislation affecting banking and credit.

The Bank's advice is sought on certain aspects of formulation of the country's Five Year Plans, such as the financial pattern, mobilization of resources and institutional arrangements with regard to banking and credit matters. As the agency for administration of exchange control, the Bank's intimate knowledge of the exchange markets, trade and balance of payments position places it in a vantage position to offer sound technical advice to Government in evolving policies on international finance and regulations regarding foreign trade and exchange. For the effective discharge of this advisory role, the Bank has built up a research and statistical organization.

The Bank is the main channel of communication between the Government on the one hand and the banks and financial institution on the other. The Bank, we now know, keeps the Government informed of the developments in the financial markets from time to time. Thus RBI being the banker to the central and state governments provides to the governments all banking services such as acceptance of deposits, withdrawal of funds by cheques, making payments as well as receipts and collection of payments on behalf of the government, transfer of funds, and management of public debt.

The Bank receives government deposits free of interest, and it is not entitled to any remuneration for the conduct of the ordinary banking business of the Government. The deficit or surplus in the central government account with the RBI is managed by the creation and cancellation of treasury bills (known as ad hoc treasury bills).

As a banker to the government, the Bank can make "ways and means advances" (i.e., temporary advances made in order to bridge the temporary gap between receipts and payments) to both the central and state governments. The maximum maturity period of these advances is- three months. However, in practice, the gap between receipts and payments in respect of the central government used to be met by the issue of ad hoc treasury bills, while the one in respect of the state governments is met by the ways and means advances. The arrangements in this regard have been changed in the recent past. The ways and means advances to the state governments are subject to some limits. These advances are of the following types: (a) normal or clean advances i.e., advances without any collateral security; (b)secured advances, i.e., those which are secured against the pledge of central government securities; and (c) special advances, i.e., those granted by the Bank at its discretion. The interest rate charged by the Bank on these advances did not, till May 1976, exceed the Bank rate. Thereafter, the Bank has been operating a graduated scale of interest based on the duration of the advance.

Apart from the ways and means advances, the state governments have made heavy use of overdrafts from the RBI.

An overdraft refers to drawls of credit by the stale governments from the RBI in excess of the credit (ways and means advances) limits granted by the RBI. In other words, overdrafts are unauthorized ways and means advances drawn by the state governments on the RBI. The management of the states' overdrafts has gradually become one of the major responsibilities of the RBI on account of the persistence of large proportions of those overdrafts. The issue, management and administration of the public (central and state governments) debt are among the major functions of the RBI as the banker to the government. The Bank charges a commission from the governments for rendering this service.

Self Check Exercise

3.What is the primary regulatory function of RBI in microfinance?
a) Funding
b) Supervision
c) Innovation
d) Marketing

4.RBI plays a crucial role in ensuring the stability and __________ of microfinancial institutions.
a) Expansion
b) Inclusion
c) Disruption
d) Profitability

5.One of the key functions of RBI in microfinance is the formulation and implementation of __________ policies.
a) Monetary
b) Agricultural
c) Social
d) Educational

2.8 SUMMARY

The lesson discusses the major roles and functions of RBI. The Reserve Bank of India was established on April 1, 1935, under the Reserve Bank of India Act, 1934. The main functions of the Bank are to act as the note-issuing authority. Banker’s Bank, Banker to the government and to promote the growth of the economy within the framework of the general economic policy of the government, consistent with the need to maintain price stability. The Bank also performs a wide range of promotional functions to support the pace of economic development. The Reserve Bank is the controller of foreign exchange. It is the watchdog of the entire financial system. The Bank is the sponsor bank of a wide variety of top-ranking banks and institutions such as SBI, IDBI, NABARD and NHB. The Bank sits on the board of all banks and it counsels the Central and State Government and all public sector institutions on monetary and money matters. No central bank, even in the developed world, is saddled with such onerous responsibilities and functions.

2.9 Keywords

- **Commercial Bank:** A financial institution that provides commercial banking services. A commercial bank accepts deposits, gives business loans and provides other services to businesses.
- **Central Bank:** The bank that provides financial and. banking services to the government of a country and its commercial banking system and which implement^ the-government's monetary policy.
- **Cash Reserve Ratio:** Ratio of cash reserve to bankas aggregate deposits.
- **Currency Chests:** Receptacles in which issuable notes are stored.
- **Exchange Control:** Control of the monetary authority over all transactions involving foreign exchange.
- **Margin Requirement:** A position of the value of the security charged to the bank, which is required to be paid by the borrower out of its own resources.

2.10 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. What is the primary objective of the Reserve Bank of India (RBI)?
2. How does the RBI contribute to the regulation and supervision of financial institutions in India?

Long Answer Type Questions

3. What is the Importance of Financial Institutions?
4. Discuss the Organization and Management of RBI.
5. What is the Role of RBI?
6. What are the functions of RBI?

2.11 Self Check Exercise (Answer Key)

1. Regulation, 2. Supervision, 3. Supervision, 4. Inclusion. 5. Monetary

Lesson No. 3

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RESERVE BANK OF INDIA - SECONDARY FUNCTIONS

STRUCTURE

3.0 Objectives
3.1 Note Issuing Authority
3.2 Supervising Authority
3.3 Exchange Control Authority
3.4 Autonomy for Central Bank
3.5 Summary
3.6 Keywords
3.7 Questions for Review
3.8 Suggested Readings
3.9 Self Check Exercise (Answer Key)

3.0 OBJECTIVES

After going through this lesson, you will be able to understand and analyse the role and performance of RBI. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand the following:

- Other major functions of RBI
- Authorities vested with RBI
- Autonomy for Central Bank

3.1 NOTE ISSUING AUTHORITY

The RBI has, since its inception, the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins, and coins of smellier denominations. The issue of currency notes is one of its basic functions. Although one rupee coins and notes, and coins of smaller denominations are issued by the Government of India, they are put into circulation only through the RBI.

The currency notes issued by the Bank are legal tender everywhere in India without any limit. At present, the Bank issues notes in the following denominations: Rs 5, 10, 20, 50, 100, 500 and 1000. The responsibility of the Bank is not only to put currency into or withdraw it from circulation but also to exchange notes and coins of one denomination into those of other denominations as demanded by the public. All affairs of the Bank relating to note issue are conducted through its Issue Department. In order to discharge its currency functions, the Bank has 15 full-fledged issue offices and 2 sub offices, and 4127 currency chests in which the stock of new and re-issuable notes, and rupee coins are stored. Of these, 17 chests were with the RBI, 2877 with the SBI and associate banks, 791 with nationalized banks, 423 with treasuries, and 19 with private sector banks (these numbers are not fixed and can be varied as per the requirement).

The Bank can issue notes against the security of gold coins and gold bullion, foreign securities, rupee coins, Government of India securities, and such bills of exchange and promissory notes as are eligible for purchase by the Bank. The RBI notes have a cent per cent backing or cover in these approved assets. Earlier i.e., till 1956, not less than 40% of these assets were to consist of gold coin and bullion and sterling/foreign securities.

In other words, the proportional reserve system of note issue existed in India till 1956. Thereafter, this system was abandoned and a minimum value of gold coin and bullion and foreign securities as a part of total approved assets came to be adopted as a cover for note issue.

PRINCIPLES OF NOTE ISSUE

At the time of establishment of the RBI, gold standard (that is, a monetary system in which the currency of the country was directly or indirectly convertible into gold) was still prevailing at the international level.

Therefore, in India the principle of linking gold and foreign reserves to note issue was followed by adopting proportional reserve system. Under this system the RBI was required to maintain a reserve of gold and foreign securities (until January 1, 1949 sterling securities), not less than 40% of the total assets. However, at any time gold reserve was not to fall below Rs. 40 crore in value. The proportional reserve system requirement could be suspended with the previous sanction of the central government. Nonetheless the RBI was required to pay a tax on the shortfall in the statutory required gold and foreign securities reserve. This system of note issue worked well for about two decades as it put a check on money supply in the economy and therefore, keeping an effective control on commodity and factor prices.

However, in 1956 with the adoption of the Second Five Year Plan a big push was to be given to development efforts. Moreover, the process of monetization became faster. Under, such circumstances the demand for money was expected to increase which under the constraints of the proportional reserve system could not be easily met. Further, it was felt that blocking of foreign exchange in reserve to back issue of currency notes served no useful purpose; rather they serve greater purpose if used to cover unavoidable deficits in the balance of payments. The system of note issue was, therefore, made more flexible in 1956.

The proportional reserve system was replaced by the minimum reserve system. This implies that the note issuing authority is under an obligation to maintain only a certain minimum of gold and foreign exchange reserve; the rest to be kept in the form of other eligible securities. In terms of the Reserve Bank of India (Amendment) Act, 1956 the minimum reserve prescribed was Rs. 400 crore in foreign securities and Rs. 115 crore in gold, adding up to Rs. 515 crore. In 1957 the provisions governing the minimum amount of reserve backing note issue were modified and the minimum requirement of the gold and foreign exchange reserve was fixed at Rs. 200 crore, of which the minimum value of gold was to be Rs. 115 crore. The Second Amendment Act of 1957 also empowered the RBI to dispense with reserve in foreign securities with the prior sanction of the Central Government. However, gold reserve of Rs. 115 crore is to be kept all the time. This system of note issue is no doubt flexible, but it does not provide for any check on inflationary tendencies.

3.2 SUPERVISING AUTHORITY

The RBI has vast powers to supervise and control commercial and co-operative banks with a view to developing an adequate and sound banking system in the country. It has, in this field, the following powers :

(a) to issue licenses for the establishment of new banks;

(b) to issue licenses for the setting up of bank branches;

(c) to prescribe minimum requirements regarding paid-up capital and reserves, transfer to reserve fund, and maintenance of cash reserves and other liquid assets;

to inspect the working of banks in India as well as abroad in respect of their organizational set-up, branch expansion, mobilization of deposits, investments, and credit portfolio management, credit appraisal, region-wise performance, profit planning, manpower planning and training, and so on;

(d) to conduct ad hoc investigations, from time to time, into complaints, irregularities, and frauds in respect of banks;

(e) to control methods of operations of banks so that they do not fritter away funds in improper investments and injudicious advances,

(f) to control appointment, re-appointment, termination of appointment of the Chairman and chief executive officers of private sector banks; and

(g) to approve or force amalgamations.

In keeping with the recommendations of Narasimham Committee (1991), the RBI function of bank supervision was separated from its traditional central banking function by the creation of a separate Department of Supervision (DOS) from 22 November 1993. Similarly, following the securities scam which showed the glaring weaknesses in the system for monitoring the financial sector, the Board of Financial Supervision (BFS) was set up on 16 November 1994 under the aegis of the RBI. The DOS initially took over the inspection of commercial banks from the Department of Banking Operations and Development (DBOD) of the RBI. Since April 1995, it has been taking steps to extend its area of supervision over the all-India financial institutions also. In July 1995, it took over the supervision of non-banking financial companies (NBFCs), and in November 1995 the registration of these companies, from the Department of Financial Companies (DFCs). The BFS has a full-time vice chairman and six other members; the RBI Governor is its chairman. It has powers to supervise and inspect banks, financial institutions, and NBFCs. There is five-member Advisory Council to render advice to it. The DOS assists the BFS.

Self Check Exercise

1. Apart from its primary functions, what is one key "monetary" secondary function of RBI in microfinance?
2. What role does RBI play in maintaining the stability and __________ of microfinancial institutions?
3. In addition to monetary policy, RBI actively engages in the development and promotion of the __________ sector in microfinance.

3.3 EXCHANGE CONTROL AUTHORITY

One of the essential functions of the RBI is to maintain the stability of the external value of the rupee. It pursues this objective through its domestic policies and the regulation of the foreign exchange market. As far as the external sector is concerned, the task of the RBI has the following dimensions:

(a) to administer the Foreign Exchange Control;

(b) to choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies;

(c) to manage exchange reserves; and

(d) to interact or negotiate with the monetary authorities of the Sterling Area, Asian Clearing Union, and other countries, and with international financial institutions such as the IMF, World Bank, and Asian Development Bank.

The RBI administers the Exchange Control in terms of the Foreign Exchange Regulation Act (FERA), 1947 which has been replaced by a more comprehensive Foreign Exchange Regulation Act, 1973. The FERA is now replaced by the Foreign Exchange Management Act (FEMA), which is consistent with full capital account convertibility and the objective of progressively liberalizing capital account transactions. The objective of exchange control is primarily to regulate the demand for foreign exchange within the limits set by the available supply. This is sought to be achieved by conserving foreign exchange, by using it in accordance with the plan priorities, and by controlling flows of foreign capital. In India, during most of the years since 1957, foreign exchange earnings have been far less than the demand for foreign exchange, with the result that the latter had to be rationed in order to maintain exchange stability. This is done through exchange control, which is imposed bothon receipts and payments of foreign exchange on trade and capital accounts.

The problem of foreign exchange shortage has been so persistent and acute that the scope of exchange control in India has steadily widened and the regulations have become progressively more elaborate over the years. The Bank administers the control through authorized foreign exchange dealers.

FEMA lays down that the exchange rates used for the conduct of foreign exchange business must be those, which are fixed by the RBI. The arrangements or the system under which exchange rate is fixed by the RBI has undergone many changes over the years. Till about 1971, as a member of the IMF, India had an exchange rate system of "managed flexibility". This arrangement changed during the 1970s as a result of international monetary crisis in 1971. Since 1975, the exchange rate of the rupee was being fixed in terms of the basket of currencies' till early 1990s.

The RBI is the custodian of the country's foreign exchange reserves, and it is vested with the responsibility of managing the investment and utilization of the reserves in the most advantageous manner. The RBI achieves this through buying and selling of foreign exchange from and to scheduled banks, which are the authorized dealers in the Indian foreign exchange market. The Bank also manages the investment of reserves in gold accounts abroad and the shares and securities issued by foreign governments and international banks or financial institutions.

The role of the RBI as a participant in the foreign exchange market, and as the stabilizer of that market and the rupee exchange rate has become all the more important with the introduction of the floating exchange rate system and the rupee convertibility on trade, current and capital accounts (the last one to take place in the near future). In the recent past, it has intervened significantly to achieve exchange rate stability Promoter of the Financial System Apart from performing the functions already mentioned, the RBI has been rendering 'developmental' or 'promotional' services, which have strengthened the country's banking and financial structure. This has helped in mobilizing savings and directing credit flows to desired channels, thereby helping to achieve the objective of economic development with social justice. It has helped in deepening and widening the financial system. As a part of its promotional role, the Bank has been pre-empting credit for certain sectors at concessional rates. In the money market, the RBI has continuously worked for the integration of its unorganized and organized sectors by trying to bring indigenous bankers into the mainstream of the banking business. In order to improve the quality of finance provided by the money market, it introduced two Bill Market Schemes, one in 1952, and the other in 1970.

With a view to increasing the strength and viability of the banking system, it carried out a program of amalgamations and mergers of weak banks with the strong ones. When the social control of banks was introduced in 1968, it was the responsibility of the RBI to administer it in the country for achieving the desired objectives. After the nationalization of banks, the RBI's responsibility to develop banking system on the desired lines increased. It has been acting as a leader in sponsoring and implementing the 'Lead Bank' scheme. With the help of a statutory provision for licensing the branch expansion of banks, the RBI has been trying to bring about an appropriate geographical distribution of bank branches. In order to ensure the security of deposits with banks, the RBI took the initiative in 1962 to create the Deposits Insurance Corporation. The RBI has rendered service in directing and increasing the flow of credit to the agricultural sector. It has been entrusted with the task of providing agricultural credit in terms of the Reserve Bank of India Act. 1934.

The importance with which the RBI takes this function is reflected in the fact that since 1955, it has appointed a separate Deputy Governor in charge of rural credit. It has undertaken systematic studies on the problem of rural credit and has generated basic data and information in this area. This was first done in 1954 by conducting an All-India Rural Credit Survey. And that was followed by studies of the All-India Rural Credit Review Committee in 1968, the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development in 1978, and the Agricultural Credit Review Committee in 1986.

As a part of its efforts to increase the supply of agricultural credit, the Bank has been working to strengthen co-operative banking structure through the provision of finance, supervision, and inspection. It provides to co-operative banks (through state co-operative banks), short-term finance at a concessional rate for seasonal agricultural operations and marketing of crops. It subscribes to the debentures of Land Development Banks. It operates the National Agricultural Credit (long-term operations) Fund, and the National Agricultural Credit (Stabilization) Funds through which it provides long-term and medium-term finance to co-operative institutions. It established the Agricultural Refinance Cooperation (now known as NABARD) in July 1963 for providing medium-term and long -term finance for agriculture.

It also helped in establishing an Agricultural Finance Corporation. The role of the Bank in diversifying the institutional structure for providing industrial finance has been equally important. All the Special Development Institutions at the central and state levels and many other financial institutions mentioned earlier were either created by the Bank on its own or it advised and rendered help in setting up these institutions. The UTI, for example, was originally an associate institution of the RBI. A number of institutions providing financial and other services such as guarantees, technical consultancy, and so on have come into being on account of the efforts of the RBI. Through these institutions, the RBI has been providing shortterm and long-term funds to the agricultural and rural sectors, to small-scale industries, to medium and large industries, and to the export sector. It has helped to develop guarantee services in respect of loans to agriculture, small industry, exports and sick units.

It also co-ordinates the efforts of banks, financial institutions and government agencies to rehabilitate sick units. The Bank has evolved and put into practice the consortium, cooperative, and participatory approach to lending among banks and other financial institutions. By developing the practice of inter-institutional participation, of expertise pooling, and of geographical presence, it has helped to upgrade credit delivery and service capability of the financial system. By issuing appropriate guidelines, in 1977, regarding the transfer of loans accounts by borrowers, it has evolved a mutually acceptable system of lending, so that the banking business grows in a healthy manner and without cut-throat competition.

To preserve and enhance the stability of the banking and financial system is an important part of the "promotional" role of the RBI. In fact, financial stability has now assumed relatively greater importance as one of the tasks of the RBI. This is evident in its work to formulate prudential norms for banks and financial institutions, its intervention in the foreign exchange market, and its participation in the operation of "safety nets" i.e., the legal and organizational structure for overseeing the safety and soundness of the banking and financial systems. It plays an important role in building up and maintaining confidence in the underlying stability of the IFS.

In short, the RBI helps to create and maintain a stable, efficient, and well-functioning financial system in India.

Self Check Exercise

4. What is the primary objective of RBI's secondary function related to "Development and Promotion of Financial Institutions" in microfinance?
   a) Profitability
   b) Inclusion
   c) Innovation
   d) Expansion
5. RBI's "Regulation and Supervision" secondary function aims to ensure:
   a) Flexibility
   b) Stability
   c) Competition
   d) Isolation
6. How does RBI contribute to the "Financial Market Development" secondary function in microfinance?
   a) Isolation
   b) Fragmentation
   c) Integration
   d) Deterioration

3.4 AUTONOMY FOR CENTRAL BANK

Autonomy for Central Bank is a crucial issue. The Reserve Bank of India Act does not assure autonomy to the bank. It is true that the Central Bank can only be independent within the government but not from the government. In US there are adequate safeguards to ensure that the Federal Reserve is not compelled to act against its own judgement. In India there have been historic accords limiting this access of government to RBI but they are breached in practice, RBI should not be involved in underwriting government securities. It acts as a principal and as an agent in the securities market. The dual role of RBI as an issuer and regulator of debt gives rise to conflict of policies of debt management and monetary policy. The advisory group on monetary and financial policies headed by M. Narsimham suggested (September, 2000) the separation of debt management and monetary policy functions and the setting up of an independent debt management office by the Government. Further the fiscal profligacy of the government is abetted by the system of pre-emption of large portion on net accrual of banks deposits through the prescription of statutory liquidity ratio. The Indian banking system was operating for a long time with a high level of reserve requirements in the form of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). SLR and CRR keeps in changing from time to time as the need be. As of date the SLR is 25% and CRR is 4-4.5%. Reduction in statutory pre-emption is constrained as long as fiscal deficit remains high.

The Report of the Committee on the Financial System, 1991 has pointed out that SLR should not be used to mobilize resources for financing budgetary deficits but as a prudential measure. It has also stated that CRR should be used for pursuing monetary policy objectives. In the context of globalization of the financial system Reserve Bank needs autonomy to define benchmarks or anchors such as inflation and money supply to guide policy and use its judgement to assess the impact of the ever changing financial environment on the design and implementation of policy. Reform of the banking system is not complete unless it includes the Central Bank. The emphasis on market as a source of financial discipline required an autonomous Central Bank, which can strike right balance with the operation of market forces. The responses would be quick and effective only if the Central Bank is autonomous.

Central banks, which mandated to pursue monetary and financial stability should enjoy autonomy in the execution of policy and be accountable for the achievement of the objective. There is consensus that the monetary authority's primary objective should be price stability, that the central bank should have sufficient independence to vary its operational instrument and its main instrument is its control over short-term interest rates.

The profound transformation of the financial environment had a major effect both on the relationship between the monetary policies across countries and their design within the countries. Central banks while defining benchmarks or anchors to guide policy to achieve monetary and financial stability have to take into account the increasing constraints that result from the growing power of markets to arbitrage across currencies, instruments and institutions as well as across legal, regulatory and tax jurisdictions. The increasing power of markets put a premium on transparency to guide market expectations, market incentives and credibility of policies. The market orientation of the framework has to be strengthened by,

- Enlisting and upgrading the markets disciplinary mechanism
- Enlarging the domain and improving the quality of public disclosure
- Designing regulatory constraints such as capital standards so as to make them less vulnerable to financial arbitrage
- Limiting the impact of those forms of intervention that provides perfection without commensurate over sight which reduces the incentive to prudent behavior.

Central bank's incentive for stability requires supporting policies in terms of sustainable fiscal positions and greater flexibility in labour market. Further the effectiveness of market forces depends on fostering ownership structures through privatization, which are more responsive to market, and removing obstacles to the adjustment of capital and labour. The systemic orientation has to be sharpened by upgrading payment and settlement systems to contain the knock on effects of failures of institutions. A right balance between the market and the central bank as a source of financial discipline has to be struck.

3.5 SUMMARY

Regulation of the financial system and its various component sectors occurs in almost all countries. A useful way to organize the many instances of regulation is to see it as having four general forms: (1) enforcing the disclosure of relevant information; (2) regulating the level of financial activity through control of the money supply as well as trading in financial markets; (3) restricting the activities of financial institutions and their management of assets and liabilities; and (4) constraining the freedom of foreign investors and securities firms in domestic markets. The most important players in financial markets throughout the world are central banks, the Government authorities in charge of monetary policy. Central banks' actions affect interest rates, the amount of credit, and the money supply, all of which have direct impacts not only on financial markets but also on aggregate output and inflation. To understand the role that central banks play in financial markets and the overall economy, we need to understand how these organizations work. Who controls central banks and determines their actions? What motivates their behavior? Who hold the rein of power?

3.6 Keywords

- **Bank Rat:** That rate of interest at which the central bank makes advances to commercial banks or rediscounts their bills.
- **Minimum Reserve System of Note Issue:** A system of note issue requiring that a certain minimum amount of reserve backing of note issue should be in the Form of gold and foreign securities.
- **Moral Suasion:** An instrument of central bank's pressure upon the lending activities of commercial banks through exhortations that they follow certain restrictive practices.
- **Open Market Operations:** Purchase or sale of eligible securities by the central balk in the open market.
- **Proportional Reserve System of Note Issue:** A system of note issue requiring that a certain percentage of reserve backing the note issue should be in the form of gold and foreign securities.
- **Selective Credit Control:** Such credit control that regulates the distribution or direction of bank resources to particular sectors.
- **Statutory Liquidity Ratio:** The ratio of liquid assets to total demand and time liabilities determined statutorily.

3.7 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the advisory role of RBI.
2. Discuss the authorities invested with RBI.
3. Discuss the autonomy for Central Bank.

Long Answer Type Questions

4. Discuss the secondary function of "Financial Market Development" by the RBI in the realm of microfinance. Explain how the central bank fosters an environment for the growth and integration of financial markets at the micro level, emphasizing the benefits to both microfinancial institutions and the individuals they serve.

3.8 SUGGESTED READINGS

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3.9 Self Check Exercise (Answer Key)

1. Regulation, 2. Supervision, 3. Financial, 4. Inclusion, 5. Stability, 6. Integration

MBA-DE(Second Year) **MFI 308**

Semester-Ill **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 4 **AUTHOR:Dr. RATINDER KAUR**

MONETARY POLICY

STRUCTURE

4.0 Objectives
4.1 Introduction
4.2 Meaning
4.3 Objectives of Monetary Policy
4.4 Instruments/Techniques of Monetary Policy
4.5 Monetary Policy 2008-09
4.6 Liquidity Adjustment Facility (LAF)
4.7 Objectives of Liquidity Adjustment Facility (LAF)
4.8 Summary
4.9 Keywords
4.10 Self-Assessment Exercises
4.11 Further Readings
4.12 Self Check Exercise (Answer Key)

4.0 OBJECTIVES

After studying this lesson; you will be able to :

- Understand the concept of monetary policy.
- Obtain a broad overview of Techniques of Monetary policy
- Understand the concept of Liquidity Adjustment Facility.

4.0 INTRODUCTION

There was no existence of Central banks in the past. In early economies, governments used to supply currency by minting dear metals with their stamp. The creditworthiness of the government was judged with the level of the underlying precious metal. A coin was worth its gold or silver content, as it could always be melted down to this. A country's worth was largely to its holdings of gold and silver in the national reserves.

During the industrial revolution, economies shifted from metal to paper money instead of gold, all that needed to produce more banknotes was paper, ink and a printing press. When gold became the de facto backing of the world's currency a "gold standard" was developed where nations kept sufficient gold to back their "promises to pay" in their national treasuries. Since they could lend more than they had to hold in reserves to meet their depositor's demands, they actually could create money. This meant that all currency was issued and controlled by the national governments, although they still maintained gold reserves to support their currencies. Commercial banks still could create money by lending more than their depositors had placed with the bank, but they no longer had the right to issue banknotes.

In India, this monopoly of note issue is with Reserve Bank of India. It has the sole right to issue currency notes of various denominations except one rupee note. The Reserve Bank has adopted the Minimum Reserve System for the note issue. Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 crore, of which at leastRs. 115 crore should be in gold. The central bank can control the process of money creation by controlling the availability of Reserves. It is a really a kid's, myth that if an individual can become more prosperous by becoming more rich and nation too can become more prosperous by printing more currency notes. Unless this money helps create more real income by expanding real output the nation can not add to its economic prosperity. So, to have stable economy appropriate flow of money is required. Monetary Policy serves this purpose of money control.

4.1 MEANING OF MONETARY POLICY

In India the Reserve Bank of India (RBI) regulates money control. It is regarded as very efficient tool of economic supervision. It basically employs central bank's control over supply, cost and use of money as device for achieving the certain given objectives of economic policy. The central bank influences the total amount and cost of credit primarily by affecting the cash reserves position of commercial banks in the economy. Monetary Policy mainly uses different techniques for monetary control by central Bank.

D. C. Rowan has defined Monetary Policy as "discretionary act undertaken by the authorities designed to influence (a) the supply of money (b) cost of money or rate of interest and (c) the availability of money". Statutory Liquidity Ratio (SLR).

4.2 OBJECTIVES OF MONETARY POLICY

In the light of the above given definition, the objectives of monetary policy are given below :

- To accelerate economic development of country by maintaining reasonable price stability.
- To achieve maximum level of employment to raise the living standards of people in the country.
- To develop suitable institutional set up in the banking and credit structure.
- To stabilize fluctuations in the Economic activity.

Self Check Exercise

1. What is the primary goal of monetary policy?
2. In the context of monetary policy, what does the term "Inflation Targeting" aim to control?
3. How does monetary policy influence economic growth through the manipulation of interest rates and money supply?

4.3 INSTRUMENTS/TECHNIQUES OF MONETARY POLICY

The various techniques of monetary policy employed by central bank can be categorized into the general or quantitative measures or selective and qualitative measures. The general instruments are as follow:

QUANTITATIVE MEASURES

a Open Market Operations (OMO)

b. Cash Reserve Ratio (CRR)

c. Bank Rate or Discount Rate

Above given techniques influence the credit-creating capacity of the commercial banks in the market by working directly or indirectly on their surplus cash reserves. Let us discuss above given terms in detail:

Open Market Operations (OMO)

It is the technique of monetary control in many countries. The .purchase and sale of government securities by central bank is known as open market operations. Banks generally carry out open market operations through treasury bills, state bank government securities, and central government securities of all maturities. The RBI is doing role of monetary control through two way purchase sale of treasury bills--and reduction in CRR-> when required. OMOs have direct impact on market interest rates and security prices. There isinverse relationship between market interest rates and security prices. When interest rate rises, security prices decreases on the contrary. So, security prices in the short run determined by supply and demand.

Thus when the RBI buys a particular govt, security, it increases the demand for that security and push the prices up. RBI purchases and sells govt, securities from the excess funds of IDBI, EXIM bank, and NABARD. It is worth mentioning here that OMOs have both monetary policy and fiscal policy goals. Thus monetary policy serves various objectives like:

(a) To manage the money control by managing reserves of commercial banks,

(b) To make bank rate policy more valuable,

(c) To maintain steadiness in govt, securities.

(d) To control the seasonal pour of funds in the bank credit bazaar.

Cash Reserve Ratio (CRR)

The commercial banks are required to keep a certain amount of cash reserves (certain percentage of demand and time liabilities) at the central bank. This percentage amount is called CRR. It influences the commercial bank's volume of credit because variation in CRR affects the liquidity position of the banks and hence their ability to Lend. It is one of the most effective & blunt way for the RBI to suck liquidity out of the financial system, which reduces demand in the economy and therefore helps to curb inflation. The present banking system is called a "fractional reserve banking system" because banks are required to keep only a fraction of their deposit liabilities in-the form of liquid cash. The reserve requirements could be changed by small fractions of percent.

Bank Rate or Discount Rate

Bank rate is a direct quantitative method of credit control in the economy. It is the rate of interest at which the central bank lends money to lower banking institutions. When commercial banks, co-operative banks, SFCs, IDBI, IFC, EXIM banks borrow from the RBI, the reserves of the banking system are increased by an amount equal to the borrowings, when they repay previous borrowings, banks reserves decrease. Usually, an increase in bank rate results in commercial banks increasing their lending rates. Changes in bank rate affect credit creation by banks through altering the cost of credit. Therefore, this technique is used to regulate the cost and availability of refinance, and change the volume of loans at disposal for banks and other financial institutions.

Statutory Liquidity Ratio (SLR)

RBI's Banking Regulation Actl934, sec 24 contains a statutory requirement regarding the maintenance of liquid assets by banks in India. Liquid assets can be kept in form of cash, gold and unencumbered approved securities. This ratio is maintained at the figure of total time and demand deposits,. It cannot be less than 25% of their total demand and time deposit liabilities. The RBI is empowered to change this ratio. Recently after a span of more than a decade, Reserve Bank has made cut off in SLR by 1% to make it 24% to inject liquidity in the market. The change in SLR also helps in curbing inflation.

QUALITATIVE MEASURES

In addition to its general instruments, the Reserve Bank of India also has other powers to control liquidity, called its selective or qualitative measures. Qualitative measures helps in stimulating various sectors of economy. The governor of Reserve Bank keeps an eye the credit trends at regular intervals and suggests to banks the corrective measures to suit prevailing situation. Following are the main qualitative measures.

(a) Moral Suasion

(b) Rationing Of Credit

(c) Regulation Of Consumer Credit
(d) Margin Requirements.

Moral Suasion

Moral suasion is a general term describing a variety of informal methods used by central bank to persuade commercial banks to behave in a particular manner. It may be a speech of governor of RBI or letters sent to all commercial banks, urging them to exercise control over certain general or advances against bankers for the same purpose. Moral suasion is used effectively to check non-food credit expansion.

Rationing Of Credit

It is smother method of qualitative control. Under this method, Reserve bank limits the quota of, commercial banks. Rationing is basically used to channelize flow of into desired areas. Rationing of credit is both quantitative as well as qualitative.. If rationing is done with respect to total amount of advance, it will be a quantitative control. But if rationing fixes the highest .ceilings for particular categories of loans, it becomes qualitative in nature.

Regulation of Consumer Credit

RBI also controls the money to regulate credit to consumers especially for consumer durable goods. For controlling liquidity in the economy, central bank can tighten the formalities of loans or even can put ceiling for maximum amount of loan. RBI forms rigid rules with regard to down payment, maximum installments for control of money supply. These regulations are imposed either to control liquidity or to inject liquidity in the market.

Margin Requirements

By changing margin requirements RBI can decrease the flow of credit. Margin is the gap between the market price of the security and amount lent by the banks against these securities. The purpose of this control is basically to restrict the speculation of securities/ commodities. By requiring higher margin, while accepting a commodity as a security, it can decrease the flow of credit into a particular trade at vice versa.

Self Check Exercise (True /False)

1. SLR (Statutory Liquidity Ratio) is a quantitative measure that mandates banks to maintain a certain percentage of their net demand and time liabilities in liquid assets.

2. CRR (Cash Reserve Ratio) is a qualitative measure that involves the adjustment of interest rates to control inflation and stimulate economic growth.

3. Qualitative measures in monetary policy include tools like moral suasion and selective credit controls, allowing the central bank to influence the direction and purpose of credit in the economy.

4.4 MONETARY POLICY 2008-09

RBI Governor Mr. DuwuriSubbarao while announcing his first policy in September 2008, addressed the concerns arising out of inflation and a continue rise in money supply and credit growth. Under the shadow of global recession, RBI emphasized supervision of banks to make sure steadiness in the Indian financial system. Because of credit demand in market and excess flow of funds, central bank announced an increase in the all-in-cost ceiling for trade credits less than three years to six months LIBOR plus 200 basis points. The RBI later announced various measures like reduction in CRR, the repo rate (It is the rate at which the bank borrow short term loan against collateral means loan against security),

SLR on November 1, 2008 to stimulate economy by injecting money into domestic financial market. The important changes in monetary policy are as follow:

1. The Repo rate cut 50 basis points to 7.50%.
2. The RBI retained flexibility to conduct overnight repo or long term repo including the right to accept or reject tenders under LAF, wholly or partially.
3. Central Bank will try to bring down inflation to bearable level of below 5%.
4. GDP growth forecast revised for 2008-09 between 7.5%-8.0%

Self Check Exercise

5. What is the primary purpose of "Moral Suasion" in monetary policy?
6. In credit management, what does the term "Rationing" refer to?

4.5 LIQUIDITY ADJUSTMENT FACILITY (LAF)

The RBI has not been using the Bank Rate in latest years since the full introduction of Liquidity Adjustment Facility in a phased manner starting 2000. The focus in using LAF is more on the Repo Rate, Reverse Repo Rates and the rate corridor (difference between repo and reverse repo rates). This is the mechanism or the window through which the RBI drains out funds (reverse repo) or injects money (repo rate) into the banking system. It is a flexible instrument in the hands of RBI to modulate, even out or to adjust or orderly conditions in the overnight/call money market. The decision of such act is decided by RBI depending on the needs of the system and clearly stated in the monetary policy. The difference between the Repo and the Reverse repo rates is commonly known as the LAF corridor. Recently to strengthen liquidity support to banks, RBI has cut down repo rate two times in one month - duration. One percent cut in repo rate was made in October 2008 and again on November 1, 2008 it has been decreased by additional 0.5% which took repo rate at last to 7.5% with effect from, November 3, 2008.

4.6 OBJECTIVES OF LIQUIDITY ADJUSTMENT FACILITY (LAF)

7. To give RBI greater flexibility in determining both the quantum of adjustment as also the rates by responding to the system on a daily basis.
8. To help RBI ensure that the injected funds are being used to fund day-to-day liquidity mismatches and not to finance more permanent assets.
9. To help RBI set a corridor for short-term rates, which should ideally be governed by the reverse-repo (top band), and repo (lower band) rates. This would impart greater stability in the markets.

Repo (Repurchase) Rate

A tool used in monetary policy that allows banks to borrow money through repurchase agreement. This is the rate at which banks borrow funds from the RBI to meet. Short term requirements. If the RBI needs to make it dearer for the banks to borrow money, it increases the repo' rate, similarly, if it wants to make it less expensive for banks to borrow 'money, it reduces the repo rate. RBI has been using the repo rate as the key interest rate indicator tool" over the past couple of years. This arrangement allows banks to respond to liquidity pressures and is used by governments to assure basic stability in the financial markets.

Reverse Repo Rate

This is the exact opposite of the repo rate in terms of who the lender is and who the borrower is. The rate at which banks lend money to RBI is termed the reverse repo rate. The RBI uses this tool to suck out the excess money floating in the system as that may lead to inflation. RBI has preferred repo rate rather than the reverse repo rate to affect interest rates.

4.7 SUMMARY

Monetary policy is one of the two ways the government can impact the economy. By impacting the effective cost of money, the RBI can affect the amount of money that is spent by consumers and businesses. There are some key set of indicators to ensure stability in the economy. These include money supply, interest rates, inflation, amongst others. The RBI uses various tools to regulate or influence these indicators. The policy also provides a platform for the RBI to announce norms for financial entities including banks, financial institutions (FIs), non-banking financial companies (NFBCs), in the money market which are regulated by the apex bank. It is a tool to deal with inflation and a recession.

4.9 Keywords

- **Interest Rates:** The cost of borrowing or the return on investment set by a central bank, influencing spending and investment in the economy.
- **Inflation Targeting:** A strategy employed by central banks to maintain a specific inflation rate, using monetary policy tools to achieve price stability.
- **Open Market Operations:** The buying or selling of government securities by a central bank to control money supply, interest rates, and liquidity in the financial system.

4.8 ASSESSMBNT EXERCISES

Short Answer Type Questions

1. Discuss briefly: Open Market Operations, CRR, and Bank Rate.
2. What are the tools available for managing liquidity in financial system?
3. What is LAF? Why this mechanism is being used?

Long Answer Type Questions

4.Explain the challenges central banks face in achieving these objectives simultaneously, and provide examples of how monetary policy tools are employed to strike a balance between controlling inflation and promoting economic growth.

5. Explore the concept of unconventional monetary policy measures. Elaborate on the circumstances under which central banks resort to unconventional tools, such as quantitative easing and negative interest rates.

4.9 FURTHER READINGS

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4.11 Self Check Exercise (Answer Key)

1. Stability, 2. Inflation, 3. Stimulate 4. True, 5. False, 6. True, 7. Guidance, 8. Allocation

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COMMERCIAL BANKING IN INDIA

STRUCTURE

5.0 Objectives
5.1 Banking in India
5.2 What is a Bank?
5.3 Historical Perspective
5.4 Commercial Banks
5.5 Scheduled Commercial Banks
5.6 Non-Scheduled Commercial Banks
5.7 Public Sector Banks
5.8 Private Sector Banks
5.9 Foreign Banks
5.10 Deficiencies of Indian Banking System
5.11 Shortcomings
5.12 Role of Commercial Banks in Industrial Financing
5.13 Summary
5.14 Keywords
5.15 Questions for Review
5.16 Suggested Readings
5.17 Self Check Exercise (Answer Key)

5.0OBJECTIVES

After studying this unit, you should be able to :

1. explain the meaning of a bank
2. describe the types of banks
3. explain the role of banks in industrial finance

5.1 BANKING IN INDIA

Banking in India originated in the first decade of 18th century with The General Bank of India coming into existence in 1786. This was followed by Bank of Hindustan. Both these banks are now defunct. The oldest bank in existence in India is the State Bank of India being established as "The Bank of Bengal" in Calcutta in June 1806. A couple of decades later, foreign banks like Credit Lyonnais started their Calcutta operations in the 1850s. At that point of time, Calcutta was the most active trading port, mainly due to the trade of the British Empire, and due to which banking activity took roots there and prospered. The first fully Indian owned bank was the Allahabad Bank, which was established in 1865.

By the 1900s, the market expanded with the establishment of banks such as Punjab National Bank, in 1895-in Lahore and Bank of India, in 1906. in Mumbai - both of which were founded under private ownership. The Reserve Bank of India formally took on the responsibility of regulating the Indian banking sector from 1935. After India's independence in 1947, the Reserve Bank was nationalized and given broader powers.

The major participants of the Indian financial system are the commercial banks, the financial institutions (FIs), encompassing term-lending institutions, investment

institutions, specialized financial institutions and the state-level development banks, Non- Bank Financial Companies (NBFCs) and other market intermediaries such as the stock brokers and money-lenders. The commercial banks and certain variants of NBFCs are among the oldest of the market participants. The FIs, on the other hand, are relatively new entities in the financial market place.

5.2 WHAT IS A BANK?

In simple words, bank is an institution which deals in money. Banks accept surplus money from those who do not need it immediately and lend it to those who need it. Let us see the various definitions of bank given by different authors and understand the main features of a bank.

"A banker is one who in the ordinary course of his business honourscheques drawn upon him by persons from and for whom he receives money on current accounts"

\- *Herbert L. Hart*

"The function of receiving money from his customers and repaying it by honouring their cheques as and when required is the function above all other functions which distinguishes a banking business from any other kind of business".

\- *H. P. Seldon*

‘’Banking means the accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise”.

\- *Banking Regulation Act [Sec. 5(l)(p)]*

"No person or body corporate or otherwise, can be a banker who does not take deposit accounts, take current accounts, issue and pay cheques and collect cheques, crossed and uncrossed, for his customers".

\- *Sir John Paget*

If you go through the above definitions of a bank, you will notice that a bank must perform two essential functions: 1) acceptance of deposits from public, and (2) lending or investing the same. It is also provided that the bank is under the obligation of repaying money on demand to respective depositors. You should note that the banker does not refund the money on his own accord, even if the period for which it was deposited expires. Thus, the depositor must make a proper demand for refund of money.

Acceptance of deposits, of money is an essential function no doubt, but simply because a company is accepting deposits of money from the public, does not make it a banker. It is necessary that the deposits accepted should be used for lending or investment. The banks mobilize the resources by accepting deposits and utilize such funds by employing them profitably. The banker is, thus, an intermediary and deals with the money belonging to the public.

In the modern days, industrial units and commercial undertakings also accept deposits of money from the public with the facility to withdraw them when required or after the expiry of a certain agreed period. But such institutions cannot be termed as bankers because acceptance of deposits is their subsidiary business, while the main function is manufacturing or trading.

Besides receiving deposits and lending or investing funds, the banks also perform various subsidiary services such as collection of cheques, drafts and bills, collection of interests and dividends on securities, making payment on behalf of his customers, remittance of funds, discounting the bills of exchange, acceptance of valuables for safe custody, etc.

From the above discussion, we can identify the distinguishing features of a bank as follows:

1. Acceptance of deposits of money from the public
2. Profitable employment of such funds
3. Obligation to refund deposits on demand
4. Lending or investing money
5. Banking as the main business.

Thus, if a concern carries on banking business only as an ancillary to same other main business, it cannot be considered as a bank.

Self Check Exercise

1. What is the primary function of commercial banks in the financial system?
2. Besides deposits, what is a major source of revenue for commercial banks?

5.3 HISTORICAL PERSPECTIVE

Bank of Hindustan, set up in 1870, was the earliest Indian Bank. Banking in India on modern lines started with the establishment of three presidency banks under Presidency Bank's act 1876 i.e. Bank of Calcutta, Bank of Bombay and Bank of Madras. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India. Imperial bank carried out limited central banking functions also prior to establishment of RBI. It engaged in all types of commercial banking business except dealing in foreign exchange.

Reserve Bank of India Act was passed in 1934 8s Reserve Bank of India (RBI) was constituted as an apex bank without major government ownership. Banking Regulations Act was passed in 1949. This regulation brought Reserve Bank of India under government control. Under the act, RBI got wide ranging powers for supervision 8s control of banks. The Act also vested licensing powers 8s the authority to conduct inspections in RBI.

In 1955, RBI acquired control of the Imperial Bank of India, which was renamed as State Bank of India. In 1959, SBI took over control of eight private banks floated in the erstwhile princely states, making them as its 100% subsidiaries.

RBI was empowered in 1960, to force compulsory merger of weak banks with the strong ones. The total number of banks was thus reduced from 566 in 1951 to 85 in 1969. In July 1969, government nationalized 14 banks having deposits of Rs.50 crores & above. In 1980, government acquired 6 more banks with deposits of more than Rs.200 crores. Nationalization of banks was to make them play the role of catalytic agents for economic growth. The Narsimham Committee report suggested wide ranging reforms for the banking sector in 1992 to introduce internationally accepted banking practices.

The amendment of Banking Regulation Act in 1993 saw the entry of new private sector banks.

Banking Segment in India functions under the umbrella of Reserve Bank of India - the regulatory, central bank. This segment broadly consists of: Commercial Banks and Cooperative Banks.

India had a fairly well developed commercial banking system in existence at the time of independence in 1947. The Reserve Bank of India (RBI) was established in 1935. While the RBI became a state owned institution from January 1, 1949, the Banking Regulation Act was enacted in 1949 providing a framework for regulation and supervision of commercial banking activity.

The first step towards the nationalization of commercial banks was the result of a report (under the aegis of RBI) by the Committee of Direction of All India Rural Credit Survey (1951) which till today is the locus classics on the subject. The Committee recommended one strong integrated state partnered commercial banking institution to stimulate banking development in general and rural credit in particular. Thus, the Imperial Bank was taken over by the Government and renamed as the State Bank of India (SBI) on July 1, 1955 with the RBI acquiring overriding substantial holding of shares. A number of erstwhile banks owned by princely states were made subsidiaries of SBI in 1959. Thus, the beginning of the Plan era also saw the emergence of public ownership of one of the most prominent of the commercial banks.

The All-India Rural Credit Survey Committee Report, 1954 recommended an integrated approach to cooperative credit and emphasized the need for viable credit cooperative societies by expanding their area of operation, encouraging rural savings and diversifying business. The Committee also recommended for Government participation in the share capital of the cooperatives. The report subsequently paved the way for the present structure and composition of the Cooperative Banks in the country.

There was a feeling that though the Indian banking system had made considerable progress in the '50s and '60s, it established close links between commercial and industry houses, resulting in cornering of bank credit by these segments to the exclusion of agriculture and small industries. To meet these concerns, in 1967, the Government introduced the concept of social control in the banking industry. The scheme of social control was aimed at bringing some changes in the management and distribution of credit by the commercial banks. The close link between big business houses and big banks was intended to be snapped or at least made ineffective by the reconstitution of the Board of Directors to the effect that 51 per cent of the directors were to have special knowledge or practical experience. Appointment of whole-time Chairman with special knowledge and practical experience of working of commercial banks or financial or economic or business administration was intended to professionalize the top management. Imposition of restrictions on loans to be granted to the directors' concerns was another step towards avoiding undesirable flow of credit to the units in which the directors were interested. The scheme also provided for the take-over of banks under certain circumstances.

Political compulsion then partially attributed to inadequacies of the social control, led to the Government of India nationalizing, in 1969, 14 major scheduled commercial banks which had deposits above a cut-off size. The objective was to serve better the needs of development of the economy in conformity with national priorities and objectives. In a somewhat repeat of the same experience, eleven years after nationalization, the Government announced the nationalization of seven more scheduled commercial banks above the cutoff size. The second round of nationalization gave an impression that if a private sector bank grew to the cut-off size it would be under the threat of nationalization.

From the fifties a number of exclusively state-owned development financial institutions (DFIs) were also set up both at the national and state level, with a lone exception of Industrial Credit and Investment Corporation (ICICI) which had a minority private shareholding. The mutual fund activity was also a virtual monopoly of Government owned institution, viz., the Unit Trust of India. Refinance institutions in agriculture and industry sectors were also developed, similar in nature to the DFIs. Insurance, both Life and General, also became state monopolies.

5.4 COMMERCIAL BANKS

The commercial banking structure in India consists of Scheduled Commercial Banks and Unscheduled Banks. Banking Regulation Act of India, 1949 defines Banking as "accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdraw able by cheques, draft, and order or otherwise."

Among the banking institutions in the organized sector, the commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having the loin's share in the total banking operations. Initially they were established as corporate bodies with shareholdings by private individuals but subsequently there has been a shift towards state ownership and control. Today, 28 banks (including IDBI Bank Ltd.) constitute the strong Public Sector Banks in Indian Commercial Banking. Up to late sixties, they were mainly engaged in financing organized trade, commerce and industry but since then they are actively participating in financing, agriculture, small business and small borrowers also. The commercial banks operating in India fall under a number of sub-categories on the basis of ownership and control of management. The RBI Act has divided the banks into two categories:

5.5 SCHEDULED COMMERCIAL BANKS

According to RBI Act 1934, a scheduled bank is that bank which has been included in the second schedule of the Reserve Bank of India. To be eligible for this concession a bank must satisfy the following three conditions:

1. It must have a paid up capital and reserves of an aggregate value of at least Rs. 5 lakhs.
2. It must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.
3. It must be a corporation and not a partnership or a single owner firm.

RBI gives these banks credit and many other facilities. These banks can also get their hundies rediscounted from the RBI. Commercial banks have to keep fixed proportions of their demand deposits and time deposits with the RBI. They have to submit deposits of their business to RBI.

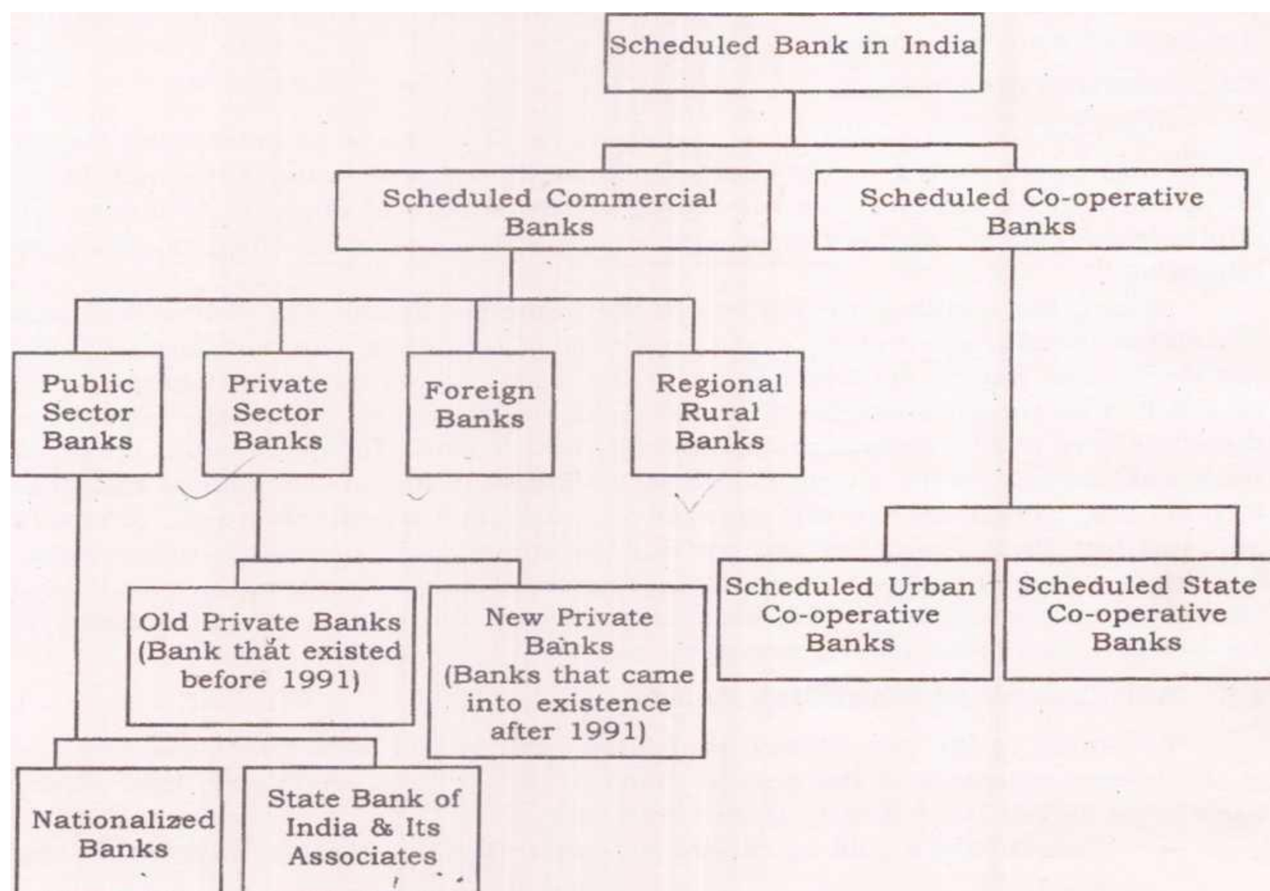
5.6 NON-SCHEDULED COMMERCIAL BANKS

These are those banks whose total capital is less than Rs. 5 lakhs. These banks are not included in the second schedule of the RBI and the same has no specific control over these banks. But they have to send details of their business to the RBI every month.

Self Check Exercise

1. What regulatory body oversees the functioning of commercial banks in many countries?
2. What is the main purpose of commercial banks in the financial system?
3. Where do commercial banks primarily derive their income besides traditional banking services?

Figure 1 : Scheduled Banking Structure in India



Source : Report on Trend and Progress of Banking in India, 2002, RBI, Mumbai.

5.7 PUBLIC SECTOR BANKS

Public Sector in Indian banking reached its present position in the following three stages:

Firstly, the conversion of the then existing Imperial Bank of India into the SBIin 1955 followed by the establishment of its seven subsidiary banks. Secondly, the nationalization of 14 major commercial banks on 19th July, 1969. Thirdly, the nationalization of 6 more commercial banks on 15th April, 1980.

One of the New Bank of India was later on merged with PNB. Thus, 28 banks constitute public sector in Indian commercial banking. Public Sector Banks includes SBI Subsidiaries of SBI, and 14 Banks Nationalized in 1969 and 6 Banks Nationalized in 1980.

Difference between State Bank of India and Nationalised Banks

Though all the 28 PSBs are corporate bodies, but the statutes under which they were established are different. The SBI was established under the SBI Act, 1955, the subsidiary banks under the SBI Act, 1959 and the nationalized banks under the Banks Companies (Acquisition and Transfer of Undertakings) Acts of 1970 and 1980. Initially, cent percent ownership of the 20 nationalized banks vested in the Govt, of India where as the SBI was owned, to a large extent, by the RBI, there was small private ownership in the share capital of the State Bank. The subsidiary banks are owned by the SBI during recent years. SBI and some of the nationalized banks- OBC, Dena Bank, Bank of India has enlarged their capital by issuing shares to the public.

The SBI acts as an agent of the RBI. According to section 45 of the RBI Act 1934, "the RBI shall appoint the State Bank as its sole agent at all places in India where it does not have an office or branch of its Banking Department and there is branch of the State Bank or branch of a subsidiary bank." However, the nationalized banks have not been conferred with this privilege of acting as agent of the RBI. Since the enforcement of the banking laws (amendment) Act, 1983, the RBI has been empowered to appoint any nationalized to act as its agent at all places in India where it has branch for the following purposes: paying, receiving, collecting, remitting money, bullion and securities on behalf of any govt, in India; undertaking and transacting and other business entrusted by the RBI from time to time.

5.8 PRIVATE SECTOR BANKS

Private Sector Banks are those banks which are owned by the private sector bodies. The private sector has played a strategic role in the growth of joint sector banks in India. In 1951, there were in all 556 private sector banks, of which 474 were non-scheduled and 92 were scheduled. But there was not a single private sector bank at that time. Since then, the number of Public Sector Banks is increasing while those of Private Sector Banks are decreasing.

In accordance with the financial sector reforms adopted in 1991, New Private Sector Banks have been permitted to be set up. According to Narasimhan Committee, New Private Sector Banks should be allowed to be established in India. These New Private Sector Banks will complement the overall Financial Sector Reforms. They will provide a financially viable technologically up-to-date, customer friendly and efficiently competitive financial intermediation. New Private Sector Banks are those entered in Indian banking industry after liberalization policy of 1991 and now they are 7 in number. In October 2004, Global Trust Bank was merged with Oriental Bank of Commerce as it was a financial failure. Again in 2004-05, Bank of Punjab and Centurian Bank were merged into a new entity Centurian Bank of Punjab to have the higher market share and to compete in the global market. In 2003-04, Kotak Mahindra Bank and in 2004-05 Yes Bank were two new banks entered in new private sector banks group and they all are performing well and competing with foreign banks operating in India.

5.9 FOREIGN BANKS

Foreign commercial banks are those banks which have been incorporated out-side India but have their bank branches in India. These banks besides financing the foreign trade of the country, undertake banking business within the country as well. In India, 33 foreign banks have been established and providing healthy competition to our banks with the use of latest technology.

Self Check Exercise (True/ False)

4. Commercial banks primarily function as financial intermediaries between depositors and borrowers.
5. Commercial banks generate revenue primarily through fees and commissions charged on financial services.
6. The central bank has no regulatory role in overseeing the operations of commercial banks.

5.10 DEFICIENCIES OF INDIAN BANKING SYSTEM

Commercial banks, as they were privately owned, on regional or sectarian basis resulted in development of banking on ethnic and provincial basis with parochial outlook. These Institutions did not play their due role in the planned development of the country. Deposit mobilization was slow. Public had less confidence in the banks on account of frequent bank failures. The savings bank facility provided by the Postal department was viewed a comparatively safer field of investment of savings by the public. Even the deficient savings thus mobilized by commercial banks were not channeled for the development of the economy of the country. Funds were largely given to traders, who hoarded agricultural produce after harvest, creating an artificial scarcity, to make a good fortune in selling them at a later period, when prices were soaring. The Reserve Bank of India had to step in at these occasions to introduce selective credit controls on several commodities to remedy this situation. Such controls were imposed on advances against Rice, Paddy, Wheat, Other food grains (like jawar, millets, ragi etc.) pulses, oilseeds etc.

When the country attained independence Indian Banking was exclusively in the private sector. In addition to the Imperial Bank, there were five big banks each holding public deposits aggregating Rs.100 Crores and more; viz. the Central Bank of India Ltd., the Punjab National Bank Ltd., the Bank of India Ltd., the Bank of Baroda Ltd. and the United Commercial Bank Ltd. Rest of the banks were exclusively regional in character holding deposits of less than Rs.50 Crores.

Government first implemented the exercise of nationalization of a significant part of the Indian Banking system in the year 1955, when Imperial Bank of India was Nationalized in that year for the stated objective of "extension of banking facilities on a large scale, more particularly in the rural and semi-urban areas, and for diverse other public purposes" to form State Bank of India. SBI was to act as the principal agent of the RBI and handle banking transactions of the Union & State Governments throughout India. The step was in fact in furtherance of the objectives of supporting a powerful rural credit cooperative movement in India and as recommended by the "The All-India Rural Credit Survey Committee Report, 1954". State Bank of India was obliged to open an accepted number of branches within 5 years in unbanked centers. Government subsidized the bank for opening unremunerative branches in non-urban centres. The seven banks now forming subsidiaries of SBI were nationalized in the year 1960. This brought one-third of the banking segment under the direct control of the Government of India.

But the major process of nationalization was carried out on 19th July 1969, when the then Prime Minister of India, Mrs.Indira Gandhi announced the nationalization of 14 major commercial banks in the country. One more phase of nationalization was carried out in the year 1980, when seven more banks were nationalized. This brought 80% of the banking segment in India under Government ownership. The country entered the second phase, i.e. the phase of Nationalised Banking with emphasis on Social Banking in 1969/70.

5.11 SHORTCOMINGS

However Nationalised banks in their enthusiasm for development banking, looking exclusively to branch opening, deposit accretion and social banking, neglected prudential norms, profitability criteria, risk-management and building adequate capital as a buffer to counter-balance the ever expanding risk-inherent assets held by them. They failed torecognize the emerging

non-performing assets and to build adequate provisions to neutralize the adverse effects of such assets. Basking in the sunshine of Government ownership that gave to the public implicit faith and confidence about the sustainability of Government-owned institutions, they failed to collect beforehand whatever is needed for the rainy day. And surfeit blindly indulged is sure to bring the sick hour. In the early Nineties after two decades of lop-sided policies, these banks paid heavily for their misdirected performance in place of pragmatic and balanced policies. The RBI/Government of India have to step in at the crisis-hour to implement remedial steps. Reforms in the financial and banking sectors and liberal recapitalization of the ailing and weakened public sector banks followed. It is relevant to mention here that the advent of banking sector reforms brought the era of modern banking of global standards in the history of Indian banking. The emphasis shifted to efficient, and prudential banking linked to better customer care and customer service. The old ideology of social banking was not abandoned, but the responsibility for development banking is blended with the paramount need for complying with norms of prudency and efficiency.

5.12 ROLE OF COMMERCIAL BANKS IN INDUSTRIAL FINANCING

Banks are the dominant financial intermediaries in developing countries including India. Bank credit is considered as an important source of industrial finance. The dependence on bank for finance could vary according to the size of the companies. The small-scale industrial units have increased their dependence on banks for loans because they have virtually no access to the capital markets.

The Reserve Bank of India's attempt at reforming the financial sector was visible from the recommendations of the Committee to Review the Working of the Monetary system (1985) (referred to as Chakraborthy Committee Report).The Committee advocated the necessity of moving away from quantitative controls which, it felt, led to distortions in the credit market and resulted in curbing the growth of the economy. But the impetus to reforms in the financial sector was given by the Report of the Committee on the Financial system (Narasimham Committee). The financial sector reforms, based on this report were mainly aimed to provide credit to the industrial sector by reducing the Cash Reserve Ratio and Statutory Liquidity Ratio. The liberalization policy also called for increased efficiency of commercial banks by encouraging them to compete in the market. The public sector banks were given autonomy to frame their policies including interest rate fixation. It may be noted that the bank credit to the industrial sector has not increased during the post-reform period, in spite of the various attempts.

Industrialization has an important role to play in the process of economic development. The importance of industrialization as a means for achieving rapid growth and prosperity had been recognized in the development strategy of independent India. The bold program of industrialization in India was started with the second five-year plan by realizing the need of the economy. Based on the pattern of investment emphasized the reallocation of resources away from the production of consumer goods towards the production of machine tools and capital goods. By the late sixties, during the fourth five year plan (1969-74), policies for protecting the small-scale sector against competition from the large-scale sector were also put into practice.

5.13 SUMMARY

At the end of late-18th century, there were hardly any banks in India in the modern sense of the term. Some banks were opened at that time which functioned as entities to finance industry, including speculative trades in cotton. With large exposure to speculative ventures, most of the banks opened in India during that period could not survive and failed. The depositors lost money and lost interest in keeping deposits with banks. Subsequently, banking in India remained the exclusive domain of Europeans for next several decades until the beginning of the 20th century. At the beginning of the 20th century, Indian economy was passing through a relative period of stability. Around five decades have elapsed since the India's First war of Independence, and the social, industrial and other infrastructure have developed. At that time there were very small banks operated by Indians, and most of them were owned and operated by particular communities. In 1948, the Reserve Bank of India, India's central banking authority, was nationalized, and it became an institution owned by the Government of India. In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India." The Banking Regulation Act also provided that no new bank or branch of an existing bank may be opened without a license from the RBI, and no two banks could have common directors. However, despite these provisions, control and regulations, banks in India except the State Bank of India, continued to be owned and operated by private persons. This changed with the nationalization of major banks in India on 19th July 1969. Currently, banking in India is generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government.

5.14 Keywords

Bank: An institution which accepts deposits from public repayable on demand and invests or lends the money. It also provides various other services to its customers.

Customer: A person who has an account with the bank.

General Lien: Right to retain any property belonging to the other till all dues are cleared.

5.15 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. What do you mean by Social control under Indian banking system? Discuss.
2. Discuss the role of Foreign Exchange Dealers Association of India (FEDAI).
3. Define the term Banker. Explain briefly the functions of a modem commercial bank.
4. Discuss various ways in which a commercial bank renders financial assistance to business.

Long Answer Type Questions

5. Explain briefly the various types of banks.
6. Explain the nature of banker's right of lien.

7. Explain the rights and obligations of a bank.

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5.17 Self Check Exercise (Answer Key)

1. Intermediation, 2. Lending, 3. Central Bank, 4. Intermediation, 5. Lending, 6. True, 7. False, 8. False

MBA-DE(Second Year)

Semester-Ill

MFI 308

MANAGEMENT OF FINANCIAL INSTITUTIONS

Lesson No. 6 AUTHOR: Dr. DHIRAJ SHARMA

WORKING CAPITAL FINANCING

STRUCTURE

6.0 Objectives

6.1 Introduction

6.2 Instruments for Financing Working Capital Needs

6.2.1 Commercial Paper (CP)

6.2.2 Inter-Corporate Deposits

6.2.3 Accounts Receivable Financing

6.2.4 Spontaneous Financing

6.2.5 Inventory Loans

6.2.6 Bank Credit

6.3 Summary

6.4 Keywords

6.5 Questions for Review

6.6 Suggested Readings

6.7 Self Check Exercise (Answer Key)

6.0 OBJECTIVES

After going through this lesson, you will be able to understand the role of working capital financing. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand the following :

6. Instruments for Financing Working Capital Needs
7. Commercial Paper (CP)
8. Inter-Corporate Deposits
9. Accounts Receivable Financing
10. Spontaneous Financing
11. Inventory Loans
12. Bank Credit

6.1 INTRODUCTION

Short-term finance can be availed for working capital from a wide range of financial intermediaries in many different forms. The credit can be Unsecured or Secured loan. Unsecured loans include all those sources that have as their security only the lender's faith in the ability of the borrower to repay the funds when due. The interest rate charged on secured short-term loans is typically higher than the interest rate on unsecured short-term loans. Typically, companies that require secured loans may not qualify for unsecured debt, and they are perceived as higher-risk borrowers by lenders. The presence of collateral does not change the risk of default; it provides a means to reduce losses if the borrower defaults. In general, lenders require security for less-creditworthy, higher-risk borrower firms. Since the negotiation and administration of these loans is more troublesome for the lender, the lender normally requires certain fees to be paid by the secured borrower. The higher rates on these secured short-term loans are attributable to the greater risk of default and the increased loan administration costs of these loans over the unsecured short-term loan. Secured loans involve the pledge of specific assets as collateral in the event the borrower

defaults in payment of principal or interest. Commercial banks, finance companies, and factors are the primary suppliers of secured credit. The principal sources of collateral are accounts receivable and inventories.

6.2 INSTRUMENTS FOR FINANCING WORKING CAPITAL NEEDS

Major sources of short-term finance include accrued wages, taxes, trade credit, bank loans, commercial paper, Inter-corporate deposits etc. In order to raise capital, it is imperative that the finance manager understands the dynamics of the market in order to accurately assess the financing options available to the business at any given time. Following are the most common sources of short-term working capital financing.

6.2.1 COMMERCIAL PAPER (CP)

The Commercial Paper in India owes its growth to the Vaghul Committee appointed by RBI in September 1986. Initially minimum size of issue was restricted to Rs 1 crore and the maturity period restricted to 91 days to 6 months. Subsequently the minimum amount was lowered to Rs 25 lakhs (now it is further reduced to 5 lakhs) and the maturity period modified to 30 days to one year (now it is further reduced to 15 days) from the date of issue. CP can be issued in denominations of Rs.5 lakhs or multiples thereof. The minimum amount invested by a single investor is at least Rs. 5 lakhs.

In India, only the most creditworthy companies can issue commercial paper. Commercial paper is simply a promise to pay for short-term debt securities. It is an unsecured money market instrument issued in the form of a promissory note. In India, Commercial Paper was introduced to enable corporate borrowers with good credit standing to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Issue of commercial paper became popular towards the late 1990 but remained essentially an instrument of working capital financing. Only highly rated corporate bodies, primary dealers, satellite dealers and financial institutions have been authorized to issue commercial papers.

The investor in CP may be any individual, bank, other corporate body registered or incorporated in India and unincorporated bodies, Non-Resident Indian and Foreign Institutional Investor. However, investment by FIIs would be within the limits set for their investments by Securities and Exchange Board of India (SEBI). At present the limit is 30 per cent set for their investments in debt instruments.

The aggregate amount of CP from an issuer shall be within the limit as approved by its Board of Directors. The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. Within 3 days of the completion of issue, a report must be submitted to Industrial and Export Credit Department (IECD), Reserve Bank of India through the Issuing and Paying Agent (IPA). Only a scheduled bank can act as an IPA for issuance of CP. Every issue of CP will be treated as a fresh issue and no issuer can have the issue underwritten or co-accepted.

There are several advantages that accrue to the issuer of commercial paper. Commercial paper interest rates are generally lower than rates on bank loans and comparable sources of short-term financing. With commercial paper as a single source for all its short-term financing, the firm can satisfy its very large credit needs. Moreover, it enhances the reputation and prestige of the issuing firm because it is widely recognized that only the most creditworthy firms have access to the commercial paper market.

Commercial paper as a short-term financing tool, however, involves high risk also. That is, the commercial paper market is highly rigid and do not provide any flexibility in terms of repayment.

6.2.2 INTER CORPORATE DEPOSITS

Apart from CPs, companies also have access to another market called Inter Corporate Deposits (ICD) market. An ICD is an unsecured loan extended by one corporate to another. This instrument of short-term finance involves movement of funds from funds-surplus companies to credit worthy corporate borrowers. The period of deposit varies from purely on call and to 180 days. This source is mostly used by those firms which do not have access to commercial paper because of low credit worthiness. Also the better-rated companies can borrow from the banking system and lend in the inter-corporate deposit market. As the cost of funds for a corporate is much higher than a bank, the rates in this market are higher than those in the other markets. ICD is an unsecured instrument, and hence the risk inherent is high. The ICD market is not well organized with very little information available publicly about transaction details.

A company cannot make any loan to any other body corporate, give guarantee or security in connection with any loan made by any person to another body corporate, or acquire, by subscription, purchase or in any other manner, securities in any other body corporate -- exceeding 60 % of its paid up share capital and free reserves or 100 % of its free reserves, whichever is more, unless approved by a special resolution passed at a general meeting of members.

Self Check Exercise(True/False)

1. Commercial paper is a short-term, unsecured debt instrument issued by corporations to raise funds.
2. Corporate deposits involve companies placing surplus funds in financial institutions for a specified period to earn interest.

6.2.3 ACCOUNTS RECEIVABLE FINANCING

A firm's receivables can be termed as its most liquid assets and they serve as prime collateral for a secured loan. Two major modes of financing based on receivables are pledging and factoring.

(i) Pledging

A pledge of accounts receivable is the use of a firm's receivables to secure a shortterm loan. The lender evaluates the quality of the accounts receivable, selects acceptable accounts, and files a lien on the collateral. After the selection of accounts, the lender determines the percentage advanced against receivables. It can range from 50 to 90 percent of the face value of the acceptable receivables; this amount becomes the principal on the loan. Pledging receivables usually costs two to five percent above the bank's prime lending rate. Finance companies usually charge an even higher rate.The major advantage of pledging accounts receivable is the ease and flexibility it provides to the borrower. Moreover, financing is done on a continuous basis. The new receivables created through further credit sales becomes the collateral for the financing of new production. The only disadvantage associated with this method of financing is its high cost as compared with other sources of short-term credit.

(ii) Factoring

Factoring accounts receivable is the outright sale to the factor or financial institution. A factor is a firm that acquires the receivables of other firms. The factor sets the conditions of the sale in a factoring agreement. The factor bears the risk of collection and services the accounts for a fee. The fee is stated as a percent of the face value of all receivables factored usually from 1 percent to 3 percent. Normally factoring is done on a non-recourse basis (the factor accepts all credit risks), and the customer is usually notified that the account receivable has been sold. The factor firm typically does not make payment for factored accounts until the accounts have been collected or the credit terms have been met.

If the firm wishes to receive immediate payment, it can borrow from the factor, using the factored accounts as collateral. Factoring can typically cost from 3 to 7 percent above the prime rate including commissions and interest. This type of financing is provided by specialized financial institutions called factors. Some commercial banks and commercial finance companies also provide this service. The biggest advantage is immediate conversion of receivables into cash and also the known pattern of cash flows.

6.2.4 SPONTANEOUS FINANCING

The short term spontaneous financing is the financing that arises from the normal operating cycle. The two major sources of spontaneous financing are accounts payable and accrued expenses. Both of these sources are spontaneous, since their levels increase and decrease directly with increases or decreases in sales. If sales increase, the firm will purchase more new materials, resulting in higher accruals of these items. Neither accounts payable nor accruals have stated cost although accounts payable often have an unstated cost in cases where a cash discount is offered.

(i) Accrued Expenses

Almost all the business firms pay salaries and wages to their employees monthly. Accrued expenses are periodically recurring short-term liabilities such as wages accrued but not yet paid to employees and taxes owed but not yet paid. Therefore, firms accrue salaries and wages for a period usually a month, in essence, a loan from their employees. Similarly, firms generally make periodical income tax payments for their estimated tax liability. This means that the firm has the use of the tax amount it owes based on quarterly profits up through the end of the quarter.

The firm can use all the accruals it can since there is no actual cost involved. However, it has little control over the amount of accruals. In the same manner, business firms pay sales taxes and withhold income taxes for their employees. So longer the period, greater is the amount of financing for the firm.

(ii) Accounts Payable (Trade Credit)

Trade credit is a primary source of spontaneous financing as it arises spontaneously with the firm's purchases. Trade credit allows a firm to defer cash payments to its suppliers in exchange for its promise to pay them in the future. Using trade credit to purchase goods or services from suppliers creates accounts payable. For trade credit, the firm needs only to place an order with its supplier of goods. The supplier depending on firm's credit rating grants the credit period and cash discount. The decision to extend trade credit to the purchasing firm is generally based on the supplier's credit policy. The amount of trade credit extended to the purchasing firm is based on supplier’s estimate of the firm’s creditworthiness, and its capacity to pay the bills. The purchasing firm pays for the goods as per the supplier's credit terms. Credit terms usually express the amount of the cash discount, the date of its expiration, and the due date.

6.2.5 INVENTORY LOANS

For a manufacturing firm, inventory loans are a source of short-term secured credit. The amount of the loan that can be obtained depends on the marketability and life of the inventory. For a manufacturer, inventory is classified into one of three categories: Raw materials, work-in-progress and finished goods. Classification into one of these categories depends on the firm's business; what are raw materials for one firm may be finished goods for another. Inventory types have different levels of liquidity. Demand for raw materials and work-in-progress depends on the demand for finished goods. Raw materials such as grains, Oil, chemicals etc. are excellent sources of collateral because of their marketability. But other items like work-in-process provide poor collateral because of their lack of liquidity.

Following are the most popular methods by which inventory can be used to secure financing.

(i) Floating Inventory Liens

Floating inventory liens are made by lenders and secured by a claim on inventory items. The interest charge on a floating lien is typically 3 to 5 percent above the prime rate. Under this the borrower gives the lender a lien against all its inventories. From the view point of lender inventory provides very weak collateral. The borrowing firm maintains the physical possession and control of the inventories. Therefore, lack of control over the inventory reduces the value of security to the lender.

(ii) Trust Receipt Inventory

Trust receipt inventory loams are often made by manufacturers' financing subsidiaries to their customers. Under this arrangement, merchandise is typically expensive, for example, automotive, industrial and consumer-durable equipments, and remains in the hands of the borrower. Moreover products such as automobiles, appliances, boats, etc. have to be displayed to be sold. The only way small firms can afford such displays is by borrowing money. The lender advances 80 to 100% of the cost of the salable inventory. Such loans are often secured by a note and a trust receipt. This trust receipt is the legal paper which is used for serial numbered merchandise. Inventory is serialized and cannot be sold without the lender's permission. Borrower retains physical control over the inventory. The interest charge is generally 2 percent or more above the prime rate.

(iii) Warehouse Receipt Loan

A warehouse receipt loan is an arrangement whereby the lender receives control of the pledged collateral. The inventory may be retained by the borrower in the firm's warehouse with security administered by a field warehousing company. Or the inventory may be stored in a terminal warehouse located in the geographic vicinity of the borrower. Generally, less than 75 to 90 percent of the collateral's value is advanced to the borrower. Banks also take commodities as security by lending money on a warehouse receipt.

Self Check Exercise

3. What term describes using assets as collateral for a loan?
4. Identify a common form of spontaneous financing related to a company's trade activities.
5. Which type of loan is specifically designed to finance a company's inventory?

6.2.6 BANK CREDIT

All over the world, bank credit is a major source of financing the working capital. Indian commercial banks have been making in larger measure, term finance to industry and providing investment banking services apart from setting up subsidiaries in such diverse areas as mutual funds securities trading and factoring. Following are the financing arrangements provided by a bank for working capital financing in India:

(i) Line Of Credit (LOC)

A line of credit is an agreement between a commercial bank and a business that states the amount of short term borrowing the bank will make available to the firm over a given period of time. In a line of credit agreement, a bank may retain the right to revoke the line if any major changes occur in the firm's financial condition or operations. To ensure that the borrower will not default, frequently a line of credit requires the borrower to maintain a minimum balance in the bank throughout the loan period, called a compensating balance. In some cases, fees in lieu of balances may be negotiated. All this increases the effective cost of the loan to the borrower, unless a deposit balance equal to or greater than this balance requirement is ordinarily maintained in the bank.

To ensure that money lent under the credit agreement is actually being used to finance working capital and not permanent asset acquisitions such as plant and equipment, banks require that the borrower have a zero loan balance for a certain number of days per year. This is called the annual cleanup period.

(ii) Revolving Credit

A revolving credit agreement is a guaranteed line of credit. Revolving credit is a special type of line of credit agreement in which the line of agreements usually extend from 1 to 5 years in duration. Under a line of credit agreement, a firm is not guaranteed that the bank will have funds available to lend upon demand, while under the more formal revolving credit agreement the availability of funds is guaranteed. Since the lender under the revolving credit agreement guarantees the availability of funds, the borrower pays a commitment fee for the unused portion of the line.

(iii) Bank Overdraft

The word overdraft means the act of overdrawing from a bank account. In other words, the account holder withdraws more money from a bank account than has been deposited in it. In the case of line of credit, a proper limit is sanctioned which normally is a certain percentage of the value of the commodities/debts pledged by the account holder with the Bank. Overdraft, on the other hand, is allowed against a host of other securities including financial instruments like shares, units of mutual funds, debentures, insurance policy etc.

(iv) Discounting Of Bills

Bills of exchange are promissory notes issued for commercial transactions involving exchange of goods and services. Bills of exchange are negotiable instruments drawn by the seller (drawer) of the goods on the buyer (drawee) of the goods for the value of thegoods delivered. These bills form a part of a company's banking limits and are discounted by the banks. Banks in turn rediscount bills with other banks. If the bill is payable at a future date and the seller needs money before the maturity of the bill then he may approach his bank for discounting the bill. The bank from the drawee will receive the maturity proceeds at the maturity date. If the bank needs fund before the maturity of the bill then it can rediscount the bill already discounted by it in the commercial bill rediscount market at the market linked discount rate.

Self Check Exercise

6. What type of credit allows a borrower to repeatedly borrow up to a predetermined limit and repay as per their convenience?
7. In a line of credit, what is the maximum amount a borrower can borrow called?

6.3 SUMMARY

Working capital finance can be availed from a wide range of financial intermediaries in many different forms. The credit can be Unsecured or Secured loan. Unsecured loans include all those sources that have as their security only the lender's faith in the ability of the borrower to repay the funds when due. The interest rate charged on secured short-term loans is typically higher than the interest rate on unsecured short-term loans. Typically, companies that require secured loans may not qualify for unsecured debt, and they are perceived as higher-risk borrowers by lenders. The presence of collateral does not change the risk of default; it provides a means to reduce losses if the borrower defaults. In general, lenders require security for less-creditworthy, higher-risk borrower firms. Since the negotiation and administration of these loans is more troublesome for the lender, the lender normally requires certain fees to be paid by the secured borrower. The higher rates on these secured short-term loans are attributable to the greater risk of default and the increased

loan administration costs of these loans over the unsecured short-term loan. Secured loans involve the pledge of specific assets as collateral in the event the borrower defaults in payment of principal or interest. Commercial banks, finance companies, and factors are the primary suppliers of secured credit. The principal sources of collateral are accounts receivable and inventories.

6.4 Keywords

13. **Bank Rate:** That rate of interest at which the central bank makes advances to commercial banks or rediscounts their bills.
14. **Inter-Corporate Deposits:** An Inter Corporate Deposits (ICD) is an unsecured loan extended by one corporate to another. This instrument of short-term finance involves movement of funds from funds-surplus companies to credit worthy corporate borrowers.
15. **Receivable Pledging:** A pledge of accounts receivable is the use of a firm's receivables to secure a short-term loan.

6.5 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. What is the Significance of working capital finance?
2. What is the Importance of a bank/Financial Institution in working capital financing?

Long Answer Type Questions

3. Explain the sources of working capital finance?

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4.1 **Self Check Exercise (Answer Key)**

1. True, 2. True, 3. Pledging, 4.Trade Credit, 5. Inventory Loans, 6. Revolving Credit, 7. Credit Limit

MBA-DE(Second Year) **MFI 308**

Semester-III **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 7 **AUTHOR : Dr. DHIRAJ SHARMA**

MANAGEMENT OF BANK FUNDS

STRUCTURE

7.0 Objectives

7.1 Introduction

7.2 Funds Management

7.3 Earlier phase

7.4 Categories of Risk

7.4.1 ''Credit Risk

7.4.2 Capital Risk

7.4.3 Market Risk

7.4.4 - Interest Rate Risk

7.4.5 , Liquidity Risk

7.5 Risk measurement Techniques

7.6 Strategies for Correcting Mismatch

7.7 Emerging Issues

7.8 Summary

7.9 Keywords

7.10 Suggested Readings

7.11 Self Check Exercise (Answer Key)

7.0 OBJECTIVES

After going through this lesson, you will be able to understand and analyse how the banks manage their funds. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand:

1. Funds Management
2. Earlier Phase
3. Categories of Risk
4. Credit Risk
5. Capital Risk
6. Market Risk
7. Interest Rate Risk
8. Liquidity Risk
9. Risk Measurement Techniques
10. Strategies for Correcting Mismatch
11. Emerging Issues

7.1 INTRODUCTION

In recent times, commercial banks in India have started functioning as universal banks. As of now, banks - whether public sector, private sector or foreign, can offer comprehensive financial services under one roof. Their functional diversity encompasses project appraisal, project financing, lease financing, extending working capital loans and quasi-credit facilities like bank guarantees and letters of credit, offering derivative products such as forwards, swaps and options, as well as syndication and consultancy services.

While the role of commercial banks has undergone a substantial change in the post liberalization era, working capital loan still continues to be a major functional area for the

commercial banks. Conventionally, working capital finance has been extended by commercial banks in India in the form of cash credit facility. Under this system, the lending bank sanctions a loan limit up to which the customer may be allowed to draw subject to availability of adequate security pledged or hypothecated to the lending bank. The amount of loan outstanding can vary freely and at times the balance in the cash credit account can even be in credit (i.e. the bank is indebted to the customer). Interest is payable based on the actual level of loan enjoyed on a daily product basis. While the borrower has the option to draw up to the limit without any prior notice, he has no corresponding obligation either to compensate the banker for this option or to ensure an optimum utilization of the facility. In such a situation, funds management and financial planning become relatively low priority issues for the borrowers, who can pass on the consequences of inadequate planning and inefficient management on their part to the banking system, where the problem manifests itself as a serious strain on cash management.

This is a major drawback of the cash credit system. In India, credit is considered a scarce commodity and need-based financing continues to be a main plank underlying the central bank's credit policy even in the liberalized regime. An arbitrary break-up of working capital facility into fixed and variable components is thus not in line with the central bank's approach.

7.2 FUNDS MANAGEMENT

Funds management and elaborates on various categories of risk that require to be managed. It examines strategies for funds (asset-liability) management from the asset side as well as the liability side, particularly in the Indian context. It also discusses the specificity of financial institutions in India and the new information technology initiatives that beneficially affect asset-liability management. The emerging contours of conglomerate financial services and their implications for asset- liability management are also described.

Asset-liability management basically refers to the process by which an institution manages its balance sheet in order to allow for alternative interest rate and liquidity scenarios. Banks and other financial institutions provide services which expose them to various kinds of risks like credit risk, interest risk, and liquidity risk. Asset liability management is an approach that provides institutions with protection that makes such risk acceptable. Asset-liability management models enable institutions to measure and monitor risk, and provide suitable strategies for their management.

It is therefore appropriate for institutions (banks, finance companies, leasing companies, insurance companies, and others) to focus on asset-liability management when they face financial risks of different types. Asset-liability management includes not only a formalization of this understanding, but also a way to quantify and manage these risks. Further, even in the absence of a formal asset-liability management program, the understanding of these concepts is of value to an institution as it provides a truer picture of the risk/reward trade-off in which the institution is engaged.

Asset-liability management is a first step in the long-term strategic planning process. Therefore, it can be considered as a planning function for an intermediate term. In a sense, the various aspects of balance sheet management deal with planning as well as direction and control of the levels, changes and mixes of assets, liabilities, and capital.

7.3 EARLIER PHASE

In the 1940s and the 1950s, there was an abundance of funds in banks in the form of demand and savings deposits. Because of the low cost of deposits, banks had to develop mechanisms by which they could make efficient use of these funds. Hence, the focus then was mainly on asset management. But as the availability of low cost funds started to decline, liability management became the focus of bank management efforts.

Liability management essentially refers to the practice of buying money through cumulative deposits, federal funds and commercial paper in order to fund profitable loan [1] opportunities. But with an increase in volatility in interest rates and with a severe recession damaging several economies, banks started to concentrate more on the management of both sides of the balance sheet.

7.4 CATEGORIES OF RISK

Risk in a way can be defined as the chance or the probability of loss or damage. In the case of banks, these include credit risk, capital risk, market risk, interest rate risk, and liquidity risk. These categories of financial risk require focus, since financial institutions like banks do have complexities and rapid changes in their operating environments.

7.4.1 CREDIT RISK '

The risk of counter party failure in meeting the payment obligation on the specific date is known as credit risk. Credit risk management is an important challenge for financial institutions and failure on this front may lead to failure of banks. The recent failure of many Japanese banks and failure of savings and loan associations in the 1980s in the USA are important examples, which provide lessons for others. It may be noted that the willingness to pay, which is measured by the character of the counter party, and the ability to pay need not necessarily go together.

The other important issue is contract enforcement in countries like India. Legal reforms are very critical in order to have timely contract enforcement. Delays and loopholes in the legal system significantly affect the ability of the lender to enforce the contract. The legal system and its processes are notorious for delays showing scant regard for time and money that is the basis of sound functioning of the market system. Over two million cases are pending in 18 High Courts alone and more than 200,000 cases are pending in the Supreme Court for admission, interim relief or final hearing. This is not the full story. Since thousands of cases are pending in the lower courts, legal experts suggest that the average time taken by Indian courts for deciding a civil case is around 7 to 10 years, if not more. The right of the lesser to repossess the leased asset, in case of default by the lessee was not very clear until the Bombay High Court ruled (and the Supreme Court upheld) that the lesser has a right to so repossess (in the case of Twentieth Century Finance Corporation vs. SLM Maneklal Industries Ltd.).

Hence the required rate of return due to feeble contract enforcement mechanisms becomes larger in countries like India. Therefore, a good portion of non-performing assets of commercial banks in India is related to deficiencies in contract enforcement mechanisms. Credit risk is also linked to market risk variables. In a highly volatile interest rate environment, loan defaults could increase thereby affecting credit quality. The expansion of banking sector was phenomenal during the 1970s and 1980s. Mobilization of deposits was one of the major objectives of commercial banks.

Self Check Exercise (True / False)

1. Credit risk refers to the potential loss that may occur when a borrower fails to repay a loan or meet its financial obligations.
2. Effective fund management involves ensuring that financial resources are utilized efficiently to achieve the organization's objectives without considering risk factors.
3. Financial institutions, in their fund management, may diversify investments to mitigate credit risk and enhance overall portfolio performance.

To that extent, performance appraisal and incentive system within the banking sector was more based on deposit mobilization and achievement of deposit targets rather than on lending practices and credit risk assessment mechanisms. Hence, it is important that the banks reorient their approach in terms of reformulating performance appraisal systems, which focus more on lending practices and credit risk assessments in the changed scenario. Credit rating to some extent facilitates the understanding of credit risk. But the quality of financial information provided by corporate leaves much to be desired. In the case of the unincorporated sector, namely a partnership and proprietorship firm, the task of credit risk assessment is more complicated because of lack of reliable and continuous financial information.

7.4.1 CAPITAL RISK

One of the sound aspects of the banking practice is the maintenance of adequate capital on a continuous basis. There are attempts to bring in global norms in this field in order to bring in commonality and standardization in international practices. Capital adequacy also focuses on the weighted average risk of lending and to that extent, banks are in a position to realign their portfolios between more risky and less risky assets.

7.4.2 MARKET RISK

Market risk is related to the financial condition, which results from adverse movement in market prices. This will be more pronounced when financial information has to be provided on a marked-to-market basis since significant fluctuations in asset holdings could adversely affect the balance sheet of banks. In the Indian context, the problem is accentuated because many financial institutions acquire bonds and hold it till maturity. When, there is a significant increase in the term structure of interest rates, or violent fluctuations in the rate structure, one finds substantial erosion of the value of the securities held.

7.4.3 INTEREST RATE RISK

Interest risk is the change in prices of bonds that could occur as a result of change in interest rates. It also considers change in impact on interest income due to changes in the rate of interest. In other words, price as well as reinvestment risks require focus. In so far as the terms for which interest rates were fixed on deposits differed from those for which they fixed on assets, banks incurred interest rate risk i.e., they stood to make gains or losses with every change in the level of interest rates.

As long as changes in rates were predictable both in magnitude and in timing over the business cycle, interest rate risk was not seen as too serious, but as rates of interest became more volatile, there was felt need for explicit means of monitoring and controlling interest gaps. In most OECD countries, the situation was no different from that which prevailed in domestic banking.

The term to maturity of a bond provides clues to the fluctuations in the price of the bond since it is fairly well-known that longer maturity bonds have greater fluctuations for a given change in the interest rates compared to shorter maturity bonds. In other words commercial banks, which are holding large proportions of longer maturity bonds, will face more price reduction when the interest rates go up. Between 1970s and the early part of 1990s, there has been a substantial change in the maturity structure of bonds held by commercial banks. During 1961, 34% of the central government securities had a maturity of less than 5 years and 27% more than 10 years. But in 1991, only 9% of the securities had a maturity of less than 5 years, while 86% were more than 10 years. During 1992, when the reform process started and efforts taken to move away from the administered interest rate mechanism to market determined rates, financial institutions were affected because longer maturity instruments have greater fluctuations for a given change in the interest rate structure.This becomes all the grimmer when interest rates move up because the prices of the holding come down significantly and in a marked-to-market situation, severely affect bottom lines of banks.

Another associated issue is related to the coupon rate of the bonds. Throughout the 1970s and 1980s, the government was borrowing from banks using the statutory obligation route at artificially low interest rates ranging between 4.5% to 8% (The World Bank, 1995). The smaller the coupon rate of bonds, larger is the fluctuation associated with a change in interest rate structure. Because of artificially fixed low coupon rates, commercial banks faced adverse situations when the interest rate structure was liberalized to align with market rates.

Therefore, the banking industry in India has substantially more issues associated with interest rate risk, which is due to circumstances outside its control. This poses extra challenges to the banking sector and to that extent; they have to adopt innovative and sophisticated techniques to meet some of these challenges.

There are certain measures available to measure interest rate risk. These include:

Maturity: Since it takes into account only the timing of the final principal payment, maturity is considered as an approximate measure of risk and in a sense does not quantify risk. Longer maturity bonds are generally subject to more interest rate risk than shorter maturity bonds.

Duration: Is the weighted average time of all cash flows, with weights being the present values of cash flows? Duration can again be used to determine the sensitivity of prices to changes in interest rates. It represents the percentage change in value in response to changes in interest rates.

Dollar Duration: Represents the actual dollar change in the market value of a holding of the bond in response to a percentage change in rates.

Convexity: Because of a change in market rates and because of passage of time, duration may not remain constant. With each successive basis point movement downward, bond prices increase at an increasing rate. Similarly, if rates increase, the rate of decline of bond prices declines. This property is called convexity.

In the Indian context, banks in the past were primarily concerned about adhering to statutory liquidity ratio norms and to that extent they were acquiring government securities and holding it till maturity. But in the changed situation, namely moving away from administered interest rate structure to market determined rates, it becomes important for banks to equip themselves with some of these techniques, in order to immunize banks against interest rate risk.

Self Check Exercise

1. What type of risk involves potential losses due to fluctuations in interest rates?
2. What risk pertains to the potential financial losses resulting from changes in market conditions and external factors?
3. What risk is associated with potential financial losses due to changes in the value of financial instruments held by an institution?

7.4.4 LIQUIDITY RISK

Affects many Indian institutions. It is the potential inability to generate adequate cash to cope with" a decline in deposits or increase in assets. To a large extent, it is an outcome of the mismatch in the maturity patterns of assets and liabilities. First, the proportion of central government securities with longer maturities in the Indian bond market, significantly increasing during the 1970s and 1980s, affected the banking system because longer maturity securities have greater volatility for a given change in interest rate structure.

This problem gets accentuated in the context of change in the main liability structure of the banks, namely the maturity period for term deposits. For instance in 1986, nearly 50% of term deposits had a maturity period of more than 5 years and only 20%, less than 2 years for all commercial banks. But in 1992, only 17% of term deposits were more than 5 years whereas 38% were less than 2 years.

In such a situation, we find banks facing significant problems in terms of mismatch between average life of bonds and maturity pattern of term deposits. The Ministry of Finance as well as the RBI have taken steps to reduce the average maturity period of bonds held by commercial banks in the last few years. In other words, newer instruments are being floated with shorter maturities accompanied by roll over of earlier instruments with shorter maturities. In order to meet short-term liability payments, institutions have to maintain certain levels of cash at a!' points of time. Thus managing cash flows becomes crucial. Institutions could access low cost funding or could have assets that have sufficient shortterm cash flows. Hence, banking institutions need to strike a reasonable tradeoff between being excessively liquid and relatively illiquid. The recent failure of many non-banking financial companies can be ascribed to mismatch between asset-liability maturities, since many of them have invested in real estate type of assets with short-term borrowings. Particularly in a declining real estate market, it becomes difficult for non-banking financial companies to exit and meet obligations of lenders. In such a context, liquidity becomes a much more significant variable even at the cost of forgoing some profitability.

7.5 RISK MEASUREMENT TECHNIQUES

There are various techniques for measuring exposure of banks to interest rate risks :

1. Gap Analysis Model

Measures the direction and extent of asset-liability mismatch through either funding or maturity gap. It is computed for assets and liabilities of differing maturities and is calculated for a set time horizon. This model looks at the repricing gap that exists between the interest revenue earned in the bank's assets and the interest paid on its liabilities over a particular period of time. It highlights the net interest income exposure of the bank, to changes in interest rates in different maturity buckets.

Repricing gaps are calculated for assets and liabilities of differing maturities. A positive gap indicates that assets get reprised before liabilities, whereas, a negative gap indicates that liabilities get reprised before assets. The bank looks at the rate sensitivity (the time the bank manager will have-to wait in border to change the posted rates on any asset or liability) of each asset and liability on the balance sheet. The general formula that is used is as follows:

Nil = R> (GAR)

While Nil is the net interest income, R refers to the interest rates impacting assets and liabilities in the relevant maturity bucket and GAP refers to the differences between the book value of the rate sensitive assets and the rate sensitive liabilities. Thus when there is a change in the interest rate, one can easily identify the impact of the change on the net interest income of the bank.

Interest rate changes have a market value effect. The basic weakness with this model is that this method takes into account only the book value of assets and liabilities and hence ignores their market value. This method therefore is only a partial measure of the true interest rate exposure of a bank.

2. Duration Model

Duration is an important measure of the interest rate sensitivity of assets and liabilities as it takes into account the time of arrival of cash flows and the maturity of assets and liabilities. It is the weighted average time to maturity of all the preset values of cash flows. Duration basic -ally refers to the average life of the asset or the liability.

$DP_p = D\ (DR\ /1 + R)$

The above equation describes the percentage fall in price of the bond for a given increase in the required interest rates or yields. The larger the value of the duration, the more sensitive is the price of that asset or liability to changes in interest rates. As per the above equation, the bank will be immunized from interest rate risk if the duration gap between assets and the liabilities is zero. The duration model has one important benefit. It uses the market value of assets and liabilities.

3. Value at Risk

Refers to the maximum expected loss that a bank can suffer over a target horizon, given a certain confidence interval. It enables the calculation of market risk of a portfolio for which no historical data exists. It enables one to calculate the net worth of the organization at any particular point of time so that it is possible to focus on long-term risk implications of decisions that have already been taken or that are going to be taken. It is used extensively for measuring the market risk of a portfolio of assets and/or liabilities.

4. Simulation

Simulation models help to introduce a dynamic element in the analysis of interest rate risk. Gap analysis and duration analysis as stand-alone tool for asset-liability management suffer from their inability to move beyond the static analysis of current interest rate risk exposures. Basically simulation models utilize computer power to provide what if scenarios, for example: What if: The absolute level of interest rates shift and There are nonparallel yield curve changes, Marketing plans are under-or-over achieved, Margins achieved in the past are not sustained/improved, Bad debt and prepayment levels change in different interest rate scenarios, There are changes in the funding mix e.g.: an increasing reliance on short term funds for balance sheet growth. This dynamic capability adds value to the traditional methods and improves the information available to management in terms of:

1. Accurate evaluation of current exposures of asset and liability portfolios to interest rate risk.
2. Changes in multiple target variables such as net interest income, capital adequacy, and liquidity
3. Future gaps

It is possible that the simulation model due to the nature of massive paper outputs may prevent us from seeing wood for the tree. In such a situation, it is extremely important to combine technical expertise with an understanding of issues in the organization. There are certain requirements for a simulation model to succeed. These pertain to accuracy of data and reliability of the assumptions made. In other words, one should be in a position to look at alternatives pertaining to prices, growth rates, reinvestments, etc., under various interest rate scenarios. This could be difficult and sometimes contentious. It is also to be noted that managers may not want to document their assumptions and data is not easily available for differential impacts of interest rates on several variables. Hence, simulation models need to be used with caution particularly in the Indian situation.

Last but not the least, the use of simulation models calls for commitment of substantial amount of time and resources. If we cannot afford the cost or, more importantly the time involved in simulation modeling, it makes sense to stick to simpler types of analysis.

7.6 STRATEGIES FOR CORRECTING MISMATCH

The strategies that can be employed for correcting the mismatch in terms of D(A) > D(L)
can be either liability or asset driven. Asset driven strategies for correcting the mismatch \focus on shortening the duration of the asset portfolio. The commonly employed asset based financing strategy is securitization. Typically the long-term asset portfolios like the lease and hire purchase portfolios are securitized; and the resulting proceeds are either redeployed in short term assets or utilized for repaying short-term liabilities.

Liability driven strategies basically focus on lengthening the maturity profiles of liabilities. Such strategies can include for instance issue of external equity in the form of additional equity shares or compulsorily convertible preference shares (which can also help in augmenting the Tier I capital of finance companies), issue of redeemable preference shares, subordinated debt instruments, debentures and accessing long term debt like bank borrowings and term loans. Strategies to be employed for correcting a mismatch in the form of D(A) < D(L) (which will be necessary if interest rates are expected to decline) will be the reverse of the strategies discussed above.

Asset driven strategies focus on lengthening the maturity profile of assets by the deployment of available lendable resources in long-term assets such as lease and hire purchase. Liability driven strategies focus on shortening the maturity profile of liabilities, which can include, liquidating bank borrowings which are primarily in the form of cash credit (and hence amenable for immediate liquidation), using the prepayment options (if any embedded in the term loans); and the call options, if any embedded in bonds issued by the company; and raising short-term borrowings (e.g.: fixed deposits with a tenor of one year) to repay long-term borrowings.

Self Check Exercise

4. Gap Analysis Model is used to assess:
   a) Market Risk
   b) Credit Risk
   c) Interest Rate Risk
   d) Liquidity Risk
5. Value at Risk (VaR) is a measure used to quantify:
   a) Credit Exposure
   b) Market Risk
   c) Liquidity Risk
   d) Operational Risk

7.7 EMERGING ISSUES

With the onset of liberalization, Indian banks are now more exposed to uncertainty and to global competition. This makes it imperative to have proper asset-liability management systems in place. The following points bring out the reasons as to why asset- liability management is necessary in the Indian context.

In the context of a bank, asset-liability management refers to the process of managing the net interest margin (NIM) within a given level of risk.

NIM = Net Interest Income/Average Earning Assets = NII/AEA

Since Nil equal's interest income minus interest expenses, NIM can be viewed as the spread on earning assets and uses the term spread management. As the basic objective of banks is to maximize income while reducing their exposure to risk, efficient management of net interest margin

becomes essential. Several banks have inadequate and inefficient management systems that have to be altered so as to ensure that the banks are sufficiently liquid. Indian banks are now more exposed to the vagaries of the international markets, than ever before because of the removal of restrictions, especially with respect to forex transactions. Asset-liability management becomes essential as it enables the bank to maintain its exposure to foreign currency fluctuations given the level of risk it can handle. An increasing proportion of investments by banks is being recorded on a marked- to-market basis and as such large portion of the investment portfolio is exposed to market- risks. Countering the adverse impact of these changes is possible only through efficient asset-liability management techniques. As the focus on net interest margin has increased over the years, there is an increasing possibility that the risk arising out of exposure to interest rate volatility will be built into the capital adequacy norms specified by the regulatory authorities. This, in turn will require efficient asset-liability management practices.

Many of the new private sector banks and some of the non-banking financial companies have gone in for complete computerization of their branch network and have also integrated their treasury, forex, and lending segments. The information technology initiatives of these institutions provide significant advantage to them in asset-liability management since it facilitates faster flow of information, which is accurate and reliable. It also helps in terms of quicker decision-making from the central office since branches are networked and accounts are considered as belonging to the bank rather than a branch.

The electronic fund transfer system as well as demat holding of securities also significantly alters mechanisms of implementing asset-liability management because trading, transaction, and holding costs get reduced. Simulation models are relatively easier to consider in the context of networking and also computing powers. The open architecture, which is evolving in the financial system, facilitates cross-bank initiatives in asset-liability management to reduce aggregate unit cost. This would prove as a reliable risk reduction mechanism.

In other words, the boundaries of asset-liability management architecture itself is changing because of substantial changes brought about by information technology, and to that extent the operations managers are provided with multiple possibilities which were not earlier available in the context of large numbers of branch networks and associated problems of information collection, storage, and retrieval.

In the Indian context, asset-liability management refers to the management of deposits, credit, investments, borrowing, forex reserves and capital, keeping in mind the capital adequacy norms laid down by the regulatory authorities. Information technology can facilitate decisions on the following issues:

1. Estimating the main sources of funds like core deposits, certificates of deposits, and call borrowings.
2. Reducing the gap between rate sensitive assets and rate sensitive liabilities, given a certain level of risk.
3. Reducing the maturity mismatch to avoid liquidity problems.
4. Managing funds with respect to crucial factors like size and duration.

It is important to note that the conglomerate approach to financial institutions, which is increasingly becoming popular in the developed markets, could also get replicated in Indian situations.

This implies that the distinction between commercial banks and term lending institutions could become blurred. It is also possible that the same institution involves itself in short-term and long-term lending-borrowing activities, as well as other activities like mutual funds, insurance and pension funds.

In such a situation, the strategy for asset-liability management becomes more challenging because one has to adopt a modular approach in terms of meeting asset liability management requirements of different divisions and product lines. But it also provides opportunities for diversification across activities that could facilitate risk management on an enhanced footing. In other words, in the Indian context, the challenge could arise from say the merger of SBI, IDBI, and LIC.

Such a scenario need not be considered extremely hypothetical because combined and stronger balance sheets provide much greater access to global funds. It also enhances the capability of institutions to significantly alter their risk profiles at short notice because of the flexibility afforded by the characteristics of products of different divisions. This also requires significant managerial competence in order to have a conglomerate view of such organizations and prepare it for the challenges of the coming decade.

As long as the artificial barriers between different financial institutions exist, asset liability management is narrowly focused and many a time not in a position to achieve the desired objectives. This is because of the fact that the institutional arrangements are mainly due to historical reasons of convenience and a perceived static picture of the operating world. The integration of different financial markets, instruments and institutions provide greater opportunities for emerging markets like India to aim for higher return in the context of minimizing risk.

Hence, it maybe appropriate to think in terms of reorienting our institutional structures (removing the distinctions between commercial banks, non-banking financial companies, and term lending institutions to start with) and having a conglomerate regulatory framework for monitoring capital adequacy, liquidity, solvency, marketability, etc. This will go a long way in ironing out the mismatches between the assets and the liabilities, rather than narrowly focused asset-liability management techniques for individual banks.

7.8 SUMMARY

The lesson discusses funds management and elaborates on various categories of risk that require to be managed. It examines strategies for funds (asset-liability) management from the asset side as well as the liability side, particularly in the Indian context. It also discusses the specificity of financial institutions in India and the new information technology initiatives that beneficially affect asset-liability management. The emerging contours of conglomerate financial services and their implications for asset- liability management are also described.

7.9 Keywords

Risk: Risk in a way can be defined as the chance or the probability of loss or damage.

Credit Risk: The risk of counter party failure in meeting the payment obligation on the specific date is known as credit risk.

Interest Rate Risk: Interest risk is the change in prices of bonds that could occur as a result of change in interest rates.

7.9 Exercise Questions

Short Answer Type Questions

1. Define the term "Fund Management."
2. What is the primary purpose of "Asset Allocation" in fund management?
3. Define "Liquidity Risk" in the context of fund management.
4. Briefly explain the concept of "Risk Mitigation" as a risk management technique.

Long Answer Type Questions

5. Explain the concept of Value at Risk (VaR) as a quantitative risk management technique. Discuss its strengths and limitations in assessing financial risk.
6. Discuss the importance of diversification in fund management. Explain how diversifying a portfolio can help manage risk and enhance potential returns. Provide examples of different asset classes that can be part of a diversified investment portfolio.

7.10 SUGGESTED READINGS

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7.11 Self Check Exercise (Answer Key)

1. True, 2. False, 3. True, 4. Interest Rate Risk, 5. Market Risk, 6. Capital Risk, 7. Interest Rate Risk, 8. Market Risk

MBA-DE(Second Year) **MFI 308**
Semester-Ill **MANAGEMENT OF FINANCIAL INSTITUTIONS**
Lesson No. 8 **AUTHOR :Dr.RATINDER KAUR**

DEVELOPMENT BANKING : AN OVER VIEW

STRUCTURE

8.0 Learning objectives
8.1 Introduction
8.2 Functions of a Development Bank
8.3 Formation of Development Banks In India
8.4 Major Development Banks in India
- 8.4.1 Industrial Development Bank of India
- 8.4.2 Export-Import Bank Of India
- 8.4.3 Industrial Credit And Investment Corporation Of India Limited
- 8.4.4 National Housing Bank
- 8.4.5 Small Industries Development Bank Of India
- 8.4.6 NABARD

8.5 Regulatory Framework
8.6 Summary
8.7 Keywords
8.8 Questions for Review
8.9 Suggested Readings
8.10 Self Check Exercise (Answer Key)

8.0 LEARNING OBJECTIVES

After reading this lesson, you will understand:

1. Operations of major FIs in India
2. Regulatory framework for FIs.

We will discuss the nature and operations of the present financial institutions operating in India.

8.1 INTRODUCTION

A Development Bank is a multilateral development finance institution dedicated to improving the social and economic development of its member nations. Its primary emphasis is the welfare of the people. For example the Asian Development Bank's overarching goal is to reduce poverty in Asia and the Pacific. It helps improve the quality of people's lives by providing loans and technical assistance for a broad range of development activities.

A development bank's policies or programs center on the following priorities :

1. Economic growth
2. Human development
3. Gender and development
4. Good governance
5. Environmental protection
6. Private sector development
7. Regional cooperation

8.2 FUNCTIONS OF A DEVELOPMENT BANK

Given below are the principal functions of a development bank

1. Extend loans and equity investments to its developing member countries (DMCs) for their economic and social development.
2. Provides technical assistance for the planning and execution of development projects and programs and for advisory services.
3. Promotes and facilitates investment of public and private capital for development, and
4. Responds to requests for assistance in coordinating development policies and plans of its developing member countries.

8.3 FORMATION OF DEVELOPMENT BANKS IN INDIA

Development banks were set up in India at various points of time starting from the late 1940s to cater to the medium to long term financing requirements of industry as the capital market in India had not developed sufficiently. The endorsement of planned industrialization at the national level provided the critical inducement for establishment of Development banks at both all-India and state levels. In order to perform their role, DBs were extended funds in the form of Long Term Operations (LTO) Fund of the Reserve bank of India and government guaranteed bonds, which constituted major sources of their funds. Funds from these sources were not only available at concessional rates, but also on a long term basis with their maturity period ranging from 10-15 years. On the asset side, their operations were marked by near absence of competition.

A large variety of financial institutions have come into existence over the years to perform a variety of financial activities. While some of them operate at all-India level, others are state level institutions. Besides providing direct loans, financial institutions also extend financial assistance by way of underwriting and direct subscription and by issuing guarantees. Recently, some DBs have started extending short term/working capital finance, although long term lending continues to be their major activity.

Prior to reforms, DBs operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the wake of financial sector reforms, the RBI started monitoring the functioning of DBs with a view to impart market orientation to their operations. In tune with the emerging scenario, their access to low cost funds of the RBI was discontinued. On their part, DBs took several steps to reposition themselves and reorient their operations in the new competitive environment. They have diversified their activities into new areas of business such as investment banking, stock broking, and other fee and commission based business. Nevertheless, their business has slowed down and their operations have become less profitable. The Committee on Banking Sector Reforms (Chairman: M. Narsimham), 1998 recommended that DBs should, over a period of time, convert themselves into banks or NBFCs (Non-Banking Financial Institutions). It is noteworthy that ICICI, one of the leading DBs, has merged with the ICICI Bank.

Historically, the Reserve Bank of India and the Central Government have played a major role in financing these institutions by subscribing to the share capital , by allowing them to issue Government guaranteed bonds, and by extending long term loans at concessional terms. However, with the financial sector reforms in the nineties, concessional lending by the RBI and the Government was phased out, leaving the financial institutions to rely for financing their needs on the equity capital and the debt markets. Expansion of their equity base through public offers and public issues of long term bonds has become an important element of their market based financing. In order to provide flexibility, the Reserve bank has allowed FIs to raise resources by way of term deposits. Commercial Deposits and borrowings from the money market is allowed within the umbrella limit fixed in terms of net owned funds. In order to expand their scope of business, a large number of them have been entering into various businesses- venture capital, mutual funds, banking and insurance.

Self Check Exercise (True/ False)

1. Development banks primarily focus on profit-driven activities like commercial banks.
2. One of the functions of development banks is to provide long-term financing for projects that contribute to economic development.
3. Development banks do not play a role in promoting industrialization and infrastructure development.

8.4 MAJOR DEVELOPMENT BANKS IN INDIA

8.4.1 Industrial Development Bank of India

Industrial Development Bank of India (IDBI), established under the Industrial Development Bank of India Act, 1964, is the principal financial institution for providing credit and other facilities for development of industry, co-coordinating working of institutions engaged in financing, promoting or developing industries and assisting the development of such institutions. IDBI has been providing direct financial assistance to large industrial concerns and also helping small and medium industrial concerns through banks and state-level financial institutions. Aggregate assistance (provisional) sanctioned during 1998-99 amounted to Rs 25,555 crore registering a rise of 6.6 percent over the preceding year. Disbursements amounted to Rs 14,403 crore in 1998-99.

8.4.2 Export-Import Bank Of India

Export-Import Bank of India (Exim Bank) was established on 1 .January 1982 for financing, facilitating and promoting foreign trade in India. During the year ended 31 March 1999, Exim Bank sanctioned loans of Rs 1,838 crore while disbursements amounted to Rs 1,271 crore. Net profit of the Bank for the period 1998-99 (April-March) on account of General Fund amounted to Rs 240 crore.

8.4.3 Industrial Credit And Investment Corporation Of India Limited

Industrial Credit and Investment Corporation of India Limited (ICICI) was established in 1955 as public limited company to encourage and assist industrial units in the country. Its objectives, inter alia, include providing assistance in the creation, expansion, and modernization of industrial enterprises, encouraging and promoting participation of private capital both internal and external, in such -enterprises, encouraging and promoting industrial development and helping development of capital markets. It provides term loans in Indian and foreign currencies, underwrites issues of shares and debentures, makes direct subscriptions to these issues and guarantees payment of credit made by others. The assistance sanctioned and disbursed by ICICI during 1998-99 aggregated Rs 34,220 crore and Rs 19,225 crore, respectively (provisional), registering a growth of 38.4 per cent and 21.6 per cent, respectively, over the -previous year.

8.4.4 National Housing Bank

National Housing Bank (NHB), the apex institution in housing finance in India, started its operation from July 1988. The authorized share capital of NHB is Rs 500, crore. As on 30 June 1998, the paid-up 'capital of NHB stood at Rs 350 crore and the reserves and surplus were Rs 425.01 crore. A major activity of NHB includes extending financial assistance to eligible institutions in the housing sector by way of (a) refinance and (b) direct finance.

NHB, extends refinance assistance to eligible primary lending institutions, viz., Scheduled Banks, Housing Finance Companies (HFCs) and Co-operative Sector Institutions. The refinance assistance is extended to the primary lending institutions in respect of housing loans provided by these institutions for individuals as also for public and private agencies towards land development and shelter projects. The total refinance assistance extended by NHB to all eligible primary lending institutions was Rs 746.99 crore in 1998-99 as against Rs 524.15 crore in 1997-98.

The cumulative refinance assistance provided by NHB to the primary lending institutions stood at Rs 4,373.99 crore up to 30 June 1999. The total number of HFCs approved for availing refinance from NHB as on 30 June 1999 stood at 29.

(a) Direct Finance : NHB provides direct finance for integrated land development and shelter projects of public agencies in respect of Land Development and Shelter Projects (LDSPs), Slum Redevelopment Projects (SRPs) and Housing Infrastructure Projects (HIPs) where the projects/ agencies are able to comply with the financial discipline norms laid down by NHB, under the direct financing window, NHB sanctioned three LDSPs with project cost of Rs 18.94 crore and loan component of Rs 16.12 crore during 1998-99.

With this, the total number of projects sanctioned under the scheme has gone up to nine with total project cost being Rs 78.56 crore and loan component being Rs 63.71 crore. During 1998-99 Rs 14.76 crore were disbursed under the scheme. Thirteen SRPs with total project cost of Rs 22.59 crore and loan component of Rs 17.01 crore were sanctioned during 1998-99. An amount of Rs 1.21 crore was disbursed for these projects during the year. The guidelines in respect of LDSPs, SRPs and HIPs pertaining to public agencies were revised during 1998-99. NHB also revised the interest rates on its refinance schemes. NHB issued Directions to the HFCs in matters relating to the acceptance of deposits. In order to ensure efficiency in the performance of the HFCs, NHB has also issued guidelines on prudential norms relating to income recognition, asset classification, provisions and credit concentration, etc.

As part of its promotional and developmental role, NHB participated in the equity of Housing Finance Companies and Building Material Industries to the extent of Rs 11.30 crore till 30 June 1999. During the 50th year of India's independence, NHB launched the Golden Jubilee Rural Housing Finance Scheme to encourage the financial sector institutions to extend loans to individuals for housing in rural areas. During 1998-99, 1,25,731 dwelling units were financed by the various primary lending institutions against the target of one lakh units. The target for 1999-2000 has been fixed at 1, 25,000 dwelling units. In order to ensure greater flow of resources to the housing sector, NHB is in the process of initiating measures for the introduction of mortgage backed securitization.

8.4.5 Small Industries Development Bank Of India

Small Industries Development Bank of India (SIDBI)^was established as a wholly- owned subsidiary of the Industrial Development Bank of India (IDBI) under the Small Industries Development Bank of India Act, 1989 as the principal finance institution for promotion, financing and development of industries in the small scale sector. SIDBI started its operations from 2 April 1990 and is engaged in providing assistance to the small-scale industrial sector in the country through other institutions like state financial corporations, commercial banks and state industrial development corporations. Provisional cumulative sanctions and disbursements at the end of March 1999 were Rs 45,144 crore and Rs 32,987 crore respectively. ‘

Self Check Exercise

4. Which institution primarily facilitates financing for export and import activities?
5. What does IDBI stand for, and what is its primary role in the financial sector?
6. NHB is a financial institution in India that specifically focuses on which sector?

8.4.6 NABARD

National Bank for Agriculture and Rural Development (NABARD) came into existence on 12 July 1982. It took over the functions of the erstwhile Agriculture Credit Department, Rural Planning and Credit Cell of the Reserve Bank of India and Agriculture Refinance and Development Corporation. The proposal for amending relevant provision of NABARD Act, 1981 enhancing the capital from Rs 500 crore to Rs 2,000 crore is under consideration of the Central government. Pending this, the Reserve Bank has contributed Rs 1,200 crore and the Central government Rs 300 crore for raising the share capital from Rs 500 crore to Rs 20 crore.

NABARD was established for providing credit for promotion of agriculture, small-scale industries, cottage and village industries, handicrafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas. NABARD as the apex institutions is concerned with all policy planning and operations in the field of credit for agriculture and other economic activities in the rural areas. Its functions are to :

(i) serve as an apex refinancing agency for institutions providing investment and production credit for promoting various development activities in the rural areas;

(ii) take measures towards institution-building for improving absorptive capacity to credit delivery system including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.,

(iii) co-ordinate rural financing activities of all institutions engaged in the developmental work at field-level and maintain liaison with Central/ State governments, Reserve Bank of India and other* national institutions concerned with policy formulation and also

(iv) Undertake monitoring and evaluation of projects refinanced by it.

NABARD provides refinance to the state land development banks, state co-operative_ banks, scheduled commercial banks and regional rural banks, while the ultimate beneficiaries of investment of credit can be individuals, partnership concerns, companies, state-owned corporations*, etc. The short-term (ST) credit limits for 1998-99 sanctioned by NABARD to State Co-operative Banks for Seasonal Agricultural Operations (SAO) up to the end of March 1999 aggregated Rs 5,979 crore as against Rs 5,210 crore during the corresponding period of the previous year. Outstanding against these limits stood at Rs 4,055.85 crore and Rs 3,017.42 crore as at the end of March 1999 and March 1998 respectively. The credit limits sanctioned for 1998-99 included Rs 215.17 crore for Development of Tribal Population (DTP), Rs 859.50 crore for Oilseeds Production Programme (OPP) and Rs 44.45 crore for National Pulses Development Programme (NPDP). The outstanding thereunder amounted to Rs 106.86 crore, Rs 364.98 crore and Rs 20.95 crore respectively as on 31 March 1999.

Self Check Exercise

7. Which sector does NABARD primarily focus on in its developmental activities?
8. What is the primary role of NABARD in the Indian financial system?

8.5 REGULATORY FRAMEWORK

The reforms taking Place in the financial sector have been affecting all the players in the market. 'While the deregulations have unleashed the competition, the guidelines introduced to streamline the Indian market players operations with that of the international player have posed significant challenges for the profitable sustenance of these players/

Significant changes that have been witnessed in the operational environment of the FIs are as follows:

Capital Adequacy Requirements: The capital to risk weighted assets ratio (CRAR) that the FIs are supposed to maintain is 9 percent. The details relating to the computation of CRAR remain the same as for banks. In addition to this, the non- cumulative preference shares permissible for issue under the companies act and which have a maturity of 20 years will form a part of the tier-1 capital. However, the FI will have to create a corpus to be invested in the government securities having maturity of such preferences shares to eliminate the reinvestment risk. The corpus should be a minimum amount, which when invested will equal the preference shares amount. Adjustment will have to be made in this corpus for the changes taking place in the tax rates. If a shortfall arises, it has to be provided from the reserves.

Further, transfers from the reserve will also have to be made for the differential interest rates i.e. if the yield on the G-Secs at the time of the initiation of the corpus and the yield at which the interest proceeds are reinvested each year the corpus should not be used for the other operations of the FIs. The amount and the purpose of the corpus, will have to be disclosed separately in the balance sheet, prospectus for raising resources, etc. The amount of preference shares less the amount of corpus created as above will be considered as Tier-1 capital.

Prudential Norms:

FIs are also subjected to the prudential norms on the same lines as banks. The asset classification, Income recognition and the provisioning norms with effect from 31-3-2002 are: interest and/or principal remain overdue for 180 days (earlier it was 365 days). However, in addition, to those guidelines, the Reserve Bank has also released prudential norms for takeout financing by financial institutions in India. Under a takeout finance management, the FII Bank financing an infrastructure project transfers the outstanding loan amount to another on a pre-determined basis. The taking over institution will have to make provisions on the NPAs being taken over in their accounts from the date of it turning into a NPA in the lending institution's books.

Further, in cases of unconditional takeover, the lending institutions should prescribe a risk weightage of 20% in its books when the credit risk is taken over entirely. The taking over institution has to prescribe a risk weightage of 100% in such cases. The weightage for the lending institution in cases of assumption of partial credit risk has been prescribed at 20% on the loan to be taken over and 100% on amount not taken over. The central bank has also prescribed 100% risk weightage in cases of conditional takeover financing for both lending and taking over institution.

ALM Guidelines: The Reserve Bank of India has issued comprehensive guidelines on asset liability management (ALM) system for the ten all-India term lending and refinancing institutions (FIs) December 31, 1999. The guidelines, which will be effective from April 1, 2000, will ensure a structured asset liability management (ALM) system by the FIs.

Exposure Norms: While deploying funds the exposure norms that need to to are - Industry - 15 percent of the net worth, Individual Company - 25% be adhered of the net worth and.; Group of Companies - 50% of the net worth. For participating in the equity, ICICI undertakes direct subscription, underwriting, loan conversion etc. Extension of credit by FIs does not have any restrictive clauses relating to the priority sector lending but however, they have to ensure balance regional development, export promotion etc.

8.6 SUMMARY

During 1999-2000, financial assistance sanctioned and disbursed by All India Financial Institutions (AIFIs) at Rs.l, 03,567 crore and Rs.67, 066 crore, respectively, registered increases of 26.3 percent and 19.1 percent, as compared with 8.6 percent and
8.5 percent during 1988-99. The substantially higher growth in both sanctions and disbursements during 1999-2000 was an indicator of improved investment activity. Financial assistance sanctioned by All India Development Banks (AIDBs), which accounted for the bulk of the sanctions (84.6 percent of total sanctions of AIFIs) grew by 22.2 percent, while their disbursements grew by 16.5 percent. During 1999-2000, specialized financial institutions increased their disbursements by 61.6 percent. Many of them are entering into venture capital activity. Investment institutions also recorded a gimlet of 31.1 percent in their disbursements. Apart from these measures, various high powered committees are being set up to review the role, structure and operations of the DFIs and banks. Significant recommendations have been made by the working group under the chairmanship of Shri S.
H. Khan. The committee has recommended a progressive move towards Universal Banking and the development of an enabling regulatory framework for this purpose. The measures taken relating to the CRAR, prudential norms, etc. are to ensure the international standards for the Indian FIs. Based on these recommendations, RBI will bring in more measures to ensure the strengthening of FIs in India. And taking cue from these developments, FIs are also making moves to ensure a smooth transition from their traditional role of FIs into Universal Banking.

8.7 Keywords

Bank Rate: That rate of interest at which the central bank makes advances to commercial banks or rediscounts their bills.

Minimum Reserve System of Note Issue: A system of note issue requiring that a certain minimum amount of reserve backing of note issue should be in the Form of gold and foreign securities.

Moral Suasion: An instrument of central bank's pressure upon the lending activities of commercial banks through exhortations that they follow certain restrictive practices.

Open Market Operations: Purchase or sale of eligible securities by the central balk in the open market.

Proportional Reserve System of Note Issue:A system of note issue requiring that
a certain percentage of reserve backing the note issue should be in the form of gold and foreign securities.

Selective Credit Control: Such credit control that regulates the distribution or direction of bank resources to particular sectors.-

Statutory Liquidity Ratio: The ratio of liquid assets to total demand and time liabilities determined statutorily.

8.8 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the operations of one of a major FI in India namely ICICI
2. Discuss the Regulatory framework for FIs.
3. What is a common function of development banks in supporting small and medium-sized enterprises (SMEs)?
4. What is the primary role of the World Bank in global development?

Long Answer Type Questions

5. Discuss the role of development banks in promoting sustainable development goals (SDGs). Examine how these institutions align their functions with SDGs, contribute to environmental sustainability, and address social and economic inequalities.

8.9 SUGGESTED READINGS

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8.10 Self Check Exercise (Answer Key)

1. False, 2. True, 3. False, 4. Export-Import Bank, 5. Industrial Development Bank of India; Industrial Financing, 6. Housing, 7. Agriculture, 8. Rural Financing

MBA-DE(Second Year) | **MFI 308**

Semester-Ill | **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 9 | **AUTHOR:Dr. RATINDER KAUR**

DEVELOPMENT BANKING: RESOURCE PLANNING AND MOBILISATION

STRUCTURE

9.0 Learning objectives
9.1 Introduction
9.2 Promotional Role and Policy Initiatives for development banking Institutions
9.3 Revised Guidelines
9.4 Performance Evaluation, Supervision and Audit
9.5 Recent Developments
9.6 Resource Planning and Mobilization
9.7 Financial Performance
9.8 Mobilization of Resources
9.9 Evaluation, Follow-up and Restructuring
9.10 Other Recent Developments
9.11 Summary
9.12 Keywords
9.13 Questions for Review
9.14 Suggested Readings
9.15 Self Check Exercise (Answer Key)

9.0 LEARNING OBJECTIVES

After reading this lesson, you will understand:

Resource Planning and Mobilization of major Development banks in India

Performance Evaluation of major Development banks in India

Recent developments in Development banking.

9.1 INTRODUCTION

The role of development banking institutions has been under discussion in recent years. Although setting up of the development finance institutions (DFIs) was an important feature in the overall development of the financial system; with the emergence of the capital market as an important source of finance in the late 1980s and early 1990s, and the renewed role of banks in term-financing, DFIs have been increasingly exposed to greater competition. Liberalization of the financial sector, with its associated processes of decontrol, deregulation and globalization, has led to increased competition for financial intermediaries across different segments. The competitive pressures have come into the business domain of FIs on account of the entry of new players. Moreover, with the initiation of financial sector reforms in the early 1990s, access of FIs to assured sources of long- duration/concessional funds from the Government, particularly 'SLR bonds' that were subscribed to by banks and insurance companies, has been gradually phased out. FIs at present are overwhelmingly dependent on market borrowings - wholesale and retail, domestic and foreign - for their resource mobilization. As a consequence, DFIs are required to raise funds from the capital market. With the removal of administrative controls on the interest rate structure, it has become increasingly difficult for DFIs to raise long-term funds. This in turn has affected their ability to offer competitive rates to their borrowers.

Apart from the competitive pressure for raising resources, the role of DFIs as an exclusive source of development finance has diminished as other intermediaries especially banks have also entered into long-term and high risk project financing. Therefore, FIs are increasingly facing competition not only in terms of raising resources but also in the deployment of funds. In short, the change in the operating environment coupled with the legacy of high non-performing assets has led to serious financial stress on the term lending financial institutions.

The Development Banking Institutions in India can be broadly classified into three categories, *viz.,* All-India Financial Institutions (AIFIs), State level institutions and other institutions. On the basis of functions and activities, the AIFIs have four segments; (i)all- India development banks, (ii) specialized financial institutions, (iii) investment institutions and (iv) refinance institutions. The State level institutions comprise State Financial Corporation's (SFCs) and State Industrial Development Corporations (SIDCs). Other financial institutions include Export Credit Guarantee Corporation of India (ECGC) Ltd. and Deposit Insurance and Credit Guarantee Corporation (DICGC). Out of 17 AIFIs, the Reserve Bank regulates and supervises only nine. Out of these nine, six FIs, *viz.,* Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) Ltd., Industrial Investment Bank of India (IIBI) Ltd., Tourism Finance Corporation of India (TFCI) Ltd., Infrastructure Development Finance Company (IDFC) Ltd. and EXIM Bank are 'Term Lending Institutions', while the remaining three FIs, *viz.,* National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) and Small Industries Development Bank of India (SIDBI) are termed as 'Refinance Institutions' for regulatory and supervisory purposes.

9.2 PROMOTIONAL ROLE AND POLICY INITIATIVES FOR DEVELOPMENT BANKING INSTITUTIONS

The Reserve Bank regulates and supervises nine AIFIs (IFCI Limited, IDBI, EXIM Bank, IIBI Limited, TFCI Limited, IDFC Limited, NABARD, NHB and SIDBI) under Section 5 of the Reserve Bank of India Act, 1934. The FIs are currently on the transition path as recommended by the Narasimham Committee II, by making endeavours, to convert themselves either into a bank or NBFC. The focus of the policy initiatives by the Reserve Bank and the Government has been on financial as well as organizational restructuring to facilitate their transition into universal banks. As a corollary, the Reserve Bank has been harmonizing its various policy measures for banks and FIs in such a manner that FIs, on becoming banks, are in a position to fully integrate themselves into the banking system. The Reserve Bank initiated various regulatory and supervisory initiatives including facilitating organizational restructuring of the FIs during 2003-04. Policy initiatives for select AIFIs laid emphasis on asset classification and provisioning, disclosures, consolidated accounting and supervision, infrastructure financing and measures to facilitate market developments. To examine the supervisory and regulatory issues relating to term lending and refinancing institutions and improve the flow of resources to them, the Reserve Bank announced the setting up of a Working Group on Development Financial Institutions which submitted its Report in May 2004.

Asset Classification and Provisioning Norms

Development Banking Institutions were advised that with effect from end-March 2006, an asset should be classified as a non-performing asset (NPA) if the interest and/ or installment of principal remain overdue for more than 90 days. As regards the additional provision arising as on March 31, 2006 on account of the modification in the norms, FIs would have the option to phase out the required provisioning over a period of three years beginning from the year ending March 31, 2006, subject to at least one fourth of the additional required provision being made in each year.

Prudential Norms

With a view to moving closer to international best practices and ensuring convergence of the norms applicable to the FIs with those of banks, the Reserve Bank in its mid-term Review of annual policy Statement for the year 2004-05 proposed that in respect of FIs, an asset would be classified as doubtful, if it remained in the sub-standard category for 12 months with effect from March 31, 2005. FIs are permitted to phase out the consequent additional provisioning over a four-year period.

In order to address the regulatory and supervisory issues and enhance the flow of credit, the Reserve Bank of India in its mid-term Review of monetary and credit policy 2003- 04 announced the setting up a Working Group on Development Financial Institutions (Chairman: N. Sadasivan). The broad objectives of the Working Group were to review the experience and prospects of DFIs for transformation into banks and to assess the financial position and recommend a regulatory framework for the existing financial institutions.

The Working Group observed that in the pre-reform period, DFIs faced little competition in the area of long-term finance as funds were available to them at cheaper rates from multilateral and bilateral agencies duly guaranteed by the Government. The reforms in the financial sector have changed the operational environment for the DFIs. Along with the changed operating environment for banks in a globalised scenario, the regulatory framework for FIs has undergone a significant change. While on the supply side, the access of DFIs to low-cost funds has been withdrawn, on the demand front, they have to compete with banks for long-term lending. Out of nine select all India financial institutions being regulated and supervised by the Reserve Bank at present, three institutions, *viz.,* NABARD, NHB and SIDBI extend indirect financial assistance by way of refinance. The financial health of these three institutions is sound as their exposures are to other financial intermediaries, which in certain cases are also supported by State Government guarantees. Of the remaining six institutions, two niche players, *viz.,* EXIM Bank and IDFC Ltd. are also healthy. On the basis of recommendations of the Working Group and the feedback received thereon, the Reserve Bank in its mid-term Review of annual policy Statement 2004-05 proposed: i) the Reserve Bank would continue to supervise NABARD, SIDBI, NHB and EXIM Bank, ii) the Reserve Bank would supervise DFIs accepting public deposits while DFIs and large NBFCs not accepting public deposit but having asset size of Rs.500 crore and above would be subjected to limited off-site supervision.

Self Check Exercise

1. What is the primary function of development banking institutions in fostering economic growth and stability?
2. In the context of development banking institutions, what do policy initiatives aim to achieve?
3. What is the overarching goal of the promotional role played by development banking institutions in the financial sector?
4. Identify the area where development banking institutions focus their policy initiatives to encourage economic progress.

Preventive Measures regarding Non-performing Assets

In pursuance of the directions of the Board for Financial Supervision (BFS), the Reserve Bank had constituted an in-house Group to identify and recommend the measures that could be instituted by the banks to prevent the slippage of the accounts from the 'substandard' category to the 'doubtful' category. Based on the recommendations of the Group, the Reserve Bank issued guidelines to banks and the same guidelines were extended to FIs. Accordingly, FIs were advised to place these guidelines before their Boards and take appropriate action for implementing the recommended measures, to the extent considered

necessary, in keeping with the spirit of the guidelines. The introduction of a 'Special Mention[1] category for asset classification is for internal control and follow-up purposes only and this, however, would not constitute an additional category under the extant asset classification norms of the Reserve Bank.

9.3 REVISED GUIDELINES

Under the revised guidelines for One Time Settlement (OTS) of chronic NPAs up to Rs.10 crore, the last date for receipt of applications from borrowers was extended up to July 31, 2004 from the close of business on September 30, 2003 and the date of completion of processing of applications was also extended up to October 31, 2004 from December 31, 2003 in consultation with the Government of India.

Guidelines on Investment in Debt Securities

FIs have been investing in the debt securities issued by companies on private placement basis from time to time. In order to provide greater transparency to such issuances and to protect the interest of investors in such securities, Securities and Exchange Board of India (SEBI) guidelines state that any listed company assuring debt securities on a private placement basis shall be required to comply with certain conditions relating to full disclosures (initial and continuing), Listing agreement with the exchanges, credit rating of not less than investment grade, appointment of a debenture trustee, issuance and trading of the debt securities in demat form, trading in stock exchanges and between Qualified Institutional Investors (QIIs) and High Net worth Individuals (HNIs), and standard denomination of Rs.10 lakh. If the intermediaries registered with SEBI associate themselves with the issuance of private placement of unlisted debt securities, they will be held accountable for such issues. They will also be required to furnish periodical reports to SEBI in such format as may be decided by SEBI.

SEBI has also directed the stock exchanges to make necessary amendments to the listing agreement, bye-laws, rules and regulations for the immediate implementation, as may be applicable and also disseminate its guidelines on the website for easy access to the investors and to the listed companies/member brokers/clearing members of the Exchange.

The investment by FIs in debt instruments issued by corporate entities - in primary as well as secondary market - increased substantially in the recent past. The Reserve Bank, therefore, issued draft guidelines in November 2003 which sought to address the risks arising from investment in non-Government debt securities, particularly through private placement. On receipt of the feedback from the FIs, the final guidelines on the subject were issued in January 2004. These guidelines mainly covered various aspects relating to coverage, effective date and transition time, regulatory requirements, internal assessment systems, prudential limits, the role of Board of Directors, reporting requirements, disclosures, and trading and settlement in debt securities. These guidelines apply to the FIs' investment in debt instruments, both in the primary market (public issue as also private placement) as well as the secondary market, issued by companies, banks, FIs and State and Central Government sponsored institutions, Special Purpose Vehicles (SPVs), Central or State Public Sector Undertakings, with or without Government guarantee; units of debt-oriented schemes of Mutual Funds, i.e., the schemes where the major part of the corpus is invested in debt securities; and capital gains bonds and the bonds eligible for priority sector status. The guidelines, however, do not apply to Government securities and the units of Gilt Funds; securities which are in the nature of advance under the extent prudential norms of the Reserve Bank; units of the equity oriented schemes of Mutual Funds; units of the 'Balanced Funds', venture capital funds and the money market mutual funds; Commercial Paper (CP); and Certificates of Deposit (CDs).

The Reserve Bank issued guidelines to FIs on investments in non-Government debt securities both in the primary (public issue and private placements) and secondary market with a view to address risks arising from investments in non-Government debt securities especially through private placements. The guidelines have been in force since April 1, 2004.

Considering the time required by the issuers of debt securities to get their existing unlisted debt issues listed on the stock exchanges, the following transition time is being provided: a) Investment in units of mutual fund schemes where the entire corpus is invested in non-Government debt securities would be outside the purview of the above guidelines till December 31, 2004; thereafter, such investments would also be subject to the guidelines, b) Investment in units of such schemes of mutual fund as have an exposure to unlisted debt securities of less than 10 per cent of the corpus of the scheme would be treated on par with listed securities for the purpose of the prudential limits prescribed under these guidelines from January 1, 2005. Hence, till December 31, 2004, investments in such units would attract prudential limits, c) Investments in existing unlisted securities, issued on or before November 30, 2003, were permitted up to March 31, 2004.

Investment by FIs are permitted only in rated debt securities with a minimum investment grade rating from an external rating agency, operating in India, as identified by the IBA/ FIMMDA. FIs cannot invest in debt securities of original maturity of less than one- year other than CPs and CDs, which are covered under the Reserve Bank guidelines. The FIs need to undertake usual due diligence in respect of investments in debt securities including the securities which do not attract these guidelines. The FIs should ensure that all fresh investments in debt securities are made only in listed debt securities of companies, which comply with the requirements of the relevant SEBI guidelines. The unlisted debt securities in which the FIs are allowed to invest up to the limits specified should be rated and Issuer Company should follow disclosure requirements as prescribed by the SEBI for listed companies.

The FIs should follow the same standards as for their credit appraisal before investing in debt securities, irrespective of the fact that the proposed investments may be in rated securities. FIs should not solely depend on the ratings of external rating agencies but strengthen their internal rating systems including building up of a system of regular (quarterly or half-yearly) tracking of the financial position of the issuer.

FIs are permitted to invest in the unlisted debt securities to the limit of not exceeding 10 per cent of their total investment in debt securities, which fall within the ambit of these guidelines, as on March 31 (June 30 in case of NHB) of the previous year. However, investment in Security Receipts (SRs) issued by Securitization/Reconstruction Companies registered with the Reserve Bank in terms of the provisions of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act,
Asset Backed Securities (ABS) and Mortgage Backed Securities (MBS) which are rated at or above the minimum investment grade will not be reckoned as 'unlisted debt securities' for the purpose of monitoring compliance. FIs, with exposure to investments in debt securities in excess of the above prudential limit as on March 31, 2003 (June 30, 2003 in case of NHB), should not make any fresh investment in such securities till the prudential limit is complied with.

The Boards of FIs would have to put in place a monitoring system to ensure that the prudential limits prescribed under these guidelines are scrupulously complied with, including the system for addressing the breaches, if any, due to rating migration. Boards of the FIs are expected to review, twice a year, total turnover (investment and divestment) during the reporting period;

compliance with the Reserve Bank-mandated prudential limits as also those prescribed by the Board for such investments; rating migration of the issuers/ securities held in the books of the FIs and consequent diminution in the portfolio quality; and extent of non-performing investments in the fixed income category.

As per the SEBI guidelines, all trades, with the exception of the spot transactions, in a listed debt security, would have to be executed only on the trading platform of a stock exchange. In addition to complying with the SEBI guidelines, the FIs would have to ensure that all spot transactions in listed and unlisted debt securities are reported on the NDS and settled through the Clearing Corporation of India Limited (CCIL) from the date to be notified by the Reserve Bank.

Guidelines Relating to Issuance of Commercial Paper (CP)

In order to provide further flexibility to both issuers and investors in the CP market, it has been decided that non-bank entities including corporate may provide unconditional and irrevocable guarantee for credit enhancement of the CP issue subject to (i) the issuer fulfilling the eligibility criteria prescribed for issuance of CP; (ii) the guarantor having a credit rating at least one notch higher than the issuer by an approved credit rating agency; and (iii) the offer document for CP disclosing the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked. Further banks are permitted to invest in CPs guaranteed by non-bank entities provided their exposure remains within the regulatory ceiling as prescribed by the Reserve Bank for unsecured exposures.

9.4 PERFORMANCE EVALUATION, SUPERVISION AND AUDIT

Consolidated Accounting and Consolidated Supervision

In the light of the guidelines and on the basis of a review, a set of final guidelines were issued on consolidated accounting and consolidated supervision. The guidelines which came into force on April 1, 2003 (July 1, 2003 in case of NHB), comprise three components in the supervisory framework, *viz.,* (i) Consolidated Financial Statements (CFS); (ii) Consolidated Prudential Returns (CPR); and (iii) application of prudential regulations like capital adequacy, large exposures and liquidity gaps on group-wide basis in addition to the solo prudential norms applicable to the parent FIs/subsidiaries. The publication of the CFS as per the Accounting Standard (AS) 21 of the Institute of Chartered Accountants of India (ICAI) is mandatory for the listed FIs in terms of the Listing agreement and the guidelines have made such publication mandatory even by the non-listed FIs since April 1, 2003.

Asset Liability Management (ALM)

The ALM guidelines have been in operation since April 2000, and with the stabilization of the ALM system, the FIs have been advised to submit data to the Reserve Bank regarding the liquidity and interest rate gaps as a part of the extant off-site surveillance system at quarterly intervals, with effect from the quarter ended June 30, 2003.

On-site Inspection and Off-site Surveillance System

The Reserve Bank continued to undertake on-site inspection of nine FIs under section 45N of the Reserve Bank of India Act, 1934. The inspections are conducted annually. During the year 2003-04, the supervisory process for all nine FIs with reference to their position as on March 31, 2003, (except NHB) was initiated and completed including submission of memoranda to the BFS.

Keeping in view the regulatory changes that have taken place since the introduction of Prudential Supervisory Reporting System (PSRS) in July 1999, and also based on the suggestions received from the FIs, the FID-OSMOS was modified with effect from September 2003. The FIs now submit the off-site returns using the modified software module provided to them for this purpose. The review of the performance of the FIs based on the off-site returns submitted by them is presented to the BFS on a quarterly basis.

9.5 RECENT DEVELOPMENTS

To encourage wider participation of all classes of investors in the secondary market for Government securities, the trading in Government of India dated securities at the stock exchanges through a nation-wide, anonymous, order-driven, screen-based system was introduced on January 16, 2003. However, participation in this segment was negligible on account of availability of alternative investment avenues with better returns like small savings instruments and savings bonds and with more tax efficient features, like units of mutual funds. Participation of wholesale entities was also adversely affected by lack of liquidity on the exchanges. As announced in the annual policy Statement 2004-05, a Working Group on Screen Based Trading in Government Securities (Chairman: Dr.R.H. Patil) was formed to study and recommend methods to improve liquidity on the Government securities trading platform of stock exchanges, in particular to improve market access for retail and mid-segment investors. As liquidity on the exchange based trading platform improves, it will provide the market participants with another efficient trading platform. The Report of the Group has been placed in the public domain for wider dissemination.

Self Check Exercise (True/False)

5. Performance evaluation is a critical aspect of development banking institutions, allowing assessment and improvement of their effectiveness.
6. Supervision and audit are not integral to the operations of development banking institutions as they primarily focus on lending.
7. Recent developments in the realm of development banking institutions may include changes in policies, regulations, or strategic initiatives.
8. Performance evaluation, supervision, and audit are static processes in development banking institutions, and there are no ongoing changes or adaptations.

9.6 RESOURCE PLANNING AND MOBILISATION

The declining trend observed in financial assistance sanctioned and disbursed by AIFIs during 2001-02 and 2002-03 was reversed during 2003-04, aided by substantial improvements recorded by investment institutions and to an extent, by specialized FIs. Bulk of the total sanctions and disbursements was made by Life Insurance Corporation of India (LIC) which were Rs.21,974 crore and Rs. 15,782 crore, respectively, in 2003-04 as compared with Rs.4,333 crore and Rs.6,206 crore in the 2002-03. The disbursement by the LIC was higher than the combined disbursements of IDBI, IFCI, IDFC, IIBI and SIDBI. This possibly reflects its strategic shift from merely investing in bonds of public and private sector corporate into active lending. In percentage terms, LIC accounted for 46 per cent of the total sanctions and 49 per cent of the total disbursements by AIFIs during 2003-04. Another noteworthy development is the steep increase in sanctions and disbursements by the IDBI to the infrastructure sector by 288.2 per cent and 45.2 per cent respectively, during 2003-04, accounting for 43.9 per cent and 34.0 per cent of its total sanctions and disbursements respectively, during this period.

Table: Financial Assistance by Financial Institutions
(Year : April-March)

(Amount in Rs. crore)

	Institution	2002-03		2003-04		Percentage variation during 2003-04	
		S	**D**	**S**	**D**	**S**	**D**
	1	**2**	**3**	**4**	**5**	**6**	**7**
A.	All-India Development Banks (IDBI, IFCI, SIDBI, IIBI, IDFC)	22,272	17,225	23,407	14,057	5.1	-18.4
B.	Specialized Financial Institutions (IVCF, ICICI Venture, TFCI)	475	490	484	441	1.8	-10.1
C.	Investment Institutions (LIC, GIC#, UTI)	5,965	7,902	23,705	17,402	297.4	120.2
D.	**Total Assistance by All-India FIs (A+B+C)**	**28,713**	**25,618**	**47,597**	**31,900**	**65.8**	**24.5**

S - Sanctions. D - Disbursements.

#Data include GIC and its subsidiaries.

Source : Respective FIs, IDBI for GIC and its former subsidiaries and SIDCs, and SIDBI for SFCs.

The financial assistance consists of project finance and non-project finance. While term loans, underwriting and direct subscription, and deferred payment guarantees constitute project finance, non-project finance comprises equipment finance, corporate loans, equipment leasing, investment/ direct subscription to shares and debentures/ bonds. There has been a significant increase in project finance, particularly loans (rupee and foreign currency loans) from investment institutions, particularly LIC, during 2003-04. Further, there was a discernible moderation in the contraction of flow of credit to commercial sector from all-India development banks during 2003-04. Strengthening of industrial growth on account of a boost to a spectrum of manufacturing industries reflecting an improvement in domestic and external demand conditions and reduction in excise duties on a host of intermediate inputs may have contributed to an increase in project finance sanctioned and disbursed by the FIs. The change in the operating environment has also necessitated realignment of FIs' asset portfolio. As the margins have become thin, it has become necessary to provide a wider range of products and services with value-added features. While project financing continues to be the main product for major FIs, various innovative products have been developed to suit the clients' varied requirements. In view of the large investment requirements of the infrastructure segment, infrastructure funding has become a major growth area while the share of traditional economy sectors has gone down. At the same time, FIs like IDBI have entered into funding of working capital and the short-term requirement of their existing borrowers. Although sanctions and disbursements to corporate sector by the all-India development banks recorded improvement, the net flow of resources from them to the corporate sector continued to be negative during 2003-04 possibly due to the emergence of other alternative sources of project finance and on account of higher redemption by the corporate sector.

Table: Resource Mobilization Flow from Development Banks to Corporate Sector

Amount in Rs. crore)

	Item	2002-03	2003-04
	1	2	3
	Sanctions	22,272	23,407
	Disbursements	17,225	14,057
	Credit (1+2+3+4)	-6,021	-2,845
1.	Investments in stocks / shares / bonds / debentures of industrial concerns / commercial concerns	-766	-151
2.	Loans and advances to industrial/ commercial concerns*	-3,804	-2,525
3.	Bills of Exchange and Promissory Notes / discounted and re-discounted	-1,546	-191
4.	Others (Non-Funded Assistance)	95	22

One encouraging development is a substantial increase in sanctions and disbursements to infrastructure sector by IDFC. IDFC has broadened its areas of coverage. From an initial focus on power, roads, ports and telecommunications; other sectors, such as, energy, information technology, integrated transportation, urban infrastructure, health care, food & agri-business infrastructure, education infrastructure and tourism are being increasingly catered to. Sanctions by IDFC increased by 148.5 per cent to Rs.5,727 crore in 2003-04 from Rs.2,304 crore in 2002-03 and disbursement increased by 184.7 per cent to Rs.2,704 crore in 2003-04 from Rs.950 crore in 2002-03. The infrastructure sectors that witnessed substantial growth in disbursements from the IDFC were energy (308 per cent), telecommunication (172 per cent), transportation (81 per cent) and urban infrastructure (2,260 per cent).

Assets and Liability Structure

The balance sheet of select FIs, as a group, showed a growth of 7.3 per cent during 2003-04 over the previous year. Broad trends in liabilities remained more or less the same. Bonds/debentures continued to be the largest component due to their in-built flexibility and their tradability. The share of deposits witnessed a decline as FIs, anticipating reversal of trends in the interest rates, reduced their deposit liabilities in the shorter end of the maturity spectrum. Borrowings, however, remained at the same level.

On the assets side, there was a compositional shift away from loans and advances towards investments and holding of more liquid assets. Loans and advances, the biggest component, registered a decline in its share partly on account of a decline in disbursements, despite an increase in sanctions due to increased provisioning and higher pre/repayments by borrowers. The share of investments, on the other hand, rose significantly partly due to the strong and broad-based rally in the capital markets in 2003-04, reflecting the increase in equity prices and a rise in market capitalization.

Sources and Uses of Funds

The total sources and deployment of funds of FIs increased substantially by 26.6 per cent during 2003-04 as against a decline of 2.1 per cent during 2002-03. Both internal and external funds registered a rise during the year under review. Reflecting the substantial improvement in the industrial climate, fresh deployments registered an increase in its share in the total. Repayment of past borrowings also rose perceptibly on account of substitution of earlier high cost debt with the cheaper debt in view of the falling interest rates. Other deployments recorded a fall due, inter alia, to a decrease in interest payments.

The share of fresh deployments is more or less equal to that of internal funds, whereas the combined share of repayments of past borrowings and other deployments equaled that of external and other sources of funds. This highlights the fact that while the internal funds are being used for the purpose of fresh deployments, including fresh investment, external and other sources of funds are being utilized for repayments of past debt .

9.7 FINANCIAL PERFORMANCE

AIFIs as a group continued to post poor performance during the year ended March 2004. The spread (net interest income) and the operating profits declined marginally both in absolute terms and also as a ratio to the total assets. However, in line with the trend witnessed by banks and other segments of the financial sector, non-interest income registered sharp increase. The IFCI and I1BI continued to incur operating losses indicating that these FIs are earning less than what they have to pay to their lenders. Barring these two institutions, all other institutions registered positive operating and net profits. A sharp fall in the provisions for tax boosted net profits, in spite of a decline in the operating profits.

The IFCI which recorded an improvement in return on assets and net profit per employee during 2002-03, suffered deterioration during the year under review, mainly attributable to their restructuring package. In line with the recommendations of McKinsey & Co, IFCI is moving towards segregating its non-performing assets with the ultimate objective of hiving these off to an asset reconstruction company and focusing on further strengthening the quality of the existing portfolio.

Prime Lending Rate (PLR)

In line with the general softening trend of interest rates during 2003-04, the long-term PLR of IDBI declined during the year under review. Moreover, the short-term PLR was merged with the medium-term PLR. IDBI has also recently initiated a series of pro-active measures to garner new business as well as retain and win back well-performing clients to improve the quality of its asset portfolio. As part of this endeavor, the IDBI has brought down its PLR. Further, IDBI is offering a graded reduction in rupee interest rates, based on credit rating, to existing borrowers in its portfolio with a view to broadly aligning their interest rates with the prevalent interest rate regime. In the case of IFCI, there was no change in the PLR structure.

Capital Adequacy

The performance of the select FIs in respect of the maintenance of a minimum capital to risk weighted assets ratio (CRAR) is presented in Table. It is seen that except IFCI and IIBI, all the other FIs had a CRAR much above the stipulated norm of 9 per cent as at the end- March 2004. In the case of IFCI, high NPAs -arising out of large-scale slippage from standard assets to the NPAs category, thereby negating the effect of additional provisioning led to the

squeezing of cash flow. This in turn resulted in restructuring of liabilities. Further, their continued losses, inter alia, led to mismatches in assets and liabilities, resulting in erosion of IFCI's capital. Similarly, in the case of IIBI, rising NPAs and provisioning thereof, coupled with the problem of declining profitability, were some of the factors behind the negative CRAR.

Non-Performing Assets

The net NPAs of AIFIs continued to increase during 2003-04 on account of time and cost overruns in projects, slippages in the standard assets, increase in legal expenses relating to NPAs, impairment of major assets of the assisted units, contraction of credit portfolio, etc.

Table : Capital Adequacy Ratio (As at end-March)

(Per cent)

Institution	1998	1999	2000	2001	2002	2003	2004
1	2	3	4	5	6	7	8
IDBI	13.7	12.7	14.5	15.8	17.9	18.7	18.3
IFCI	11.6	8.4	8.8	6.2	3.1	0.95	-17.0
IIBI	12.8	11.7	9.7	13.9	9.2	-11.0	-20.1
IDFC	N.A.	235.5	119.7	85.5	56.7	51.3	36.9
Exim Bank	30.5	23.6	24.4	23.8	33.1	26.9	23.5
TFCI	16.4	15.4	16.2	18.6	18.5	19.8	22.8
SIDBI	30.3	26.9	27.8	28.1	45.0	44.0	51.6
NABARD	52.5	53.3	44.4	38.5	36.9	39.1	39.4
NHB	16.7	17.3	16.5	16.8	22.1	22.3	31.9

* Net of provisioning and write offs. *Source :*
Respective balance sheets of FIs.

9.8 MOBILIZATION OF RESOURCES

During the year 2003-04, total resources mobilized by way of issue of rupee bonds/ debentures (including private placement and public issue) by select AIFIs aggregated Rs.23,419 crore as against Rs.14,144 crore during the previous year ended March 2003. Taking advantage of the lower interest rates as in the previous year, FIs such as IDBI, NABARD, SIDBI, NHB and IDFC have raised substantial amounts during the current year. However, IFCI and IIBI (since September 18, 2003) due to their deteriorating financial position were not permitted to raise fresh borrowings from the market. Since IFCI has been reinvesting the amounts arising out of its treasury operations and financial restructuring package with banks, FIs and provident funds; it has been able to effectively reduce its cost of borrowings. As a consequence, IFCI witnessed a decline in its outstanding borrowings at the end-March 2004 as compared to end-March 2003. IIBI and TFCI also have been able to reduce their outstanding borrowings. The total outstanding borrowings of all the FIs, however, increased to Rs. 1,05,677 crore as at the end of March 2004 as against Rs.90,060 crore as at the end of March 2003 which is around 53.6 per cent of the total asset base of FIs.

Of the total resources raised by the FIs, private placements continued to be the major mode of mobilizing the resources which involved less transaction costs and also less time in terms of raising resources. Resource mobilization by IDBI both from public issues and private

placement market increased during 2003-04 as compared with the previous year. However, IDBI's reliance on the private placement market for funds requirements increased substantially as compared with the public issues during 2003-04. IFCI relied solely on the private placement market for raising resources.

Table : Resources Raised by Way of Rupee Bonds/Debentures

(Amount in Rs. crore)

Institution	Resources raised		Outstanding (end-March)	
	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5
IDBI	5,009	10,477	41,798	46,967
IFCI	267	-	20,203	17,564
IIBI	44	176	2,566	2,281
EXIM Bank	2,505	2,025	5,424	11,920
NABARD	2,988	5,334	8,702	11,883
NHB	1,877	2,526	4,675	6,958
SIDBI	961	1,429	4,692	5,428
TFCI	93	102	600	426
IDFC	400	1,350	1,400	2,250
Total	14,144	23,419	90,060	1,05,677

* Includes only rupee resources and does not include foreign currency borrowings.

Data are provisional.

- indicates nil.

Source : Respective DFIs.

Reserve Bank's Assistance

The practice of advancing loans by the Reserve Bank of India to industrial and agricultural financial institutions from the Long

Table : Resources Raised through Public Issues/Private Placement/Bonds/Debentures

(Amount in Rs. crore)

Type of Issuance	IDBI		IFCI		Total	
	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04
1	2	3	4	5	6	7
Public Issue	2,216 (42.4)	2,930 (29.7)	0.0 (0.0)	0.0 (0.0)	2,216 (35.8)	2,930 (28.9)
Private Placement	3,008 (57.6)	6,942 (70.3)	965 (100.0)	267 (100.0)	3,973 (64.2)	7,209 (71.1)
Total	5,224 (100.0)	9,872 (100.0)	965 (100.0)	267 (100.0)	6,189 (100.0)	10,139 (100.0)

Note : Figures in brackets indicate percentage share in total resource mobilization.

Term Operations (LTO) funds before transferring the surplus profit of the Reserve Bank to the Government of India was discontinued subsequent to an announcement made in the Union Budget for 1992-93. Accordingly, from the year 1992-93, the Reserve Bank has been making only token contributions to these funds.

Major FIs, *viz.,* IDBI, IFCI, SIDBI are engaged in venture capital funding activities to promote entrepreneurship and support them during critical phases of venture. FIs also encourage commercial applications of indigenous technologies or adaptation of imported technologies, development of innovative products and services, holding substantial potential for growth and bankable ventures but involving higher risk including those in the information technology (IT) Sector. Similarly, FIs have been assigned to provide need based assistance for technological development. Government of India introduced the Technology Up gradation Fund Scheme (TUFS) for textile and jute industries in April 1999, which is in operation up to March 2007. The Scheme is intended to provide induction of state-of-the-art or near state-of-the art technology in textile industry. IDBI and SIDBI are nodal agencies for assistance under TUFS for textile industry (non-SSI) and textile industry (SSI), respectively while IFCI is the nodal agency for the jute industry.

9.9 EVALUATION, FOLLOW-UP AND RESTRUCTURING

With the blurring of functions between banks and FIs, the business model of a bank is being increasingly accepted for FIs also. Accordingly, there is a move to restructure FIs like IDBI and IFCI. The merger of the ICICI with ICICI Bank on March 30, 2002 was the beginning of the conversion of DFIs into universal banks as a solution to their problems. Universal banks would engage not only in traditional banking, but also investment banking and other Financial activities. Since the merger of ICICI with ICICI Bank, similar moves are underway to transform the other principal DFIs in the country, *viz.,* IFCI and IIBI. In the Union Budget 2004-05, it was indicated that IFCI will be restructured through transfer of its impaired assets to an asset reconstruction company and by effecting merger with a large public sector bank.

In view of the changing operating environment following initiation of reforms since the early 1990s, Government of India decided to transform IDBI into a commercial bank without eschewing its traditional development finance obligations. The migration to the new business model of commercial banking, with its access to low-cost current/savings bank deposits, would not only enable it to overcome most of the limitations of the current business model of development finance but also simultaneously help in diversifying its client/ asset base by offering various retail liability products. Towards this end, the IDBI (Transfer of Undertaking and Repeal) Act 2003 was enacted in December 2003 which became effective since July 2,
2004. The Act provides for repeal of IDBI Act, corporatization of IDBI (with majority Government holding) and transformation into a commercial bank. On July 29, 2004, the proposal to merge IDBI and IDBI Bank was accorded in-principle approval. IDBI became IDBI Ltd. on October 1, 2004 and being a 'scheduled bank' under the Reserve Bank of India Act, 1934, IDBI Ltd. can formally enter the portals of banking business over and above the business currently being transacted.

In this connection, the Government of India has already approved the IDBI's proposal to set up a Stressed Asset Stabilization Fund (SASF) wherein stressed assets of IDBI worth Rs.9,000 crore would be transferred by IDBI to SASF against transfer of equivalent amount of 20 year bonds issued by the Government of India in favour of SASF on cash/budget neutral basis. Apart from significantly improving the quality of IDBI's portfolio, the measure may facilitate recovery from the earmarked NPAs over an elongated time-frame.

The Board of Directors of IFCI has approved, in principle, its merger which is expected to facilitate progress towards universal banking. IFCI has also continued to give renewed thrust on expanding the advisory service business during the year.

Given the need to achieve global scales of production, funding of expansion and diversification programmes of the existing corporate have also been identified as a key business objective. As competition has created pressure on margins and disintermediation has altered the scope of term lending, FIs have accorded priority to fee-based activities like merchant banking and corporate advisory services.

The SARFAESI Act enacted in 2002 has provided an enabling legal/regulatory environment for dealing with NPAs by term-lending institutions. Under the Act, FIs can now attach assets of defaulting borrowers without having the requirement of approaching the court for recovery of NPAs. Given the problem of NPAs faced by FIs, the role of Securitization Companies/Asset Management Companies/ Asset Reconstruction Companies which buy the assets of banks and FIs with substantial amount of NPAs, becomes important.

Self Check Exercise

1. What aspect of development banking institutions does financial performance primarily assess, focusing on profitability and efficiency?
2. In the context of development banking institutions, what is the term for the process of gathering and acquiring funds from various sources?
3. Identify the key area that financial performance evaluation and resource mobilization target to ensure the sustainability of development banking institutions.

9.10 OTHER RECENT DEVELOPMENTS

The Government has spelt out a number of positive measures for financial sector participants. The focused pursuit of infrastructure development through pooled investment of Rs.40,000 crore by the proposed Inter-Institutional Group (IIG), comprising IDBI and select FIs and banks, is expected to stimulate their business volumes.

Corporate Debt Restructuring (CDR) system was developed in India based on the international experience. Detailed guidelines were issued for implementation by banks and FIs in 2001. The objective of the framework has been to ensure timely and transparent mechanism for restructuring the corporate debt of viable entities, outside the purview of Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunals (DRTRs) and other legal proceedings. The CDR system effectively became operational from March 2002 with the execution of Inter Creditor Agreement (ICA) on February 25, 2002

Asset management companies/asset reconstruction companies (AMCs/ARCs) have been set up in various countries to solve the problem of bad loans. AMCs take over non-performing assets (NPAs) of banks at discounted rate and manage and dispose of such assets.

The word 'asset reconstruction company' is a typical Indian word - the global equivalent of which is asset management companies and owes its origin to Narasimham Committee I which envisaged the setting up of a central Asset Reconstruction Fund. The money contributed by the Central Government to ARF was sought to be used by banks to clean up their balance sheets by writing-off the non-performing loams. This idea of ARF did not work as Government opted to recapitalize weak public sector banks to manage their own NPAs. Narasimham Committee II recommendations submitted in 1998, however, reiterated its proposal in the form of ARCs.

The Union Budget 1998-99, thus encouraged a few banks with high NPAs to set up ARCs on an experimental basis and subsequently set up a task force in July 1998 to study possible modalities and prepare an operating plan for establishing ARCs in India. To provide the necessary legal backing for ARCs, the Government passed theSecuritization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. Similarly, a way out of the current dilemma, faced by the financial institutions in respect of shortage of resources, is to resort to ARCs as an asset reconstruction device to sell off the NPAs of the FIs.

Similar entities had already been successful in Malaysia, Korea and several other countries in the world. AMCs used broadly two approaches: i) restructuring of the debt/ borrowing and ii) the outright sale of the loan/underlying assets. The experience of AMCs suggests that a prompt disposal of assets enables them to achieve their objective. In the aftermath of the East Asian financial crisis, Indonesia, Korea, Malaysia, and Thailand each established a centralized AMC to purchase, restructure, and dispose of NPLs from banks and other financial institutions, and instituted informal mechanisms for corporate debt restructuring. Nearly seven years since the onset of the crisis, some of these 'crisis- created' institutions have already ceased operations. Likewise over the next two years, a couple of the AMCs will reach the end of their mandates. Major factors facilitating the successful functioning of an AMC are strong political will, supportive legal structure, efficient market environment, adequate governance, realistic asset pricing and speedy disposal of acquired assets.

In India, the enactment of SARFAESI Act, 2002 enabled lending agencies (banks and financial institutions) to foreclose and sell underlying assets without court intervention. The existing framework envisages non-Government supported multiple ARCs/securitization companies, which may be set up by the lenders, NPA investors or corporate. The SARFAESI Act permits an ARC to commence operations with a minimum net-owned funds of Rs. two crore. Directions require an ARC to maintain a capital adequacy ratio of 15 per cent of its risk-weighted assets. However, financial assets held in trusts shall not be subject to capital adequacy requirements. An ARC may issue bonds and debentures for meeting its funding needs but cannot mobilize deposits. All the rights of the lender vest in the ARC after acquiring the assets and become party to all the contracts/deeds/ agreement etc. ARCs are also allowed to function as a manager of collateral assets taken over by the lenders under security enforcement rights available to them as a recovery agent for any bank/ institution. Since the date of acquisitions of assets, ARCs are given a resolution time frame of maximum five years. As per the Act, to discharge its function of asset reconstruction, an ARC can undertake (i) enforcement of security interest, (ii) takeover or change the management of the borrower, (iii) undertake sale or lease of the borrowers' business and iv) enter into settlements and reschedule the debt. However, as per the SARFAESI, for enforcement of security interest, at least 75 per cent of the secured creditors need to agree to exercise this right.

For speedier resolution of NPAs, financial assets due from a single debtor to various banks/ FIs may be considered for acquisition. Similarly, financial assets having linkages to the same collateral may be considered for acquisition to ensure relatively faster and easy realization. As per the guidelines, the valuation process should be uniform for assets of same profile and a standard valuation method should be adopted to ensure that the valuation of the financial assets is done in a scientific and objective manner. Valuation may be done internally and or by engaging an independent agency, depending upon the value of the assets

involved. The acquired assets may be sold by inviting quotations from persons dealing in such assets, by inviting tenders from the public, by holding public auctions or by private treaty. While there is no restriction on ARCs to acquire assets which are considered to be unreliable, as per the guidelines to banks, ARCs will normally not takeover such assets and will act as an agent for recovery on a fee basis for these assets.

The Resource mobilization by mutual funds increased more than nine-fold during 2003-04 mainly due to a large increase in resource mobilization by the private sector mutual funds and a net inflow in UTI in contrast to a net outflow during the corresponding period of the previous year. Bulk of the resources mobilized by the mutual funds is by way of money market schemes (52.5 per cent) and debt instruments (27.3 per cent) while mobilization in equity oriented schemes accounts for just over 15.4 per cent. In the secondary market, although traditionally, mutual funds were seen to be net sellers in equity and net buyers in debt, there has been a reversal of the trend with the mutual funds turning out to be net buyers of equities and debt to the tune of Rs. 1,308 crore and Rs.22,701 crore, respectively. The debt oriented schemes accounted for the largest share of assets under management of the mutual funds (45 per cent) followed by money market schemes (30 per cent) and equity oriented schemes (18 per cent).

9.11 SUMMARY

The present lesson discusses the Resource Planning and Mobilization of major Development banks in India, Performance Evaluation of major Development banks in India and Recent developments in Development banking. The role of development banking institutions has been under discussion in recent years. Although setting up of the development finance institutions (DFIs) was an important feature in the overall development of the financial system; with the emergence of the capital market as an important source of finance in the late 1980s and early 1990s, and the renewed role of banks in term-financing, DFIs have been increasingly exposed to greater competition. Liberalization of the financial sector, with its associated processes of decontrol, deregulation and globalization, has led to increased competition for financial intermediaries across different segments. The competitive pressures have come into the business domain of FIs on account of the entry of new players. Moreover, with the initiation of financial sector reforms in the early 1990s, access of FIs to assured sources of long-duration/concessional funds from the Government, particularly SLR bonds' that were subscribed to by banks and insurance companies, has been gradually phased out. FIs at present are overwhelmingly dependent on market borrowings - wholesale and retail, domestic and foreign - for their resource mobilization. As a consequence, DFIs are required to raise funds from the capital market. With the removal of administrative controls on the interest rate structure, it has become increasingly difficult for DFIs to raise long-term funds. This in turn has affected their ability to offer competitive rates to their borrowers. Apart from the competitive pressure for raising resources, the role of DFIs as an exclusive source of development finance has diminished as other intermediaries especially banks have also entered into long-term and high risk project financing. Therefore, FIs are increasingly facing competition not only in terms of raising resources but also in the deployment of funds. In short, the change in the operating environment coupled with the legacy of high nonperforming assets has led to serious financial stress on the term lending financial institutions.

9.12 Keywords

Moral Suasion: An instrument of central bank's pressure upon the lending activities of commercial banks through exhortations that they follow certain restrictive practices.

Open Market Operations: Purchase or sale of eligible securities by the central balk in the open market.

Selective Credit Control: Such credit control that regulates the distribution or direction of bank resources to particular sectors.

Statutory Liquidity Ratio: The ratio of liquid assets to total demand and time liabilities determined statutorily.

9.13 QUESTIONS FOR REVIEW

Short Answer Type Questions

1. Discuss the Resource Planning and Mobilization of major Development banks in India
2. Discuss the Performance Evaluation of major Development banks in India
3. Discuss the Recent developments in Development banking.

Long Answer Type Questions

4. Evaluate the challenges and opportunities in mobilizing resources for development projects, emphasizing the role of financial planning in achieving sustainable economic growth.
5. Explore how development banks strategically plan and mobilize resources to support projects in sectors such as infrastructure, agriculture, and small-scale industries. Analyze the impact of external factors, including economic conditions and global trends, on resource mobilization strategies.

9.14 SUGGESTED READINGS

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9.15Self Check Exercise (Answer Key)

1. Promotion, 2. Development, 3. Growth, 4. Initiatives, 5. True, 6. False, 7. True, 8. False, 9. Performance, 10. Mobilization, 11. Viability

MICRO FINANCING IN INDIA

STRUCTURE

10.1 Introduction
10.2 Micro finance in India
10.3 Legal Framework of Micro Finance Institutions in India
10.4 MFIs as Charitable Institutions
10.5 MFIs as Co-Operatives
10.6 MFIs as Companies
10.7 MFIs as Banking Institutions
10.8 Micro Finance Delivery Models in India
10.9 Summary
10.10 Keywords
10.11 Practice question
10.12 Suggested Readings

10.13 Self check exercise (Answer Key)

10.0 OBJECTIVES

After going through this lesson, you will be able to understand the concept of micro financing. Lesson ends with summary and chapter-based questions. After reading this lesson, you will understand:

12. Micro Finance in India
13. Legal Framework of Micro Finance Institutions in India
14. MFIs as Charitable Institutions
15. MFIs as Co-Operatives
16. MFIs as Companies
17. MFIs as Banking Institutions
18. Micro Finance Delivery Models in India

10.1 INTRODUCTION

Major impediments to poverty alleviation and rapid economic growth in developing countries are the lack of capital resources, especially in rural areas. A vicious cycle of low capital, low productivity, low incomes, low savings and consequently weak capital base is clearly operating. This results in a permanent poverty syndrome. A multi-agency approach for providing working capital and asset acquisition to rural borrowers has been in operation in India since 1969 with the nationalization of 14 large commercial banks. Regional Rural Banks were formed since 1975 with increasing emphasis on priority sector lending targeted to the poor and the weaker sections of society. The failure of many supply-led state interventions in rural-credit involving capital or interest subsidies (like IRDP) is an established fact. This has been accompanied by the rise in the social entrepreneurs. Using strategies involving groups of women, joint liability lending, small loans, weekly repayments, it has been proved that lending to poor people is possible and profitable. Micro Finance has been emerging as a tool in this regard.

Micro Finance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, insurance to poor and low-income households; their micro enterprises etc. Micro Finance services are provided by three types of sources:

19. Formal Institutions, such as Rural Banks and Cooperatives;
20. Semi formal Institutions, such as Non-Government Organizations;
21. Informal sources such as moneylenders and shopkeepers.

Institutional micro finance is defined to include micro finance services provided by both formal and semi formal institutions. Micro Finance Institutions are defined as institutions whose major business is the provision of micro finance services. Actually, Micro Finance represents more than micro-credit as it refers to savings products, to insurance, to pawns and remittances - in sum to a much wider range of financial services.

Two overlapping categories of micro finance initiatives are poverty lending and micro banking. Poverty lending programmed and institutions often offer savings and insurance services as well. The objective of the poverty lending programmed is to give higher priority to social outreach than financial sustainability, though an organization may strive for both- The main focus of micro banking on the other hand, is income promotion by a MFI, and a drive for financial sustainability as a permanent financial intermediary. There are a host of micro finance institutes in India. They assume paramount importance in the context of pension reform, as they have the ability to mobilize large amounts of savings from people who are beyond the purview of formal sector mechanisms.

10.2 MICRO FINANCE IN INDIA

In India SEWA (Self Employed Women's Association) Bank is the oldest micro Finance organization. It was founded in 1974 in Ahmedabad, Gujarat. It is a trade union that first started organizing self-employed women. More recently, many Non GovernmentalOrganisations(NGOs), Community Based Organisations (CBOs) and Self Help Groups have started micro finance delivery systems successfully in rural areas of India. These organizations motivate the poor to join the credit groups, help manage their savings, loan- deposit and recovery process and may also provide an interest free loan to the group that acts as a start-up fund.

Group lending activities first started in the Southern states of India such as, Andhra Pradesh, Kerala, Karnataka and Tamilnadu; while West Bengal and Orissa have joined later. Micro/financeprogrammersare mostly organized by non-governmental 0rganizations (NGOs)/in India, National Bank for Agriculture and Rural Development NABARDlaundered a Bank Self help group (SHG) linkage programmed in a small way in 1992.The idea of introducing the programmed emanated mainly from the successful experiences of theinstitutions-in other countries. The linkage programmed under NABARD aims to reach those outside the network of formal credit, improve living standards of poorer sections of rural society and achieve high deposit- credit mobilization and recovery of loans.

10.3 LEGAL FRAMEWORK OF MICRO FINANCE INSTITUTIONS IN INBIA

There is no unique legal framework for MFIs in India. MFIs in India mainly follow one of the four structures as below.

10.4 MFIS AS CHARITABLE INSTITUTIONS

These are societies registered under Societies Registration Act, 1860 and Trusts registered under Trust Act, 1882. They work on grants. They are not able to handle funds of SHGs or act as an intermediary beyond a level. They are not allowed to raise equity and mobilize deposits. These structural restrictions limit the availability of capital to these MFIs. Often, these institutes are found to survive on foreign grants.

10.5 MFIS AS CO-OPERATIVES

Co-operatives have legal sanction to work as financial intermediaries. The activities of State Co-operatives are restricted in the State. Their activities are heavily controlled by the controlling authority, Registrar of the Cooperative .Societies and the State Government. National Co-operatives' need lesser Govt. Control than State Cooperatives for multi-state operations. Co-operatives are allowed to raise share, to mobilize deposits. No tax is charged on Co-operatives. They can get foreign debt but are not allowed to raise foreign equity. The New Generation Cooperative Act (for example, Mutually Aided Cooperative Societies Act, 1995 in Andhra Pradesh) has become a landmark legislation. It has been used by other organizations and as well as by associations like SHGs, Grameen joint liability groups. According to this Act there is less government control on mutually aided co-operative Societies but they can be incorporated within a state only. Presently co-operative societies in nine states Andhra Pradesh, Jharkhand, Bihar, Jammu and Kashmir, Madhya Pradesh, Chhattisgarh, Orissa, Karnataka and Uttaranchal are registered under this new Act. This Act reduces the role of the Registrar; gives greater flexibility in savings mobilization and fund utilization and allows the co-operative to set up subsidiary organizations.

MCQ 1: What is the primary focus of microfinance in developing countries?
A. Infrastructure development
B. Poverty alleviation and economic growth
C. Urban development
D. Technological innovation

10.6 MFIS AS COMPANIES

MFIs have to have Rs.2 crore as its initial funds if these are operating as Non Banking Financial Companies (NBFC). These MFIs are required to obtain a registration certificate from RBI (under Section 45-1A of the RBI Act) after satisfying the initial conditions. They are allowed to mobilize deposits after satisfying conditions stipulated by RBI. After two years of their operations, they have to obtain minimum investment grade or other specified credit rating for fixed deposits from any one of the RBI recognized credit rating agencies at least once a year. They are then required to forward it to the RBI along" with the annual returns. They are allowed to collect foreign equity upto 51% of US$ 0.5 million; more than 51% to 75% of US$5 million and 100% of US$50 million.

A NBFC is also exempted from RBI registration if it does not deliver credit of more than Rs.50000 for a business enterprise and Rs.25000 for meeting the cost to raise the level of income of a poor person. This NBFC is licensed under Section 25 of the Companies Act, 1956. It is not allowed to accept public deposits. Recently seven categories of NBFCs are exempt from RBI registration. Housing Finance Companies. Mutual Benefit Financial Companies (Nidhis), Insurance Companies are important in these exempted categories.

10.7 MFIS AS BANKING INSTITUTIONS

The MFIs who are operating as banks are registered under RBI but it is very difficult to obtain this registration. These institutions are regulated by RBI on daily affairs. To set up a MFI as a bank it would require initial capital from Rs.100 to 300 crore. For Local Area Bank the amount is Rs. 5 crore. Local Area Banks are permitted to operate on three contiguous districts in a state. These are also highly management and technology intensive to achieve sustainability. These MFIs are permitted to deliver credit, to mobilize savings and to give insurance (under the regulation of IRDA).

10.8 MICRO/FINANCEDELIVERY MODELS IN INDIA

There exist a wide range of microfinance models in India. It can be said that India hosts the maximum number of microfinance models. Each model has succeeded in their respective fields. The main reason behind the existence of these models in India may be

due to geographical size of the country, a wide range of social and cultural groups, the existence of different economic classes and a strong NGO movement.

Micro Finance Institutions (NGO-MFIs, Mutual Benefit MFIs and For-Profit MFIs) in India have adopted various traditional as well as innovative approaches for increasing the credit flow to the unorganized sector. They can be categorized into four broad categories.

Let us discuss the important features of these four microfinance models in this section. These models vary in their legal forms, in the channels and methods of delivery, in their governance structure, in their approach to sustainability and also in their approach to microfinance.

SELF/HELP GROUP (SHG) MODEL

SHG has emerged as the "Indian" model of Micro Finance. It is so popular in India that Government programes have SHG as the core of their strategy.

Dynamics of SHG Model:

22. The SHG model has evolved in the NGO Sector. NGOs primarily have the functions of enabling, educating and networking. This model has emerged as the capacity building of community based institutions.
23. SHGs are small and informal groups (strength of members: - 10 to 20). Group members are socio-economically homogenous.
24. Groups are composed either by male only or by female only. In India 90 percent of the SHGs are composed of female only.
25. Group members are self-selected. NGO acts as a facilitating agency to build in processes and systems that make the SHGs viable and sustainable institutions.
26. The group members meet regularly at an appointed time and place for carrying out their savings and credit activities and other issues of development.
27. The group mobilizes savings among the members and issues need based loans to the members (only) out of the common funds created.
28. The rules and norms are determined by members themselves and the NGO does not interfere in this matter.
29. After the SHG has been put on the path to sustainability, organizationally and financially, the NGO may decide to withdraw from supporting the SHG and move on to new groups.
30. The main motive of the SHG is to empower poor socio-economically and improve their livelihood pattern.

Federated Self Help Group Model:

Federations of SHGs bring together several SHGs. In India FSHGs include those promoted by the Dhan Foundation, PRADAN, Chaitanya and SEWA are famous in India.

Dynamics of Federated SHG Model:

31. Federations usually come under the Societies Registration Act. They have between 1000-3000 members.
32. There is a distinct three-tier structure in federations - the SHG is the basic unit; the cluster is the intermediate unit and an apex body or a federation, represents the entire membership.
33. Each SHG participates directly in the representative body at the cluster level. Two members from each SHG attend the monthly cluster meetings. Information from the groups to the apex body and vice-a-versa is channeled through the cluster

level representative body.

34. The cluster leaders are a highly effective part for group monitoring and strengthening. So the operations of the apex body are decentralized through the clusters.
35. The executive body at the apex level is consists of 9 to 15 members.
36. Three common financial activities of Federations are
    (a) Acting as an agent and manager of external credit funds.
    (b) Assisting SHGs with loan recovery in difficult cases.
    (c) Strengthening weak SHGs, so that they are able to carry out their savings and credit function smoothly.
37. Other financial services provided by the federations are :
    (a) Additional options for members to save: Federations often offers additional saving schemes to the group members, which is apart from group savings. So the members have savings with the group and in addition, with the Federation.
    (b) Satisfactory returns on savings to members.
    (c) Credit giving patterns also vary. Generally, federations have credit activities at the group level, although federations provide credit to their members. These loans are disbursed from member's savings that may be deposited with the federation and from external funds that it is able to access independently. Federations are able to increase the amounts of credit available to members. Federations even provide bridge loans.
    (d) Federations provide insurance and housing finance, and also support services to facilitate productive use of credit. One federation in India (Chaitanya) started to provide insurance services to its members. It has become an agent of the insurance company.

Grameen Bank Model:

The Grameen Bank Model of Bangladesh, developed by Muhammad Yunus, its former chairman was considered as the pioneer microfinance institution. It has been highly successful in its banking service to the poor as well as in its poverty alleviationprogrammed. With its well-recognized success, many organizations in India, like SHARE Micro finance Ltd, Activities for Social Alternative (ASA) and CASHPOR Financial and Technical Services Ltd. have adopted this methodology with little variations.-

Dynamics of Grameen Bank Model :

38. Homogenous groups of five members are formed at the village level.
39. The field worker of the Grameen Bank facilitates the process of group formation.
40. All the group members undergo a 7day compulsory training of 1-2 hours per day. Some groups undergo the Group Recognition Test (GRT). It is a screening test that can distinguish between serious and non-serious groups. Actually it is an effective tool to overcome the adverse selection problem.
41. Once the preliminary groups have passed GRT, and then the women become members of Grameen Bank by paying a one-time member fee.
42. Eight joint liable groups affiliate together to form a center. Every weak Centre meets at a defined time. Bank Assistant attends the meeting and it is mandatory for the members to attend the weekly meeting and all the loan applications have to be approved by other group members as well as Centre members. The loan is

disbursed from the bank fund and it is not linked with the group savings. Loan is given to the individual not to the group or the center.

43. The loan disbursement is always done in the Centre. The housing loans are disbursed at the Branch to maintain documentation.
44. Various loans are provided by the Grameen Bank such as General Loans, Supplementary Loans, Special General Loans, Sanitation and Housing Loans etc. The size of loan ranges from Rs. 4,000 to Rs. 10,000 for general yearly loans. The first loan is Rs.4000 and there is an annual increase of Rs l, 000 in loan size in each year thereafter.
45. Every members save Rs. 10 per weak and it is compulsory. This saving is deposited with Bank. The bank funds their consumption with this deposit. This strategy overcomes the problem of default as it is proved that nobody is likely to default on his or her own money.
46. All loans are repayable within a year in 52 equal installments (over 52 weeks).
47. Bank charges 5_percent tax on all productive loans to a member. In this way group fund is increasing.
48. The group leader collects the loan repayments and savings prior to the meeting and hands it over to the Centre leader who gives it to the field worker during the meeting. This collected amount is deposited in the branch on the same day. No new loan is issued from this collected amount. It discourages all possible leakages in monetary transactions.
49. Peer pressure replaces the collateral. Member-borrowers who repaid the loan in time are allowed to get repeated loans and continuous access to increasing credit from Bank. The most significant aspect of the Grameen Bank Model has been its high loan recovery rate (98% and above).

The Co-operative Model:

The leading organization that has been successful in using the co-operative form in rural micro finance in India has been the Cooperative Development Forum (CDF), Hyderabad. It has built up a network of financial co-operatives based upon women's and men's thrift groups. It has registered under the New Generation Cooperatives Act, 1995.

Dynamics of Co-operative Model:

50. The primary entities of CDF's Micro Finance Cooperative are the Women's / Men's Thrift Cooperative (W(M)TC). Each consists of 300 members. Generally these members reside in the same village.
51. CDF has started to promote much smaller units and now it has encouraged these units to extend into large unit.
52. The important factors behind the running of a successful cooperative venture are :
    (a) to justify human resources (staffs);
    (b) to meet statutory /administrative requirements such as audit.
53. The WTC or MTC are divided into small groups (10 to 50 members) to facilitate better monitoring of thrift and repayment of loans.
54. The group members nominate a group leader and the leader enjoys the confidence of the group.
55. CDF encouraged members to identify more strongly with their WTC/MTC rather than with the groups, as WTC/MTC are the primary legal entities and viable units

of operation.

56. Most of the WTC/MTCs decided to register themselves under the New Generation Cooperative Act, which allows for greater flexibility and autonomy in operations.
57. The General Body constitutes of all the members of the primary cooperatives. It adopts a uniform set of bylaws. The General Body meets once in a year to elect the directors, review and discuss the other issues. The Board of Directors consists of 12 directors who are elected by the members.
58. Each director is elected for three-year term. The retired directors are eligible for re-election.
59. The directors elect a chairperson and appoint a managing director (MD) among themselves. Chairperson and MD have a one-year term. They are also eligible for re-election.
60. The Chairperson presides the board meetings. He/She represent the cooperatives in other organizations (forums) and ensure that they function in accordance with the Cooperative principles and by-laws.
61. The MD is responsible for ensuring that the operations of Cooperative are properly conducted and that the resolutions of the board are implemented.
62. A set of geographically contiguous cooperatives forms an Association of WTC/ MTCs. The Chairperson and MD of each participating Cooperative are members of the General Body of the Association.
63. General Body elects a Chairperson and MD to oversee the affairs.
64. The Association provides training, management of the Loan Insurance Fund and inter-lending. It also plays a support role by helping the member cooperatives in handling accounting, auditing and other administrative matters

10.9 SUMMARY

The lesson highlights the concept and significance of micro financing in India. Further, important issues such as a) the legal structures under which microfinance Institutions in India are operating; and b) the important micro finance delivery models which are used by different micro finance institutions in India have also been discussed The success of MFIs encouraged the Reserve Bank of India to take the programme of financing MFIs in India. The Indian MFIs have proved that lending to the poor is possible and profitable. Now MFIs have not only delivered credit to the poor and mobilized deposits but also they have started to provide insurance to the poor, which help the poor to meet the uncertain events. These organizations improve the socio-economic environment of India. They are able to empower poor women and to reduce the gender discrimination among the poor people.

10.10 Keywords

65. **SEWA:** In India SEWA (Self Employed Women's Association) Bank is the oldest micro Finance organization. It was founded in 1974 in Ahmedabad, Gujarat.
66. **Risk:** Risk in a way can be defined as the chance or the probability of loss or damage.
67. **Credit Risk:** The risk of counter party failure in meeting the payment obligation on the specific date is known as credit risk.
68. **Interest Rate Risk:** Interest risk is the change in prices of bonds that could occur as a result of change in interest rates.

Self-check exercise

MCQ 1: What is the primary focus of microfinance in developing countries?

A. Infrastructure development

B. Poverty alleviation and economic growth

C. Urban development

D. Technological innovation

2: Which of the following is NOT mentioned as a source of microfinance services in the lesson?

A. Formal Institutions

B. Semi-formal Institutions

C. Informal sources such as moneylenders and shopkeepers

D. Multinational Corporations

3: In India, which organization is mentioned as the oldest microfinance organization?

A. National Bank for Agriculture and Rural Development (NABARD)

B. Self Employed Women's Association (SEWA) Bank

C. Mutually Aided Cooperative Societies

D. Andhra Pradesh Cooperative Bank

4: What is the primary focus of micro-banking?

A. Social outreach

B. Financial sustainability

C. Both social outreach and financial sustainability

D. Infrastructure development

5: Under which legal structure are Micro Finance Institutions (MFIs) in India registered as charitable institutions?

A. Companies Act, 1956

B. Societies Registration Act, 1860

C. Mutually Aided Cooperative Societies Act, 1995

D. Trust Act, 1882

6: What is the minimum initial fund required for MFIs operating as Non-Banking Financial Companies (NBFC)?

A. Rs. 1 crore

B. Rs. 2 crore

C. Rs. 5 crore

D. Rs. 10 crore

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10.12 Self-check exercise (Answer key)

MCQ: 1(B),2(D),3(B),4(C),5(B),6(B)

Lesson No. 11 **AUTHOR:Dr.DHIRAJ SHARMA**

BANKING SECTOR REFORMS IN INDIA

STRUCTURE

11.1 Introduction
11.2 Reform Measures
11.3 Policy Environment
11.4 Regulatory Environment
11.5 Banking Reforms in India
11.6 Commendations of Narasimham Committee I & II
11.7 Way Forward
11.8 Provisioning Standards
11.9 Capital Adequacy
11.10 Prompt Corrective Action
11.11 Greater Functional Autonomy for Boards of Bank
11.12 Profitability
11.13 Return on Assets
11.14 Operational Costs
11.15 Implementation of Corporate Governance
11.16 Basel Committee Second Accord
11.17 Summary
11.18 Keywords
11.19 Suggested Readings

11.20 Self check exercise (Answer key)

11.0 OBJECTIVES

After going through this lesson, you will be able to understand banking reforms in India. Lesson ends with summary and chapter based questions. After reading this lesson, you will understand:

69. Reform Measures
70. Policy Environment
71. Regulatory Environment
72. Banking Reforms in India
73. Recommendations of Narasimham Committee I & II

11.1 INTRODUCTION

Profitability in the banking sector has been very low and some banks have become financially weak. The reform of the banking sector has only addressed these problems partially. It has however sought to develop the money market as well as a secondary market in long-term government debt. Very high statutory liquidity requirements through which banks are compelled to invest in government securities have been reduced. Indian banks must maintain 25% of their demand and time deposits in government securities. Government paper now carries market-clearing rates. There is only one ceiling rate on term deposits prescribed by the RBI. Interest rates on money market instruments have been freed. With government securities now carrying market rates, the basic requirement for developing a secondary market in such paper has been met. Institutions and fora have been created to

help develop trade in money and long-term debt markets. To improve the working of banks, a strong prudential regime regarding capital adequacy, income recognition, loan-loss provisions and transparency of accounts has been established. Profitable banks have been permitted to access the capital market to augment their capital.

Commercial banks are increasingly entering new businesses such as merchant banking, underwriting, mutual funds and leasing, usually through subsidiaries. Efforts are on for expediting computerization of bank operations. To enhance competition, many new private sector banks, including some more foreign banks, have been allowed entry into the market. RBI's supervision over commercial banks and other financial institutions including non-bank financial companies has been strengthened. One of the critical areas where banking sector reforms have not progressed relates to government control over public sector banks.

Public sector ownership imposes several constraints including limitations in methods of recruitment and promotion and restrictions on the salaries they can pay. Public sector banks are also burdened by standards of public accountability, which may be inconsistent with the degree of flexibility needed for commercial decision-making. The Committee on Banking Sector Reforms has recommended that the government's equity holding should be reduced to 33 percent. However, no action on this recommendation has been taken so far. Over the last two decades, the capital market has grown phenomenally in terms of capital raised, listed companies, trading volumes, market capitalization, and investor base. The number and diversity of market intermediaries - merchant banks, underwriters, custodians, share registrars and transfer agents, mutual fund, rating agencies etc. have grown rapidly. There are 23 stock exchanges. The Over-the Counter Exchange of India (OTCEI) and the National Exchange have screen based trading and are developing a nationwide reach. The capital market has been liberalized. Corporates are now free to issue capital and price their issues. FIIs (about 280 in number) have been permitted to invest in the Indian market and about 80 of them are quite active.

11.2 REFORM MEASURES

The major challenge of the reform has been to introduce elements of market incentive as a dominant factor gradually replacing the administratively coordinated planned actions for development. Such a paradigm shift has several dimensions, the corporate governance being one of the important elements. The evolution of corporate governance in banks, particularly, in PSBs, thus reflects changes in monetary policy, regulatory environment, and structural transformations and to some extent, on the character of the self-regulatory organizations functioning in the financial sector.

11.3 POLICY ENVIRONMENT

During the reform period, the policy environment enhanced competition and provided greater opportunity for exercise of what may be called genuine corporate element in each bank to replace the elements of coordinated actions of all entities as a "joint family" to fulfill predetermined Plan priorities.

Greater competition has been infused in the banking system by permitting entry of private sector banks (9 licenses since 1993), and liberal licensing of more branches by foreign banks and the entry of new foreign banks. With the development of a multi- institutional structure in the financial sector, emphasis is on efficiency through competition

irrespective of ownership. Since non-bank intermediation has increased, banks have had to improve efficiency to ensure survival.

11.4 REGULATORY ENVIRONMENT

Prudential regulation and supervision have formed a critical component of the financial sector reform programme since its inception, and India has endeavored to international prudential norms and practices. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Bank exposures to sensitive sectors such as equity and real estate have been curtailed. The Banking Regulation Act 1949 prevents connected lending (i.e. lending by banks to directors or companies in whichdirectors are interested).

Periodical inspection of banks has been the main instrument of supervision, though recently there has been a move toward supplementary 'on-site inspections' with 'off-site surveillance'. The system of 'Annual Financial Inspection' was introduced in 1992, in place of the earlier system of Annual Financial Review/Financial Inspections. The inspection objectives and procedures, have been redefined to evaluate the bank's safety and soundness; to appraise the quality of the Board and management; to ensure compliance with banking laws & regulation; to provide an appraisal of soundness of the bank's assets; to analyses the financial factors which determine bank's solvency and to identify areas where corrective action is needed to strengthen the institution and improve its performance. Inspection based upon the new guidelines have started since 1997.

11.5 BANKING REFORMS IN INDIA

Banking & Financial Sector reforms came to the forefront for active implementation in 1992-93 after first Report of Narasimham Committee. What are the results obtained in Banking Industry after a decade of reforms, and what are the areas that need greater attention in the future? The decade gone by witnessed a wide range of financial sector reforms, with many of them still in the process of implementation. Some of the recently initiated measures by the RBI

74. for risk management systems
75. anti money laundering safeguards and
76. corporate governance in banks, and
77. regulatory framework for non bank financial companies, urban cooperative banks,
78. government debt market and
79. forex clearing and payment systems

are aimed at streamlining the functioning of these instrumentalities besides cleansing the aberrations in these areas. Further, one or two all India development financial institutions have already commenced the process of migration towards universal banking set up. The banking sector has to respond to these changes, consolidate and realign their business strategies and reach out for technology support to survive emerging competition. It is appropriate to take stock of the impact of regulatory changes initiated, and the central bank's expectations as regards response and performance by the banking system in order to achieve the avowed objectives of ongoing financial sector reforms.

11.6 RECOMMENDATIONS OF NARASIMHAM COMMITTEE I & II

The regulatory framework for banks was one area which has seen a sea-change after the financial sector reforms and economic liberalization and globalization measures were introduced in 1992-93. These reforms followed broadly the approaches suggested by the two Expert Committees both set up under the chairmanship of Shri M. Narasimham in 1991 and
1998, the recommendations of which are by now well known. The underlying theme of both the Committees was to enhance the competitive efficiency and operational flexibility of our banks which would enable them to meet the global competition as well as respond in a better way to the regulatory and supervisory demand arising out of such liberalization of the financial sector. Most of the recommendations made by the two Expert Committees which continued to be subject matter of close monitoring by the Government of India as well as RBI have been implemented. Government of India and RBI have taken several steps to -

(a) strengthen the banking sector,
(b) provide more operational flexibility to banks,
(c) enhance the competitive efficiency of banks, an
(d) Strengthen the legal framework governing operations of banks.

Important Measures Taken to Strengthen the Banking Sector

80. Introduction of capital adequacy standards on the lines of the Basel norms,
81. prudential norms on asset classification, income recognition and provisioning,
82. introduction of valuation norms and capital for market risk for investments
83. Enhancing transparency and disclosure requirements for published accounts ,
84. Aligning exposure norms - single borrower and group-borrower ceiling - with international best practices
85. Introduction of off-site monitoring system and strengthening of the supervisory framework for banks.

Measures Introduced to Provide Better Operational Flexibility to Banks

86. Besides deregulation of interest rate, the boards of banks have been given the authority to fix their prime lending rates. Banks also have the freedom to offer variable rates of interest on deposits, keeping in view their overall cost of funds.
87. Statutory reserve requirements have significantly been brought down.
88. The quantitative firm-specific and industry-specific credit controls were abolished and banks were given the freedom to deploy credit, based on their commercial judgement, as per the policy approved by their Boards.
89. The banks were given the freedom to recruit specialist staff as per their requirements,
90. The degree of autonomy to the Board of Directors of banks was substantially enhanced.
91. Banks were given autonomy in the areas of business strategy such as, opening of branches / administrative offices, introduction of new products and certain other operational areas.

92. Setting up of Debt Recovery Tribunals providing a mechanism for expeditious loan recoveries.
93. Constitution of a High Power Committee under former Justice Shri Eradi to suggest appropriate foreclosure laws.
94. An appropriate legal framework for securitisation of assets is engaging the attention of the Government,

Results Achieved through the Paradigm Shift in the Regulatory Framework for Banks

The banking sector has shown considerable degree of resilience.

95. The level of capital adequacy of the Indian banks has improved: the CRAR of public sector banks increased from an average of 9.46% as on March 31, 1995 to 11.18% as on March 31, 2001.
96. The public sector banks have also made significant progress in enhancing their asset quality, enhancing their provisioning levels and improving their profits.
97. The gross and net NPAs of public sector banks declined sharply from 23.2% and 14.5% in 1992-93 to 12.40% and 6.7% respectively, in 2000-01.
98. Similarly, in regard to profitability, while 8 banks in the public sector recorded operating and net losses in 1992-93, all the 27 banks in the public sector showed operating profits and only two banks posted net losses for the year ended March 31, 2001.
99. The operating profit of the public sector banks increased from Rs.5628 crore as on March 31, 1995 to Rs. 13,793 crore as on March 31, 2001.
100. The net profit of public sector banks increased from Rs.1116 crore to Rs.4317 crore during the same period, despite tightening of prudential norms on provisioning against loan losses and investment valuation.
101. The accounting treatment for impaired assets is now closer to the international best practices and the final accounts of banks are transparent and more amenable to meaningful interpretation of their performance.

11.7 WAY FORWARD

Much more needs to be done in this area. Globally some of the best managed banks in developed countries are proactive in building up reserves when the profits are on the upswing and do not wait for regulatory goading. Many of them unhesitatingly resort to timely write off and provisioning in respect of problem assets. This is a culture that Indian banks have to emulate. It is desirable that Indian banks to go for larger provisioning when the profits are good without frittering them away by way of dividends, however tempting it may be. As a method of compulsion, RBI has recently advised banks to create an Investment Fluctuation Reserve upto 5 per cent of the investment portfolio to protect the banks from varying interest rate regime.

11.8 PROVISIONING STANDARDS

One of the means for improving financial soundness of a bank is by enhancing the provisioning standards of the bank. The cumulative provisions against loan losses of public sector banks amounted to a mere 41.67% of their gross NPAs for the year ended

March 31, 2001. The amount of provisions held by public sector banks is not only low by international standards but there has been wide variation in maintaining the provision among banks. Some of the banks in the public sector had as low provisioning against loan losses as 30% of their gross NPAs and only 5 banks had provisions in excess of 50% of their gross NPAs. This is inadequate considering that some of the countries maintain provisioning against impaired assets at as high as 140%. Indian Banks should improve the provisioning levels to at least 50% of their gross NPAs. There should therefore be an attitudinal change in banks' policy as regards appropriation of profits and full provisioning towards already impaired assets should become a priority corporate goal.

11.9 CAPITAL ADEQUACY

The banks should also develop a concept of building desirable capital over and above the minimum CRAR which is insisted upon in developed regulatory regimes like UK. This can be at; say around 12 percent as practiced even today by some of the Indian banks, so as to provide well needed cushion for growth in risk weighted assets as well as provide for unexpected erosion in asset values.

As banks would have observed, the changes in the regulatory framework are now brought in by RBI only through an extensive consultative process with banks as well as public wherever warranted. While this serves the purpose of impact assessment on the proposed measures it also puts the banks on notice to initiate appropriate internal readjustment to meet the emerging regulatory prescriptions. Though adequate transitional route has been provided for switchover to new regulatory measures such as scaling down the exposure to capital market, tightening the prudential requirements like switch over to 90 day NPA norm, reduction in exposure norms, etc., I observe from the various quarters from which RBI gets its inputs that the banks are yet to take serious steps towards implementation of these measures. I would like to exhort my banker friends to move in this regard at a faster pace so that compliance with the norms is in place and at the same time, it will turn out to be a painless exercise.

11.10 PROMPT CORRECTIVE ACTION

The prompt corrective action framework which had already been circulated amongst all concerned and undergoing consultative process with the Government may reach the enforcement stage shortly. Such a mandatory framework when it comes into effect won't distinguish between banks; banks which fall short of the prescribed levels of CRAR and ROA and exceed net NPA level would be facing the mandatory enforcement actions irrespective of the stable ownership. The banks should well note to go in for proactive measures towards improving the financial fundamentals and restore the soundness and stability of the institution than waiting for the supervisor's cease and desist orders to initiate such corrective steps.

11.11 GREATER FUNCTIONAL AUTONOMY FOR BOARDS OF BANK

The Boards of banks have been accorded considerable autonomy in regard to their corporate strategy as also several other operational matters. This does not; however, seem to have translated to any substantial improvement in customer service. It needs to be recognized that meeting the requirements of the customer - whether big or small - efficiently and in a cost effective manner, alone will enable the banks to withstand the global competition as also the competition from non-bank institutions.

MCQ.1 What is the primary focus of banking sector reforms in India?
a. Profit maximization
b. Government control
c. Developing the money market
d. Increasing public sector ownership

2. What is the statutory liquidity requirement for Indian banks according to the text?
a. 10%
b. 15%
c. 25%
d. 30%

3. What has the Banking Regulation Act 1949 prevented in the banking sector?
a. Connected lending
b. foreign investments
c. Market speculation.
d. Asset mismanagement

4. In the regulatory environment, what has been the main instrument of supervision for banks?
a. Off-site inspections
b. Annual Financial Inspection
c. Quarterly reviews
d. Random audits

5. What is the underlying theme of the recommendations by the Narasimham Committee I & II?
a. Increase government control
b. Enhance competitive efficiency and operational flexibility
c. Restrict foreign investments
d. Reduce market competition

6. Which of the following is NOT a measure taken to strengthen the banking sector?
a. Introduction of capital adequacy standards
b. Deregulation of interest rates
c. Enhancing transparency and disclosure requirements
d. Increasing statutory reserve requirements

7. What committee was constituted to suggest appropriate foreclosure laws?
a. Narasimham Committee
b. Eradi Committee
c. Basel Committee
d. Prudential Committee

8. How has the level of capital adequacy of Indian banks changed from 1995 to 2001?
a. Decreased
b. Stayed the same
c. Fluctuated
d. Increased

9. What has the Banking Regulation Act 1949 prevented in the banking sector?
a. Connected lending
b. Asset mismanagement
c. foreign investments
d. Market speculation

11.12 PROFITABILITY

The profitability of the public sector banks is coming under strain. Despite the resilience shown by our banks in the recent times, the income from recapitalization bonds accounted for a significant portion of the net profits for some of the nationalized banks. The Return on Assets (RoA) of public sector banks has, on an average, declined from 0.54 for the year ended March 31, 1999 to 0.43 for the year ended March 31, 2001.

Therefore, the Boards' attention needs to be focused on improving the profitability of the bank. The interest income of public sector banks as a percentage of total assets has shown a declining trend since 1996-97: it declined from 9.69 in 1996-97 to 8.84 in 2000-

1. Similarly, the spread (net interest income) as a percentage of total assets also declined from 3.16 in 1996-97 to 2.84 in 2000-01. The importance of interest spreads and ways of improving net interest margins by public sector banks were discussed threadbare in a technical seminar at NIBM recently. If the new private banks and foreign banks can despite a high cost of funds could still optimize their profits, why not public sector banks and old private sector banks which have a much wider reach to low cost deposits through large branch network achieve the same? CMDs of banks should therefore initiate cost cutting measures in the operating expenditure besides giving a customer oriented thrust for attracting quality clientele through quality service.

11.13 RETURN ON ASSETS

A disheartening feature is that a large number of public sector banks have recorded far below the median ROA of 0.4% for 2000-01 in their peer group. Incidentally the ROA recorded by new private banks and foreign banks ranged from 0.8% to 1% for the same period. An often quoted reason for the decline in profitability of public sector banks is the stock of NPAs which has become a drag on the bank's profitability. As we are aware, the stock of NPAs does not add to the income of the bank while at the same time, additional cost is incurred for keeping them on the books. To help the public sector banks in clearing the old stock of chronic NPAs, RBI had announced 'one-time non-discretionary and non-discriminatory compromise settlement schemes' in 2000 and 2001. Though many banks tried to settle the old NPAs through this transparent route, the response was not to the extent anticipated as the banks had been bogged down by the usual fear psychosis of being averse to settling dues where security was available. The moot point is if the underlying security was not realized over decades in many cases due to extensive delay in litigation process, should not the banks have taken advantage of the one time opportunity provided under RBI scheme to cleanse their books of chronic NPAs? This would have helped in realizing the carrying costs on such non-income earning NPAs and released the funds for recycling. Banks should also pursue action in tackling large willful defaults, effective utilization of DRTs, and go in for compromise settlements wherever feasible under the banks' own schemes with transparency and accountability.

11.14 OPERATIONAL COSTS

The Boards of public sector banks need to be alive to the declining profitability of the banks. One of the reasons for the low level of profitability of public sector banks is the high operating cost. The cost income ratio (which is also known as efficiency ratio of public sector banks) increased from 65.3 percent for the year ended March 31, 2000 to 68.7 per cent for the year ending March 31, 2001. The staff expenses as a proportion to total income formed as high as 20.7% for public sector banks as against 3.3% for new banks and 8.2% for foreign

Banks for the year ended March 31, 2001. There is thus an imperative need for the banks to go for cost cutting exercise and rationalize the expenses to achieve better efficiency levels in operation to withstand declining interest rate regime.

11.15 IMPLEMENTATION OF CORPORATE GOVERNANCE

As you have observed from Governor's address in the recent NIBM annual day function, the corporate governance principles acquire a different connotation when applied to the banking system. Unlike other sectors, banks are highly leveraged institutions and depositors being larger stake holders than equity owners require to be protected. In a deregulated environment, the Boards of banks are expected to play a more pro-active role in preserving the financial soundness and stability of the institution for depositors' protection, besides enhancing shareholders value. The decisions in regard to deployment of resources and pricing of the assets and liabilities are vested with the Boards themselves. This brings us to the need for a professional and qualified Board of Directors who are able to guide the bank in regard to audit, risk management, transparency, etc. in a de-regulated environment.

Taking a cue from the recent happenings in some of the banks in relation to capital market exposures and recognizing the need for better corporate governance in the banks, RBI has recently constituted a High Powered Group under the Chairmanship of Dr Ashok Ganguly, a director of the Central Board of RBI. The group has drawn representatives from various fields including from management institutes, non official directors of banks, and eminent industrialists and is in the process of formulating its recommendations to strengthen the internal defenses at all levels. The international recommendations in this area call for transparency and accountability at the Board level as well at various senior management and other functional levels so that policy and operational aberrations and deviations from good practices are effectively checked and prevented. The CMDs/CEOs of banks both in private and public sector should try to promote participative governance and adopt well defined disclosure standards at Board level as well as at controlling levels down the line.

Boards of banks have much more freedom now than they had a decade ago, and obviously they have to play the role of change agents. They should have, the expertise to identify, measure and monitor the risks facing the bank and be capable to direct and supervise the bank’s operations and in particular, its exposures to various sectors of the economy, and monitoring / review thereof, pricing strategies, mitigation of risks, etc. The Board of the banks should also ensure compliance with the regulatory framework, and ensure adoption of the best practices in regard to risk management and corporate governance standards. The emphasis in the second generation of reforms ought to be in the areas of risk management and enhancing of the corporate governance standards in banks.

11.16 BASEL COMMITTEE SECOND ACCORD

Another crucial area which should receive the attention of the Board is the preparedness for switching over to the New Capital Adequacy Framework being introduced by the Basel Committee on Banking Supervision, effective from 2005. The basic thrust of the New Framework is to assign capital in relation to the underlying risk of the counterparties instead of the existing one-size-fits-all formula for assessing credit risk. This would require a more scientific assessment of the credit risk by the banks. In order to have a smooth transition to the New Framework, the banks would need to substantially

Upgrade their MIS and risk management systems. The banks would also need to upgrade the technical skills of their staff. The adoption of the New Framework, it has been estimated by some analysts, could lead to an increase in the existing level of capital of banks by about 2 percentage points. The signals to the banks are therefore, to enhance the level of core capital, strengthen MIS and historical data base and upgrade the skills of the personnel.

11.17 SUMMARY

Banking & Financial Sector reforms came to the forefront for active implementation in 1992-93 after first Report of Narasimham Committee. What are the results obtained in Banking Industry after a decade of reforms, and what are the areas that need greater attention in the future? The decade gone by witnessed a wide range of financial sector reforms, with many of them still in the process of implementation. Further, one or two all India development financial institutions have already commenced the process of migration towards universal banking set up. The banking sector has to respond to these changes, consolidate and realign their business strategies and reach out for technology support to survive emerging competition. It is appropriate to take stock of the impact of regulatory changes initiated, and the central bank's expectations as regards response and performance by the banking system in order to achieve the avowed objectives of ongoing financial sector reforms.

11.18 Keywords

Reserve Money: A component of money supply directly controlled by RBI.

High Power Money: Money produced by RBI and the Government of India in the form of small coins and one rupee a note which is held by the public and banks. High power money is also called the reserve money of RBI.

Cash Reserve Ratio (CRR): The ratio of cash required to be maintained from time to time with the RBI by the banks against their total net demand and time liabilities (deposits).

Statutory Liquidity Ratio (SLR):The proportion of deposit liabilities to be maintained by a bank in the form of specified liquid assets.

Investment Institutions: All institutions making investments for commercial or industrial purposes. This includes commercial banks, development banks (or institutions) cooperative banks and non-banking institutions including LIC, GIC, UTI, and private finance companies.

Development Banks: Specified finance institutions performing the twin functions of providing medium- and long-term finance and performing various promotional roles for economic development of the country.

Commercial Banks: Banks accepting deposits from the public and lending money for short term requirements of industrial and commercial enterprises.

Public Sector Banks: Commercial banks owned and managed by the Government (after nationalization), banks not falling in this category are called private sector banks.

Monetary Policy: Policy of the Government concerned primarily with the maintenance of stability in domestic prices and exchange rate stability. The subsidiary objectives may be social justice, growth etc.

Self-check exercise

10. What has happened to the gross and net NPAs of public sector banks from 1992-93 to 2000-01?
a. Increased
b. Stayed the same
c. Decreased
d. Fluctuated

11. What percentage of demand and time deposits in government securities must Indian banks maintain?
a. 10%
b. 15%
c. 25%
d. 30%

12. What recommendation did the Committee on Banking Sector Reforms make regarding government's equity holding in public sector banks?
a. Increase to 50%
b. Maintain at 75%
c. Reduce to 33%
d. No specific recommendation

13. In the regulatory environment, what has been a critical component of the financial sector reform program?
a. Increasing exposure to sensitive sectors
b. Tightening prudential norms and practices
c. Allowing connected lending
d. Abolishing periodic inspections

14. Which committee's recommendations have played a significant role in shaping the regulatory framework for banks in India?
a. Rajan Committee
b. Patel Committee
c. Narasimham Committee
d. Swaminathan Committee

15. What has been a major challenge of banking sector reforms in India?
a. Increasing government control over public sector banks
b. Introducing market incentives
c. Reducing competition in the banking system
d. Enhancing public sector ownership

16. What measure aims to provide better operational flexibility to banks?
a. Increasing statutory reserve requirements
b. Deregulation of interest rates
c. Abolishing capital adequacy standards
d. Tightening credit controls

17. What is one area where banking sector reforms have not progressed according to the provided information?
a. Reduction in government control over public sector banks
b. Increase in statutory liquidity requirements
c. Expansion of public sector banks
d. Deregulation of interest rates

18. What has been the impact of banking sector reforms on the profitability of public sector banks?
a. Decreased profitability
b. No change in profitability
c. Increased profitability
d. Bank losses

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11.20 Self-check exercise (ANSWER KEY)

1(C),2(C),3(A),4(B),5(B),6(D),7(B),8(D),9(A), 10(C),11(C),12(C),13(B),14(C),15(B),16(B), 17(A),18(C)

NON BANKING FINANCE COMPANIES (NBFCS)

STRUCTURE

12.1 Introduction
12.2 Categories of NBFCs
12.3 Banking and non banking financial institutions - A Comparison
12.4 The Genesis
12.5 Regulatory Framework For NBFCs
12.6 Problems and Prospects
12.7 Growth and performance of NBFCs
12.8 Summary
12.9 Keywords
12.10 Suggested Readings
12.11 Self check exercise (Answer key)

12.1 INTRODUCTION

Reflecting the imperatives for the evolution of a vibrant, competitive, and dynamic financial system, the non-banking financial institution in India has recorded marked growth in recent years in terms of number of NBFCs.

In a broader sense NBFCs means, a company whose principle business is receiving of deposits, under any scheme of arrangement or in any other manner, or lending in any manner, but not qualified enough to be called a 'bank ' as defined in banking regulation act, 1949.

NBFCs started in a small way in the sixties and seventies and tried to serve the needs of savers and investors whose needs remained unfulfilled by the banking system. In early years the operations of NBFCs were limited and these did not have a significant impact on the financial system and therefore not much attention was paid to them in the eighties & nineties, however these recorded an impressive growth record and started competing with the banks because of their greater customer orientation and higher rates of interest offered on deposits as compared to banks. Thus, NBFCs overtime has grown and have started playing a relatively significant role in the economy especially in the mobilization of deposits as compared to banks thus NBFCs overtime has grown and have started playing significant role in the mobilization of deposits from the public and dispersion of credit to road transport and SSI sectors and corporate sectors. After Dr. Man Mohan Singh initiated financial sector reform in 1991, the industry grows significantly. Since then there has been a proliferation of NBFCs In the absence of a single comprehensive regulatory agency, various agencies attempted to grapple with this mushrooming segment. Multiplicity of regulatory agencies in the form of SEBI, the RBI, department of company affairs and respective state governments provided the right forum for misendearours in a nascent industry.

12.2 CATEGORIES OF NBFCS

According to the RBI (amendment act) 1997.

A non banking finance company (NBFC) means,

(a) a financial institution which is a company ;
(b) a non banking institution which is a company and which has as its principal

Business the receiving of deposits under any scheme of arrangement or in any other manner or lending in any manner;

(c) Such other non institution or classes of such institution as bank may with the previous approve of the central government specify."

The definition excludes the financial institutions besides institutions, which carry on agriculture operations as their principal business.

NBFCs consists of mainly of finance companies, which carry on hire purchase Finance, housing finance, investment, loan, equipment leasing or mutual benefit finance companies but do not include insurance companies or stock exchanges or stock-broking companies.

NBFCs in India represent a heterogeneous group belonging to both indigenous type and include different categories of companies such

as:

- Loan companies
- Investment companies
- Hire- purchase finance companies
- Equipment leasing companies
- Housing finance companies
- Mutual benefit finance company
- Chit fund companies
- Miscellaneous non banking companies

A brief introduction of the above are as:

- Loan Companies : The companies which are financial institutions carrying on as its principal business of providing finance either by making loans or advances or otherwise for any activity other than its own.
- Investment Companies: The Company which carry on its principal business the acquisition of securities.
- Hire Purchase Finance Companies : The company which is a financial institution carrying on its principal business of hire - purchase transaction for the acquisition of capital as well as consumption goods mainly to the small road transport operators, farmers professional etc.
- Equipment Leasing Companies: These companies provide medium and long term financial assistance through lease agreement to the industrial and business clients who cannot afford to buy the required asset on their own.
- Housing Finance Companies : In the recent years with the growing needs for housing facilities, especially in urban and metropolitan center, these housing financial assistance for either acquisition, construction or expansion of the housing accommodations.
- Mutual Benefit Financial Companies : The companies, which are notified by the central govt., under section 620-a of the companies act, 1956, Enable their members to save money, invest their saving and secure loans etc. at favorable rate of interest.
- Chit Fund Companies: These are one of the at least form of indigenous financial institutions in India. They meet simultaneously saving and credit needs of their members who are mostly drawn from the lower and middle stage of society.
- Miscellaneous NBFCs: Any other business not included in the above categories.

12.3 BANKING AND NON BANKING FINANCIAL INSTITUTIONS - A COMPARISON

Financial institutions are usually classified as banking institutions and nonbanking financial intermediaries. Banks, subject to legal reserve requirement, can advance credit by creating claims against themselves, while NBFC's can lend only out of resources put at their disposal by the ultimate savers. The distinction between the two has been highlighted by says while characterizing the former as "creators" of credit and the latter as mere "purveyors" of credit. The volume of money in a country is composed of currency and bank deposits large part of the deposits of commercial banks is demand deposits and major part of this is in operations. Commercial banks are in a position to multiply their deposits by multiplying their credit. Commercial banks are therefore, rightly regarded as manufacturers of money. Non-banking financial intermediaries resemble commercial banks, as they receive the saving of general public and lend the same to various parties or make investments. They cannot create money, for they do not hold demand deposits. But they perform certain services, which help to increase the velocity of circulation of money. Recent study of ICICI of the financial performance of 175 leasing and hire purchase companies shows more efficient utilization of funds by NBFCs as compared to banks -both in public and private sector. The ratio of profits to total working funds was 4.73% for NBFCs as compared to 1.04%for private sector banks and 0.24%for public sector banks. NBFCs have also recorded impressive growth rates in total income, asset creation and fund mobilization. In 1994-95, while growth of total assets was 71%, the total income of NBFCs grew by 69%. Despite a higher cost of funds, NBFCs outperformed the banks in terms of spread earned. The ratio of net interest income to total income was 40.2% for NBFCs as compared to 29.9% for private sector banks.

Services Offered By NBFCs

- Leasing and hire purchase financing.
- Consumer finance
- Investment banking
- Fixed deposit brooking
- Inter-corporate deposits
- Issue management
- Under writing
- Project counseling and pre investment studies
- Credit syndication
- Bill discounting
- Corporate counseling
- Capital structuring and restructuring
- Portfolio management
- Venture capital finance
- Stock exchange operations
- Money market activities
- International services
- Promotional services
- Bought-out deals

12.4 THE GENESIS

The regulations for NBFCs were introduced in the sixties with the inclusion of chapter 111 in the RBI act of 1934. Various committees were set up to regulate the financial system until the recent RBI (amendment) ordinance 1997, promulgated on 9.1.1997 (effected comprehensive changes in the provisions of chapter Hand 5of the RBI act 1934.

The Shah Committee:

In May 1992, the RBI set up a study group headed by Ac Shah. It submitted its report in September 1992 making many far-reaching recommendations, which have been fully accepted, principal by the RBI and implemented in phases commencing April 1993.

The regulatory framework had three basic objectives:

(a) To encourage the orderly growth of NBFCs ;

(b) To protect the interest of depositors;

(c) To ensure the efficacy of monetary credit policy.

The group recommended dismantling the category classification and application of uniform regulation for all NBFCs. The definition of NOF was revised to reflect the correct position. Companies with NOF of Rs.50 lakh and above are required to be registered compulsorily with the RBI; the cut-off point is reviewed from time to time for effective control. Registration of companies with NOF below the cut-off point may be optional. The registered companies will be allowed to accept a public deposit up to a multiple of their NOF, and the unregistered companies with NOF less than Rs.50 lakhs, will be allowed to accept public deposits at a lower level. New companies with NOF of Rs. 50 lakh and above should be registered with the RBI. They will be restricted to deposit acceptance activity at the level permitted to all unregistered companies in the first two financial years, and after completion, on the basis of track record, quality of management and methods of operation, they can be put on par with the existing companies.

The study group also recommended the constitution of a high- powered supervisory board that will be responsible for onsite, as well as offsite surveillance to monitor the operation of NBFCs.

The Khanna Committee :

In the light of the recommendations of the shah committee, an expert group under the chairmanship of Shri P. R. Khanna was set up to design a suitable supervisory framework for NBFCs and submitted its report in April 1996.

The Khannacommittees observed that out of about 40000 NBFCs, only 10845 companies (28%of the total) are submitting their annual reports to the RBI. In 1984, the aggregate deposits were Rs.3161 crore. It stood at Rs.56559 crore during 1994_i.e, 17.4% of the aggregate deposits of the commercial banks. The committee then suggested:

- Unless certified by the RBI, no new company can start operations.
- A minimum NOF of Rs. 1 crore is required as promoter's contribution, which should be raised to Rs.5 crore over a period of time.
- Companies with NOF over Rs.l crore are required to be registered.
- NBFCs should invest between 5-25 % in approved securities to be prescribed by RBI of the deposit liabilities.
- NBFCs should create a reserve fund of an amount no less than 20% of their disclosed net profit every year to the fund.

- NBFCs should observe the lending policy and follow the directives relating to income recognition, accounting standards, asset classification, provision for doubtful debts, capital adequacy, the deployment of funds, etc. and follow the instructions for which advances may not be made.
- To enforce the repayment of deposits and interest by defaulting companies on the lines of the companies act 1956, as applicable to the non-financial companies act 1996, As applicable to non- financial companies.
- Submit return/information to the other regulatory bodies like the SEBI, ICAI. etc.
- To safeguard the interest of the depositors, the RBI should initiate proceedings for liquidation/winding up any NBFC whose financial position is found to be weak.

The committee also suggested stratification of NBFCs according to their size:

- Unregistered NBFCs.
- registered NBFCs with asset size;
    - I. Up to Rs.25 core.
    - II. Between Rs.25crore and Rs.500crore.
    - III. Rs.500 crore and above.

12.5 REGULATORY FRAMEWORK FOR NBFCS

RBI announced a set of measures to protect the interest of depositors and provide more effective supervision over non-banking financial companies (NBFCs) particularly those, which accept public deposits. For this purpose, RBI has drawn
Necessary powers under the provisions of RBI (amendment) act, 1997. The
Regulations stipulate an upper limit of public deposit, which NBFCs can accept. This limit is linked to the credit rating of an approved rating agency. An upper limit has also been put on the rate of interest on deposits in order to restrain NBFCs from offering incentives and mobilize excessive deposits, which they may not be able to service. Furthermore, disclosure requirements have been strengthened and responsibilities have been cast on the board of directors and auditors of the companies to ensure that the operations of NBFCs conform to the deposit regulations and prudential norms prescribed by RBI. The salient features of the new regulatory framework are as under

1 Categorization of Companies

For the purpose of the new regulations, NBFCs have been divided into three broad categories as indicated below:

- NBFCs accepting public deposits;
- NBFCs not accepting public deposit and are engaged in loan, investment, hire purchase finance and equipment leasing activities; and
- NBFCs not accepting public deposit and have acquired shares/securities in their own group/holding/ subsidiary companies of not less than 90 per cent of their total assets and are not trading in these shares/securities.
- Provisions of the directions, those, which do not accept public deposits, will be supervised in a limited manner.

2 Definition Of Public Deposits

Public deposit will include fixed, recurring etc. deposit received from public, deposit received from relatives and friends, deposit from shareholders by a public limited company -

And the money raised by issue of unsecured debentures/bonds. Public deposits would, however, exclude money raised by NBFCs by way of issue of secured debentures/bonds, borrowings from banks/financial institutions, deposit from directors, inter-corporate deposit (ICD), deposit received from foreign citizens and those received by the private limited companies from their shareholders.

3 Prohibition from accepting public deposit for NBFCs having net owned fund of less than Rs. 25 lakh

The NBFCs having net owned fund of less than Rs- 25 lakh will not be entitled to accept deposit from public. However, they can raise borrowings from other sources.

4 Credit Rating Requirement and Quantum of Public Deposit

The ceiling on quantum of public deposit for a NBFC has been linked to its level of credit rating as given by approved credit rating agencies. Higher credit rating will entitle NBFCs to raise larger quantum of public deposit as per details given here under:

level of credit rating	Equipment leasing/ Hire purchase cos. (as a multiple of NOF)	Loan and investment cos.
AAA	3 times	2 times
AA	2 times	1 time
I'- A	1 time	0.5 time

NBFCs having a credit rating lower than 'a' cannot accept public deposit. Those NBFCs, which have accepted public deposit in excess of the prescribed limits, have been allowed time upto December 31, 1998 to regularize their position.

5 Interest Rate Ceiling

All the NBFCs have now been subjected to the interest rate ceiling of 16 per cent per annum. NBFCs, which are presently offering interest rates in excess of the prescribed ceiling, are required to roll back their interest rate to bring it within the ceiling with immediate effect.

6 Brokerage

Brokerage payable by NBFCs on deposit of one year to five years has now been uniformly fixed at two per cent as against the varying rates earlier. In addition, NBFCs may also pay to the brokers by way of reimbursement on the basis of vouchers/bills produced an amount not exceeding 0.5 per cent of the deposits collected.

7 Submission of Returns

NBFCs accepting public deposits only will be required to submit to RBI annual statutory returns and financial statements. NBFCs not accepting public deposit are exempted from this requirement.

8 Capital Adequacy Ratio

Capital adequacy requirement for NBFCs with net owned fund of Rs.25 lakh and above and accepting public deposits has been raised from the present level of 8 per cent to 10 per cent to be achieved by march 31, 1998 and to 12 per cent by march 31, 1999.

9 Compliance of Prudential Norms

The NBFCs including residuary non-banking companies accepting public deposit will be required to comply with all the prudential norms compassing income recognition,

Accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy and credit/investment concentration. Prudential norms have been revised to make them more transparent and have been reissued in the form of directions to make them mandatory. Some of the important changes made in the norms are mentioned below.

Income Recognition Norms for Lease and Hire Purchase Assets

The income recognition, asset classification and provisioning norms as applicable to lease and hire purchase assets have been relaxed having regard to their distinctive nature. Hitherto, such assets were to be treated as NPAs in case the lease rentals and hire purchase installments remained past due for six months. In terms of new norms, such assets will be classified as NPAs if the said installments are overdue for 12 months and above.

10The Credit/Investment Concentration Norms

While the existing credit concentration norms to a single borrower and a group of borrowers at 15 and 25 per cent of the owned fund remain unchanged, the investment concentration norms have been modified. It has been prescribed that investment in a single company or in a single group of companies should not exceed 15 and 25 per cent respectively of the NBFCs owned fund. Further, composite limits of credit and investment by a NBFC in a single entity and a single group of entities have been prescribed at 25 per cent and 40 per cent respectively of its owned fund.

11 Prohibition from Grant of Loan Against the Security of its Own Shares

NBFCs have been advised not to grant any loan against the security of its own shares. Any such loan granted so far should be repaid in due course. However, no fresh loan should be granted against such security.

- The NBFCs, which are accepting and holding public deposits only, are required to submit half-yearly prudential returns. These returns will be duly certified by their auditors. The NBFCs engaged in leasing, hire purchase finance, loan and investment activities and not accepting public deposits are required to comply with prudential norms other than norms on capital adequacy and credit/investment concentration. They will, however, not be required to submit the prudential norm return to RBI. The investment companies holding not less than 90 per cent of their assets being the securities of their group/ holding/subsidiary companies and not accepting public deposits are exempted from the prudential norms.

12 Maintenance Of Liquid Assets

The liquid asset requirement will now be applicable to public deposits only. The ratio of liquid assets shall also be uniform for all NBFCs accepting public deposits at 12.5 and 15.0 per cent effective from April 1, 1998 and April 1, 1999 respectively.

13 Application Forms For Deposit Acceptance

The contents of the deposit application forms have been further modified to make the depositors aware of the for available for redressed of their grievances and also to give them a proper perspective regarding the role and responsibility of the regulatory authority. The deposit taking companies have been directed to certify the correctness of their financial position and confirm that their operations comply with reserve bank's directions. The depositors have also been enjoined to satisfy themselves about the financial details of the company before placing their deposits, and to declare on the deposit application form that theyHave gone through the declarations made by the company regarding its conformity with the RBI regulations.

14 Regulations for not Accepting Public Deposits

The NBFCs not accepting/holding public deposits shall be regulated in a limited manner. These companies are exempt from all the provisions of directions relating to acceptance of public deposits and the requirements of capital adequacy as also credit/ concentration norms. However, in order to avail of the exemptions from the regulations, these NBFCs are required to get a resolution passed by their board of directors to the effect that they will not accept any 'public deposit'. The board resolution in the case of investment companies not accepting public deposits and which have acquired shares of not less than 90 per cent of their assets in their group/holding/subsidiary companies will also specifically include the names of their holding/group/ subsidiary companies whose shares/securities they hold or propose to invest during the ensuing year. It will be the duty of the statutory auditors to comment in their report that these companies have not accepted public deposit and have complied with the specified norms. Any violation/non-compliance is required to be reported by the statutory auditors to reserve bank of India by exception.

15 Classification of NBFCs

Reserve bank has also made certain refinements in the norms for classification of NBFCs into various sub-groups based on their principal activity as evidenced from the asset/ income pattern. Having regard to the special regulatory dispensation accorded to equipment leasing and hire purchase finance companies, the criteria for classification of the NBFCs into these categories has been tightened. Thus, an NBFC to be eligible for being classified as equipment leasing company or a hire purchase finance company shall have not less than sixty per cent of its assets and shall derive not less than sixty per cent of its income from equipment leasing and hire purchase activities taken together.

- All new NBFCs incorporated after January 9, 1997 will be provisionally classified as loan or investment companies for a period of one year and the classification will be reviewed thereafter on the basis of their asset/income pattern as disclosed in their balance sheet/profit and loss account and other related aspects. Existing NBFCs as also those, which remain unclassified, will be classified on the basis of their principal activity as evidenced from their financial statements into various categories such as equipment leasing companies. Hire purchase finance companies, loan companies, investment companies, miscellaneous non-banking companies or residuary non-banking companies as the case may be. Only such of the NBFCs as have been specifically notified under section 620a of the companies act, 1956 by the government of India will be classified as Nidhi companies. NBFCs which have been incorporated with the intention to function, as Nidhis will be classified as loan companies and the directions as applicable to 'loan companies' will be made applicable to them till such notification.

Depositors Cautioned

Reserve bank has cautioned the depositors that whatever be the rigors of regulation, the regulations by themselves cannot provide a fail-safe system for ensuring repayment of deposit. Depositors should, therefore, be circumspect and satisfy themselves about the financial soundness and health of the companies before placing their deposits keeping inmind that they are investing their money at their own risk and responsibility.

PROBLEMS PROSPECTS

The best news in a long time for NBFCs is that industrial growth is picking up. For finance companies in the fund -based business, the implications are positive, but for past disbursements too. In addition to opening up new opportunities, industry sources say there has been a positive impact on over dues. With the improved flows of orders, clients on default list have begun to pay up once again. The commercial vehicle segment- the bedrock of industrial growth in the country where 60%of all goods is moved by road-has shown definite signs of revival. Not only have sales of all types of commercial vehicles risen in the first quarter of this year over the corresponding previous period, the production figure have shown up trend. In addition to commercial vehicles, the data for other sector are also encouraging. The index of industrial production (IIP) grew 5.6% in the first quarter of this financial year over the corresponding previous period. The portents are promising for finance companies that have shown a marked shift towards financing industrial assets over the last couple of years. Regulatory Stability

According to industry sources, the environment is marked by stability now after a few regulatory shocks in the last couple of years. January 1998 saw a crackdown on NBFCs by RBI on the heels of defaults and credit rating downgrades. While the RBI's intent was universally hailed, the measures appeared draconian and threw the industry into turmoil. In particular, the measures to curb the NBFCs' access to deposits and the stiff deadlines for repayment of excess deposits had an across- the -board impact. Since then, the situation has changed significantly. For one, the RBI amended its initial regulations to bring them in line with the ground reality. There has been a clear demarcation between the companies carrying on the fund -based activities and others. The access to public deposits has been linked to capital adequacy rather than credit rating. Another aspect to the changed regulatory environment is that the RBI consciously encouraged banks to augment funding to finance companies. Any boost in wholesale funding is likely to impart more stability to the liabilities side of finance company's balance sheet. Now when RBI has reduced the interest rates on deposits, NBFCs will definitely be going to benefit because as per the guidelines issued by RBI NBFCs can offer to a maximum of 16% interest rate whereas in case of banks it is not more than 11%.

Consolidation

A significant consequence of the turbulent phase is that the industry is in the process of a consolidation .In the boom years of early 1990s, the industry saw a number of new entrants even the existing players built capacities in term of infrastructure that was soon to prove excessive, on the heels of economic slowdown and deteriorating asset quality, many NBFCs folded up. The consolidation is happening through mergers and portfolio acquisitions. For instance, India equipment leasing (IEL) was merged with one of its promoters, sunder finance. Birla global finance recently purchased the retail portfolio of dabur finance.

The process was given push by drastic regulatory changes in the year 1998. The RBI's notification struck at the root of funding source for NBFCs-fixed deposits. The measures were aimed at bringing more discipline and accountability into the system by linking it with investment grade credit rating. Because of number of relative shaky NBFCs overreaching

Themselves on public deposits, many were forced to shrink businesses to bring the quantum of public deposits in line with the new regulations. The upshot of the forced move to shrink business was that many customers perforce moved to the stronger players with fewer competitors, and the survivors are among the fittest companies. In the event of an improvement in the economic fundamentals and the euphoria that typically accompanies it; the danger of new entrants exceeding business opportunities is real. But, for, now the problem seems unlikely because the RBI has sharply scaled up the entry barriers. The new set of regulations may be an important factor in keeping seasonal competitors at bay and out of business.

Threat of Competition

The noteworthy factor among the recent developments in the financial sector is the increasing thrust of all the players in the retail segment. This puts finance companies in a spot as they have to face competition from players qualitatively and quantitatively different in terms of balance sheet strength and reach .the presence of banks, foreign finance entities and financial institutions in the retail market is growing. In the last couple of years, banks have made their presence felt in the car finance area. ICICI too has made an aggressive foray into the car finance market, the increased competition that has lead to a narrowing of spreads. In the hire purchase of products from the automobile sector, car finance has the lowest spread. While car finance is the most viable foray of banks in the retail segment, their presence is also increasing in other areas, such as durables.

Banks began business in this market with a big advantage -the ability to access funds at a much lower cost. This is sharpened by the widespread network with most banks. NBFCs are not deeply disturbed by the increased competition from banks and financial institutions for one while they appear reconciled to increased competition, the NBFCs point out their ability to reach out to areas where institution players cannot.

In a multi-layered economy, characterized by sharp difference in the risk profile, it is nearly impossible for institutions such as banks to handle the credit needs of all participants. In this environment, financial intermediaries other than banks are a natural alternative, and NBFCs can comfortably bank on this. The flip side of the ability to cater to the needs of the second rung of customers is the increased risk from asset of lower quality. Leading NBFCs however, have proved adept at keeping delinquencies at bay, even during the economic slowdown. For instance, sunder finance reported NPAs of 3.26% of total business assets on March 31, 1999. In comparison, the state bank of India's net NPAs as a percentage of total asset was 7.18% on March 31, 1999.

The Personal Touch

Given their positioning in the financial structure the NBFCs see efficient collection mechanisms as strength. The personal touch of the NBFCs, among other things, enables an accurate assessment of the borrower's repayment capacity. Delinquencies lead to the problem of increasing provisions reported in NBFC balance sheets. Top rung NBFCs kotakMahindra finance and sunder finance, for instance - were able to check the balance sheet growth over the last year after deterioration in asset quality.

Cost

In the boom of early 1990s, financing businesses provided a spread an interest spread of about 6% or more. Now, the industry has to operate on narrow spread, believed to be around 3%, on an average. An increase in spread can only come along with higher level of risk in

Self-check exercise

1.What is the primary business activity of Non-Banking Financial Companies (NBFCs) according to the given information?

a) Insurance

b) Stock-broking

c) Lending and deposit-taking

d) Agriculture operations

2.When did NBFCs start gaining significant attention and competing with banks?

a) 1950s

b) 1960s

c) 1980s

d) 1990s

3.Which financial sector reform in 1991 initiated significant growth in the NBFC industry?

a) Banking Regulation Act

b) SEBI Act

c) Companies Act

d) Financial sector reform by Dr. Manmohan Singh

4.According to the RBI (amendment act) 1997, what does NBFC stand for?

a) National Banking and Finance Corporation

b) Non-Banking Financial Corporation

c) New Banking Finance Companies

d) None of the above

5.Which of the following is NOT a category of NBFCs mentioned in the text?

a) Loan Companies

b) Stock-broking Companies

c) Chit Fund Companies

d) Housing Finance Companies

6.What does NOF stand for in the context of NBFCs?

a) National Operational Framework

b) Net Owned Fund

c) Non-operational Finance

d) New Ownership Fund

7. What is the Capital Adequacy Ratio required for NBFCs with net owned fund of Rs. 25 lakh and above accepting public deposits?

a) 5%

b) 8%

c) 10%

d) 12%

the form of assets of poor quality. With banks increasing focus on retail assets, finance companies have to operate in an environment of softer interest rates on lending the key to profitable operations in the future will be the ability to access low - cost funds that provide a reasonable spread. There may be a shift towards wholesale source of funds where the possibility of checking cost is higher. The last few years have seen finance companies increase their dependence on public deposits - an expensive and often fickle source of funds. However, to-rung players say there has been a change for the better as far as bank lending goes. Bank, flush with funds, is seen more willing to lend to finance companies. To make things better, IDBI has also begun taking a look at disbursing medium- and long -term loans to finance companies. In an environment of declining spreads, the ability to keep a tight control on finance cost will determine the competitiveness of the latter. Finance companies are on the threshold of better times.

12.7 GROWTH AND PERFORMANCE OF NBFCS

There are thousands of market players in the NBFCs sector. The number of NBFCs has increased from 2941 in 1970 to 48969 in 1994; and it is reported that there were about 41000 thousand NBFCs at work in 1997. The number of these companies doubled during 1990-94. The proportion of NBFCs to the total non-bank (financial and non-financial) companies increased from about 11% in the 1981 to 16% in 1994. The majority i.e. 80 to 84%) of NBFCs

Table No. 1 : Number of NBFCs

Year	Public Ltd.	Pvt. Ltd.	Total	Total No. of Companies
1970	-	-	2941	-
1975	-	-	4293	-
1981	1064	5999	7063	61675
1984	2266	11253	13519	94264
1987	3337	16281	19618	137971
1990	3783	20266	24009	198262
1991	6255	27265	33520	224058
1992	6680	29152	35832	249181
1993	8523	35312	43835	275664
1994	10635	38334	48969	305624
1995	-	-	41000	-
1996	-	-	41000	-
1997	-	-	41000	-

are private limited companies (the rest being public limited companies).

NBFC has increased from 2941 in 1970 to 48969 in 1994; and there were about 41000 NBFCs at work in 1997. The number of these companies doubled during 1990-94. The proportion of NBFCs to total non-bank(financial and non- financial) companies increased about 11% in 1981 to 16% in 1994.The majority (80 to 84%) of NBFCs is private limited companies (rest being public limited companies).

For judging the performance after taking the overall view about the performance of

NBFCs we take a study analysis of 697 companies which closed their accounts during the period April 1997 to march 1998 have been taken.

The segment of financial and investment companies in the private corporate sector include two giant companies, viz., ICICI & HDFC. These two companies together claimed 17.4% of the total paid up companies, 58% of main income and 61.0% of total net assets of the total net assets of the selected 697 companies in 1997-98.

12.8 SUMMARY

The NBFCs in India has grown at a very fast speed over the period of time. Inspite of their cost of funds being high many corporate preferred the NBFC route because few questions were asked, service was speedy and there was tremendous flexibility in structuring the repayments. It was therefore little surprise that NBFCs commanded hefty premiums in the equity markets and began to grow at a frenetic pace.

Public deposits account for a major chunk of funding for NBFCs in India. But in the after math of the CRB and ITC classic fiasco this source of deposits has evinced a distinct slow down. The modest increase in NBFC deposits as compared to previous year is testimony to the fact that depositors have turned cautious towards finance companies. With the overall easing of interest rates in the economy and the rise in their effective cost of funds caused by higher NPAs most NBFCs had reduced their interest rates on deposits. This could be another reason for poor growth in deposits. To add this bank finance remains restricted to a handful of NBFCs with high credit rating and equity market continues to be in doldrums.

Income of NBFCs has been growing over the period from 1995-96 to 1997-98 and onwards. It has increased mainly in case of hire purchase and leasing companies. Deposits have also grown from 1995-96 to 1996-97 at the growth rate of 60.28%. Interest which constitutes the major portion of expenditures have increased which clearly indicate the growth in deposits and increasing popularity of NBFCs. NPAs which have been major problem of NBFCs have become major problem, which clearly indicate that bad-debts are increasing. Profits (both after tax &before tax) have continuously been decreasing which has reduced the profitability position of the NBFCs. Dividends also present a mixed picture i.e. some times increasing some times decreasing. Operating profits have also been declining. All these factors taken together represents that position of NBFCs in India has been worsening in India that is why RBI come up with the new set of regulations to protect the interest of depositors. RBI has set the limit on NBFCs for accepting deposits on the basis of Net owned funds (NOF).

Moreover, credit rating has been made compulsory for the NBFCs for accepting public deposits. The regulations will seriously impair the deposit raising capacities of NBFCs. Experts view that dilution in accounting norms will only make "weak NBFCs weaker": they will be showing book profits without any real cash flow presenting a rosy picture when the situation is very different. In the present form the new permissible limits for deposit taking will sound death knell for many NBFCs. Rigidly applied many-even NBFCs which have investment grade rating- will be forced to refund deposits. The importance given to rating agencies has invited maximum criticism. Smaller NBFCs feel that the rating process has an in built bias against them. The present rating (of their FD's) have been arrived at a time when their borrowing limits were at a much higher level. Hence they may not be valid now. One major benefit NBFCs got over their competitors i.e. banks that they can offer maximum interest rate 16% while in case banks it is very low. RBI has adopted a gradual approach in

tightening its regulations. In the end we can conclude that after doing the evaluation of NBFCs in India the performance is not up to satisfactory level. The RBI has also permitted NBFCs to enter into insurance business, which might increase its speed of growth in India and earn the confidence of investors in them.

12.9 Keywords

- **Overdrafts:** This is a facility allowed to a current account holder for a short period. Under this facility, the account holder is allowed to draw from his account more than what stands to his credit, either on the personal security of the borrower or on the basis of collateral security.
- **Cash Credit System:** This is a method of granting credit by banks. Under this method the bank prescribes a limit, called the Cash Credit limit, up to which the customer is permitted to borrow against the security of tangible assets or guarantee. The borrower may withdraw from the account as, and when he needs money. Surplus funds with him may be deposited with the banker any time. Thus, it is running a/c with the banker, wherein withdrawals and deposits may be made frequently in any number of times.
- **Loan:** Under the Loan System of granting credit a definite amount is lent for a specified period.
- **Bridge Loan**: Bridge Loan is a short term loan which is usually granted to industrial undertakings to enable them to meet their urgent needs. It is granted when a term loan has already been sanctioned by a bank/financial institution, but its disbursement takes some time or when the company is taking steps to raise funds for the capital market. It is a type of interim finance.
- **Composite Loa**n: Those loans that are granted for both investment in capital assets and for working capital purposes are called composite loans.
- Secured Loans: A secured loan is a loan made on the security of any tangible asset of the borrower. It means that a charge or right is created on the assets of the borrower in favour of the lender. The value of the security must be equal to the amount of the loan.
- **Pledge:** Pledge is a method of creating a charge over the movable assets of the borrower in favor of the lender. Under the pledge, the movable assets of the borrower are delivered to the banker as a security, which he will return back to the borrower, after he repays the amount due from him in respect of principal and interest.

Self-check exercise

MCQ.8 What is the primary distinction between banking institutions and non-banking financial intermediaries?

a) Credit creation capability

b) Asset management

c) Government regulation

d) Customer service

9.According to the ICICI study, what was the ratio of profits to total working funds for NBFCs compared to private and public sector banks?
a) NBFCs: 4.73%, Private: 1.04%, Public: 0.24%
b) NBFCs: 1.04%, Private: 4.73%, Public: 0.24%
c) NBFCs: 0.24%, Private: 1.04%, Public: 4.73%
d) NBFCs: 0.24%, Private: 4.73%, Public: 1.04%

10.What services are NOT offered by NBFCs, as per the information provided?
a) Leasing and hire purchase financing
b) Consumer finance
c) Stock exchange operations
d) Agricultural loans

11.Which committee was set up in 1992 to regulate NBFCs, and who was its chairman?
a) Shah Committee, Chairman: Dr. Manmohan Singh
b) Khanna Committee, Chairman: P. R. Khanna
c) RBI Committee, Chairman: Ac Shah
d) ICICI Committee, Chairman: P. Chidambaram

12.What is the purpose of the high-powered supervisory board recommended by the Shah Committee?
a) Onsite surveillance only
b) Offsite surveillance only
c) Both onsite and offsite surveillance
d) Auditing financial statements

13.What is the minimum Net Owned Fund (NOF) required for registration with the RBI, as per the Khanna Committee?
a) Rs. 1 lakh
b) Rs. 25 lakh
c) Rs. 50 lakh
d) Rs. 5 crore

14.What does the new regulatory framework stipulate for NBFCs accepting public deposits regarding credit rating and interest rates?
a) No relation to credit rating, no interest rate ceiling
b) Direct relation to credit rating, no interest rate ceiling
c) Direct relation to credit rating, interest rate ceiling of 16%
d) No relation to credit rating, interest rate ceiling of 16%

15.What is the Capital Adequacy Ratio required for NBFCs with net owned fund of Rs. 25 lakh and above accepting public deposits?
a) 5%
b) 8%
c) 10%
d) 12%

16.What is the purpose of the high-powered supervisory board recommended by the Shah Committee?
a) Onsite surveillance only
b) Offsite surveillance only
c) Both onsite and offsite surveillance
d) Auditing financial statements

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12.11 Self-check exercise

1(C),2(C),3(D),4(B),5(B),6(B),7(A),8(C),9(A),10(D),11(C),12(C),13(B),14(C),15(C),16(C)

MBA-DE(Second Year) **MFI 308**

Semester-Ill **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 13 **AUTHOR:Dr. DHIRAJ SHARMA**

MUTUAL FUNDS: AN OVERVIEW

STRUCTURE

13. Objectives

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13.2 Schemes of Mutual Funds

13.2.1 Operational Classification

13.2.2 Return-Based Classification

13.2.3 Investment-Base Classification

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13.4.4 Assets Management Company (AMC)

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13.7 Practical questions

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13.0 OBJECTIVES

The objectives of this lesson are:

- To provide you with an overview of the concept and philosophy of mutual funds;
- To introduce and explain the organization of mutual funds in India;
- To explain the performance measures of mutual funds in India.

13.1 INTRODUCTION

Mutual Fund is an important segment of the financial system. Mutual Fund is a no fund based special type of institution which acts as an investment conduit. It is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with an avowed objective of attractive yields and appreciation in their value. A Mutual Fund is a Financial Service Organization that receives money from shareholders, invests it, earns returns on it, attempts to make it grow and agrees to pay the shareholder cash on demand for the current value of his investment. A Mutual fund offers investors a proportionate claim on portfolio of assets that fluctuates in value with the value of the assets that make up the intermediaries portfolio. It is rather difficult to give a comprehensive concept of a mutual fund. What is a mutual fund is better understood by the functions it performs and role it plays. It is a non-depository financial intermediary. Mutual funds sire mobilize of savings, particularly from the small and household sectors, for investments in stock and money markets. Mutual funds mobilize funds by selling their own shares also known as units. When an investor owns a unit in mutual funds he owns a proportional share of the securities portfolio held by a mutual fund. In other words, share of a mutual fund actually represents a part share in many securities that it has purchased. Mutual fund

Share/unit certificate combines the convenience and satisfaction of owning shares in many industries. Thus, mutual funds are primarily investment intermediaries which pool investors' funds to acquire individual investments and pass on the returns thereof to fund investors.

The idea of mutual fund had its formal origin in Belgium (SocieteGeneral de Belgiue, 1822) as an investment company to finance investments in national industries associated with high risks. In 1860s this movement started in England. In 1868, the Foreign and Colonial Government Trust was established to spread risks for investors over a large number of securities. In U.S.A., the idea took root in the beginning of the 20th century. Three investment companies were organized: Massachusetts Investors Trust, State Street Investment Corporation and U.S. and Foreign Securities Corporations. In Canada, during 1920s many close ended investment companies were organized. The first mutual fund in Canada to issue its share to general public was the Canadian Investment Fund in 1932.

Subsequently hundreds of mutual funds emerged and expanded their wings in many countries in Europe, the Far East and Latin America. In recent years mutual funds in Japan and Far East countries have been showing excellent performance probably as a result of growth and performances of the economies of these countries and their capital market. Countries in Pacific area like Hong Kong, Thailand, Singapore and Korea have also entered this field in a long way. Mauritius and Netherlands are emerging as tax heavens for offshore mutual funds. Thus, mutual fund culture is now global in scope.

13.2 SCHEMES OF MUTUAL FUNDS

Schemes of mutual funds refer to the products they offer to investors. Investors are to choose out of such schemes as per their objectives of earnings. Mutual funds adopt different strategies to achieve these objectives and accordingly offer different schemes of investments as per the need of investors. Schemes can be grouped as under:

13.2.1 OPERATIONAL CLASSIFICATION

Open Ended Schemes: Such schemes accept funds from investors by offering its units on a continuing basis. Such fund even stands ready to buy back its securities at any time. It implies that the capitalization of the fund is constantly changing as investors sell or buy their shares or units (shares in USA, unit in India). Further, these shares or units are normally not traded on the stock exchange. Open ended schemes have comparatively better liquidity despite the fact that these are not listed. The reason is that investor can any time approach mutual fund for sale of such units. No intermediaries are required. Moreover, the realizable amount is certain since repurchase is at a price based on declared net asset value.

No minute to minute fluctuations in rates haunt the investors. In such funds, option to reinvest its dividend is also available.

Close Ended Schemes:

Such schemes have a definite period after which their units are redeemed. Unlike open- ended funds, these funds have fixed capitalization, i.e. their corpus normally does not change throughout their tenure. While open ended funds are repurchased or sold directly by mutual funds on the basis of NAV, the close ended fund units being quoted on the stock exchanges are traded amongst the investors in the secondary market. Their price is determined on the basis of demand and supply in the market. Their liquidity depends on the efficiency and understanding of the engaged broker. Their price is free to deviate from the NAV, i.e., there is every possibility that market price may be above or below its NAV.

From management point of view, managing close ended scheme is comparatively easy since fund managers can evolve and adopt long term investment strategies depending on the life of the scheme. Need for liquidity arises after comparatively longer period, i.e. normally at the time of redemption.

There is a variant of close ended scheme known as Interval Scheme. It is basically a close ended scheme with a peculiar feature that every year for a specified period (interval) it is made open. Prior to and after such specified interval the scheme operates as close ended. During the said period mutual fund is ready to buy or sell the units directly from or to the investors.

13.2.2 RETURN-BASED CLASSIFICATION

To meet the diversified needs of investors, the mutual fund schemes are designed accordingly. Basically, all investments are made to earn good returns. Returns expected are in the form of regular dividends or capital appreciation or a combination of these two. In the light of this fact, mutual fund schemes can also be classified into three categories on the basis of returns.

Income Funds

For Investors who are more curious for regular returns, Income Funds are floated. Their object is to maximize current income. Investment is made in fixed income securities like bonds debentures. Such funds distribute periodically the income earned by them. These funds can further be split up into two categories i.e. those that target constant income at relatively low risk and those that attempt to achieve the maximum income possible, even with the use of leverage. Obviously the higher the expected return, the higher the potential risk of the investment.

Growth Funds

Such funds aim at appreciation in the value of the underlying investments through capital appreciation. Such funds invest in growth oriented securities i.e. in shares of companies which can appreciate in long run. Growth funds are also known as Nest eggs or Long haul investments. An investor who selects such fund should be able to assume a higher than normal degree of risk.

Conservative Fund

The funds with a philosophy of all things to all issue offer document announcing objectives as: (1) To provide a reasonable rate of return. (2) To protect the value of investment and, (3) To achieve capital appreciation consistent with the fulfillment of the first two objectives. Such funds which offer a blend of all these features are known as conservative fund. These are also known as middle of the road funds. Such funds divide their portfolio in common stocks and bonds in a way to achieve the desired objectives. Such funds have been most popular and appeal "to the investors who want both growth and income.

13.2.3 INVESTMENT-BASE CLASSIFICATION

Mutual funds may also be classified on the basis of securities in which they invest. Basically, it is renaming the sub-categories of return-base classification.

Equity Fund

Such funds, as the name implies, invest most of their investible funds in equity shares of companies and undertake the risk associated with the investment in equity shares. Such funds are clearly expected to outdo other funds in a rising market, because these havealmost all their capital in equity. A special type of equity fund is known as 'Index Fund' or 'Never beat market fund'.

These are known as Index funds since these funds transact only those scrips which are included in any specific index e.g., the scrips which constitute the BSE-30 Sensex or 100 shares National index. Due to the overall poor performance of managed funds this type of fund has emerged. The fund consists of a portfolio designed to reflect the composition of some broad based market index and it is done by holding securities in the, same proportion as the index itself. The portfolio of the index fund is constructed in exactly the same proportion with respect to rupees involved. The value of such index linked funds will go up whenever the market index goes up and conversely, it will come down when the market index comes down. Such fund is not to beat a specific index but is to match that index. These funds have comparatively lower operating costs.

Bond Fund

Such funds have their portfolio consisting of bonds, debentures, etc. This type of fund is expected to be very securing with a steady income but with little or no chance of capital appreciation. Obviously risk is low in such funds. In this category we may come across the funds called Liquid funds which specialize in investing short-term money market instruments. The emphasis is on liquidity and is associated with lower risks and low returns.

Balanced Fund

The funds which have in their portfolio a reasonable mix of equity and bonds are known as balanced funds. Such funds will put more emphasis on equity share investments when the outlook is bright and will tend to switch to debentures when the future is expected to be poor for shares, majority of funds fall in this category, of course, their mix- proportion varies. Fund of Funds (FOF)

It is a mutual fund scheme that invests in other mutual funds schemes instead of investing in securities. Such schemes are prevalent in international markets. These schemes can have different investment patterns and investment strategies as disclosed in offer documents. The investors may invest their funds in those FOF schemes which meet their investment objectives instead of investing in different schemes of a mutual fund and keeping track of their NAVs. Such FOF schemes may invest in other sector specific schemes or those schemes which have more weight age of certain stocks and can exit from those schemes when growth prospects of those sectors are not good. The investors putting their money in one sector specific scheme may not be able to decide when to exit.

13.2.4 SECTOR-BASED CLASSIFICATION

There are number of funds that are directly investing in a specified sector of an economy. While such funds do have the disadvantage of low diversification by putting all their eggs in one basket, the policy of specializing has the advantage of developing in the fund managers an intensive knowledge of the specific sector in which they are investing. The specialized sectors can be (i) gold and silver, (ii) real estate, (iii) specific industry say oil and gas companies, (iv) off shore investments, etc.

13.2.5 LEVERAGE-BASED CLASSIFICATION

Some mutual funds broad base their investible funds by borrowings from the market and then make investments thereby making leverage benefits available to the mutual fund investors. Such funds are known as 'leveraged funds'. It depends on the regulatingprovisions in a country whether borrowings are allowed or not. Normally leverage funds use short sale, which allows the management of the fund to avail the advantage of declining markets in order to realize gains in the portfolio. Leverage funds also use options specifically call options.

13.2.6 OTHER FUNDS

There are some other types of schemes which do not fit into the above given classifications. Some of such funds are mentioned here. There are 'load funds' and 'no-load funds'. In load funds, the mutual funds charge a fee over and above the net asset value from the purchaser. In No load funds no load-fee is charged because little sales efforts are made to promote the fund's sales except through direct advertising. Mutual funds schemes can also be designed to offer some tax exemption. Besides these, there are money market mutual funds which interact only in money market.

Off-shore mutual funds (also known as regional or country funds) are the funds mobilizing funds abroad for deployment in local market. Many mutual funds abroad have floated property funds, art funds, commodity funds, energy funds, etc.

One point needs to be viewed that irrespective of classification of schemes, every scheme will be either an open ended scheme or a close ended scheme.

13.3 MUTUAL FUNDS IN INDIA

In India mutual fund concept took root only in the nineteen sixties, after a century old history elsewhere in the world. Reacting to the need for a more active mobilization of household savings to provide investible resources to industry, the idea of first mutual fund in India i.e. UTI born out of the far sighted vision of Sri T. T. Krishnamachari, the then Finance Minister. UTI in 1964 started with a unit scheme popular as "US-64". Since Unit Trust of India was the result of a special enactment, no other open end mutual fund activities could emerge because of restrictive conditions of Indian Companies Act, 1956. Of course, close end investment companies existed for in-house investments as well as portfolio investment for a long time. But their activities were again on restricted scale.

In 1987 the monopoly of UTI came to an end when Government of India by amending Banking Regulation Act enabled commercial banks in Public sector to set up mutual funds as their subsidiaries. First of all State Bank of India got a nod from RBI. Next to follow was Canara Bank. It was the Abid Hussain Committee's unequivocal support to the concept that could be accepted as something of a landmark. It called for a greater number of mutual fund players. LIC and GIC also entered the field of mutual funds. During 1987-92, nine mutual funds came into being with investible resources Rs. 37000 crores. This amount was only 4563 crores up to June 1987. Major share was of UTI.

13.4 CONSTITUTION OF MUTUAL FUNDS

SEBI, in its regulations contemplated a four-tier system for managing the affairs of Indian mutual funds ensuring arm's length distance between the sponsor and the fund. Since mutual fund is a specialized type of financial institution which acts as investment conduit for investors at large especially the small investors, the authorities are concerned about the investors' safeguards. Accordingly SEBI regulations are drafted to give a specific direction to the constitution and management of mutual funds. These provisions are designed to safeguard investors, check speculative activities of mutual funds and ensuring financial discipline through transparency and fair play. Regarding constitution, SEBI (Mutual Fund)Regulations require a four tier system to organize mutual fund, these being Sponsor, Trustee, Assets Management Company and Custodian.

Self check exercise

MCQ 1. What is the primary objective of a Mutual Fund?
A. Guaranteeing fixed returns
B. Speculative trading
C. Attractive yields and appreciation in value
D. Providing loans to investors

2. Where did the formal origin of the concept of a mutual fund take place?
A. United States
B. England
C. Belgium
D. Canada

3. Which type of mutual fund scheme constantly changes its capitalization as investors buy or sell shares?
A. Closed-Ended Scheme
B. Index Fund
C. Open-Ended Scheme
D. Leveraged Fund

4. What does NAV stand for in the context of mutual funds?
A. Net Asset Value
B. Non-Aligned Value
C. National Asset Valuation
D. Net Appreciation Value

5. Income Funds primarily aim to:
A. Maximize current income
B. Achieve capital appreciation
C. Outperform the market index
D. Speculate in the stock market

6. Which type of fund invests mainly in equity shares and takes on the associated risks?
A. Bond Fund
B. Conservative Fund
C. Equity Fund
D. Balanced Fund

7. What is the term used for funds that invest in other mutual fund schemes instead of securities?
A. Index Funds
B. Bond Funds
C. Fund of Funds (FOF)
D. Conservative Funds

8. Who is responsible for deciding about the sale and purchase of securities in a mutual fund?
A. Fund Manager
B. Trustees
C. Custodians
D. Sponsors

9. What is the primary function of a Fund Manager in a mutual fund's investment department?
A. Safeguarding securities
B. Collecting income/dividends
C. Deciding investment strategies
D. Executing sale and purchase transactions

13.4.1 SPONSORS

It refers to anybody corporate which initiates the launching of a mutual fund. It is this agency which of its own, if eligible or in collaboration with other body corporate complies the formalities of establishing a mutual fund. The sponsor should have a sound track record and experience in the relevant field of financial services for a minimum period of 5 years. SEBI ensures that sponsors should have professional competence, financial soundness and general reputation of fairness and integrity in business transactions. Every mutual fund shall be registered under the said regulations and it is the sponsor who files an application (format is prescribed) with fee to SEBI. Sponsor is also to contribute at least 40 per cent of the net worth (Rs. 4 crore) of the Asset Management Company. It is the sponsors who identify and appoint the trustees and AMC. Sponsors are to appoint a board of trustees as well as to get the AMC incorporated. It is the duty of sponsors to submit to SEBI the trust deed and draft of memorandum and Articles of Association of AMC. Once MF is registered, the sponsors technically go in background.

13.4.2 TRUSTEES

A mutual fund is to be constituted as a Trust under Indian Trust Act and trustees are to look after the trust. A trustee is a person who holds the property of the mutual fund in trust for the benefit of the unit holders. A company is appointed as a trustee to manage the mutual fund with approval of SEBI. To ensure fair dealings, at least 75 per cent of the trustees are to be independent of the sponsors. Trustees take into their custody, or under their control all the property of the schemes of mutual fund. It is the duty of the trustees to provide information to unit holders as well as to SEBI about the mutual fund schemes. Trustees are to appoint Asset Management Company (AMC) to float the schemes. The trustees are to evolve Investment Management Agreement to be entered into with AMC. It is trustee's duty to observe and ensure that AMC is managing schemes in accordance with the trust deed.

Trustees can dismiss the appointed AMC. It is the responsibility of trustees to supervise the collection of any income due to be paid to the scheme. Trustees for their services are paid trusteeship fee which is to be specified in the trust deed. Trustees are to present annual report to the investors.

Mutual fund is basically a principal - agent problem where the principle is unit holder who hires an agent i.e., mutual fund (trustees) and the principal tries to ensure and expects that actions of the agent are in the best interest of the former. Mutual funds by nature are custodians of the money of investors (specially the small investors who do not excel in investment activities) entrusting their savings in the belief that the former have better expertise and skills for investing than of their own.

SEBI regulations desire appointing a trustee either as individuals, comprising a board of trustee, or a trustee company. Traditionally mutual funds have been operating with a board of trustees but some new entrants in this field have opted for a company to be appointed as a trustee to manage the mutual fund. The main reason why a trustee company is preferred over a board of trustees is that in their individual capacity, boards of trustees have an unlimited liability. Consequently, their personal property may be at stake if a scheme fails. Whereas for trustee company board of directors have limited liability.

Trustees are regulated by a Trust- Deed which is to be submitted to SEBI. The trustees

are to manage the Mutual Fund in accordance with the laws, regulations, directions and guidelines issued by SEBI, the stock exchanges and other governmental and regulatory agencies. They are to hold in safe custody and preserve the mutual fund's property. Trustees are to report on operations to SEBI and the Unit holders. They are to ensure that AMC has been diligent in conducting the affairs.

The trustees' working has been made subject to a code of conduct. To ensure fair dealings, mutual fund regulations require that one cannot be a trustee or a director of a trustee company in more than one mutual fund. Further, at least two- third of the trustees are to be independent of the sponsors. These independent trustees, of course, enjoy multi trusteeship.

Asset management company or its directors or employees shall not act as trustees of any MF. Trustees should be persons with experience in financial services. Every trustee should be a person of ability, integrity and standing. Trustees appoint Asset Management Company (AMC) to float the schemes in consultation with sponsors. The trustees are to evolve Investment Management Agreement (IMA) to be entered into with AMC.

It is trustee's duty to observe and ensure that AMC is managing schemes in accordance with the trust deed.

Trustees can dismiss the AMC. It is the responsibility of trustees to supervise the collection of any income due to be paid to the scheme. Trustees for their services are paid trusteeship fee which is to be specified in the trust deed. Trustees are to present annual report to the investors. They can call a meeting of the unit holders if a requisition is filed. Rights and obligations of the trustees under SEBI (Mutual fund) Regulations along with due diligence (general and specific) is as under:

13.4.3 CUSTODIANS

In a mutual fund depending on its size there is substantial work involved in managing the scrips bought from and sold in the market. Their safe custody and ready availability is to be ensured. SEBI requires that each mutual fund shall have a custodian who is not in any way associated with the Asset Management Company. Such custodian cannot act as sponsor or trustee of any mutual fund. Further, custodian is not permitted to act as a custodian to more than one mutual fund without the prior approval of SEBI. A custodian's main assignment is safekeeping of the securities or participation in any clearing system on behalf of the client to effect deliveries of the securities. The custodian, depending on terms of agreement, also collects income/dividends on the securities. Some of the other associated assignments of custodians axe:

- Ensuring delivery of scrips only on receipt of payment and payment only upon receipt of scrips.
- Regular reconciliation of assets to accounting records.
- Timely resolution on discrepancies and failures.
- Securities are properly registered or recorded.

Depending on the volume there can be co-custodian(s) for a mutual fund.

These custodians are entitled to receive custodianship fee, based on the average weekly value of net assets or sale and purchases of securities along with per certificate custody charges.

13.4.4 ASSETS MANAGEMENT COMPANY (AMC)

The sponsor or the trustees appoint an AMC, also known as 'Investment Manager', to

Manage the affairs of the mutual fund. It is the AMC which operates all the schemes of the fund. Any AMC cannot act as a trustee of any other mutual fund. AMC can act as an AMC of only one mutual fund. AMC is not permitted to undertake any business activity except activities in the nature of management and advisory services to off shore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis, if these activities are not in conflict with the activities of the mutual fund. It can also operate as an underwriter provided it gets registered under SEBI (Merchant Bankers) Regulations. SEBI regulations in this matter are as under:

The asset management company shall:

(1) Not act as a trustee of any mutual fund;

(2) Not undertake any other business activities expect activities in the nature of portfolio management, services management and advisory services to offshore funds, pension funds, provident funds, venture capital fund, and management of insurance funds. Financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual funds. (Asset management company shall meet capital adequacy requirements, if any, separately for each such activity and obtain separate approval, if necessary under the relevant regulations);

(3) not investment in any of its schemes unless full disclosure of its intention to invest has been made in the offer documents an asset management company shall not be entitled to charge any fees on its investment in that scheme.

SEBI desires that assets Management Company should have a sound track record (good net worth, dividend paying capacity and profitability, etc.), general reputation and fairness in transaction. The directors of AMC should be expert in relevant fields like portfolio management, investment analysis and financial administration because any AMC is basically involved in these three activities. An AMC is expected to operate independently. SEBI regulations require that at least fifty per cent of the directors should be those who do not have any association with sponsor or trustees, Its Chairman should be an independent person. To ensure stake of sponsors in the AMC, it is required that at least 40 per cent of its net worth is contributed by the former, AMC, itself should be financially sound and should have a net worth of at least Rs. 10 crores. All these provisions are to ensure good governance of mutual funds in India.

Working Mechanism of AMC

The major strength of any AMC lies in its investment function. Investment function is a specialized function which, depending on operational strategies of AMCs, can further be divided into specialized categories. The Investment Department operates with the following set up:

Fund Manager

Asset Management Companies manage the investment of funds through a fund manager. The basic function of a fund Manager is to decide about which, when, how much and at what rate securities are to be sold or bought. To a great extent the success of any scheme depends on the caliber of the fund manager.

For many mutual funds especially in bank sponsored funds, the entire investment exercise is not left to one individual. They have created committees to handle their investments. One such mutual fund has created two committees. First is 'Investment

Committee' which is a broad based committee having even nominees of the sponsor. It decides about the primary market investments. The second is a Market Operation Committee having the assignment of disinvestments and interacting with secondary market. It is normally an in-house committee. These committees also make their judgments on the basis of data provided by the research wing.

Research and Planning Cell

It performs a very sensitive and technical assignment. Depending on the operational policies, such unit can be created by AMC on its own or research findings can be hired from outside agencies. The research can be with respect to securities as well as prospective investors. The fund manager can contribute to the bottom line of mutual fund by spotting significant changes in securities ahead of the crowd. In India, at present many funds depend on outsiders. Such outsiders need not be technical analyst; even brokers provide tips to mutual funds. Such a strategy saves a lot of funds to be invested in research infrastructure. The new mutual funds with small corpus can hardly afford to have their own data base. But there are mutual funds following the philosophy; your expertise is your original research.

Dealer

To execute the sale and purchase transactions in capital or money market, a separate section may be created under the charge of a person called dealer having deep understanding of stock market operations. Sometimes, this division is under the charge of marketing division of AMC. Dealer is to comply with all formalities of sale and purchase through brokers. Such brokers are to be approved by Board of Directors (B.O.D.) of AMC. It is B.O.D. which lays down the guidelines for allocation of business to different brokers.

FUNCTIONS OF AMC

It is not required that AMC performs all its functions on its own. It can hire services of outside agencies as per its requirements some of the common functions performed by mutual funds are listed below:

(a) One of the main functions of mutual fund is receiving and processing the application forms of investors, issuing unit certificates, sending refund orders, recording all transfers of units and maintaining all such records, repurchasing the units, redemption of units, issuing dividend or income warrants. If the volume of work is huge and needs specialized expertise, mutual funds may engage the services of Registrars and Transfer Agents. For such services they are entitled to a fee which is in proportion to the number of unit-holders and number of transactions, etc. Such fee is charged by AMC from the mutual fund and is paid to the agents.

Computing the net asset value per unit of the scheme, maintaining its books and records, maintaining compliance with the schemes investment limitations as well as the SEBI Regulations and other regulations, preparing and distributing reports on the scheme of the unit holders and SEBI and maintaining the performance of mutual funds custodians, recording all accounting transactions maintaining their records etc. is another group of activities under taken which can be termed as Fund Accounting. Again depending on the size of the fund, its age and number of expected transactions Fund Accounting may be assigned to specialized agencies. In India, in the absence of rigorous accounting norms, this service hardly availedof outsiders but in times to come outside agencies will be required.

(b) Activities of intermediaries such as advertising agency, printers, collection centres and marketing of the services are to be coordinated.

13.5 SUMMARY

Mutual Fund is a non-fund based special type of institution which acts as an investment conduit. It is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with an avowed objective of attractive yields and appreciation in their value. A Mutual Fund is a Financial Service Organization that receives money from shareholders, invests it, earns returns on it, attempts to make it grow and agrees to pay the shareholder cash on demand for the current value of his investment. A Mutual fund offers investors a proportionate claim on portfolio of assets that fluctuates in value with the value of the assets that make up the intermediaries portfolio. It is rather difficult to give a comprehensive concept of a mutual fund. What is a mutual fund is better understood by the functions it performs and role it plays. It is a non-depository financial intermediary. Mutual funds are mobilized of savings, particularly from the small and household sectors, for investments in stock and money markets. Mutual funds mobilize funds by selling their own shares also known as units. When an investor owns a unit in mutual funds he owns a proportional share of the securities portfolio held by a mutual fund. In other words, share of a mutual fund actually represents a part share in many securities that it has purchased. Mutual fund share/unit certificate combines the convenience and satisfaction of owning shares in many industries. Thus, mutual funds are primarily investment intermediaries which pool investors' funds to acquire individual investments and pass on the returns thereof to fund investors.

13.6 KEYWORDS

- AMC: An agency which evolve policies for investments and disinvestment of the corpus of schemes of a mutual fund.
- Closed End Scheme: A scheme which terminates after a specific period.
- Corpus: Total funds with a scheme at any time.
- Custodian: An agency for the handling and safekeeping of funds, cash and securities.
- Fund: In India fund refers to a mutual fund whereas in U.S.A. fund refers to one scheme. One fund may launch many schemes in India.
- Funds Manager: An individual or a group of individuals who make sale and purchase of securities for the schemes of a mutual fund.
- Load: It is the charge levied on those who purchase units of a scheme after the initial issue of the scheme. It can be back-end load or front-end load.
- Mutual Funds: An agency collecting savings, investing them to get better returns and share returns with contributors.

Self check exercise

10.Which classification of mutual funds involves investing in a specified sector of the economy?

A. Leverage-Based

B. Sector-Based

C. Return-Based

D. Operational Classification

11.In the context of mutual funds, what does AMC stand for?
A. Asset Management Consortium
B. Annual Mutual Contribution
C. Asset Management Company
D. All Mutual Currencies

12.What does SEBI stand for in the context of mutual funds in India?
A. Securities and Exchange Board of India
B. State Equity Bureau of Investments
C. Systematic Exchange of Bond Investments
D. Securities and Exchange Bureau of Investment

13.Who appoints the Asset Management Company (AMC) in a mutual fund structure?
A. Trustees
B. Custodians
C. Sponsors
D. Unit Holders

13.7 PRACTICAL QUESTION

Short answer type question

(1) Discuss the features of different types of schemes which a mutual fund normally launches.

(2) SEBI (MF) Regulations ensured diversification of portfolio.

Long answer type question

(1) Identify the specific provisions for this and their need.

(2) 'SEBI (MF) Regulations have made trustees more responsible'. Discuss.

13.8 Self check exercise (ANSWER KEY)

1(C),2(C),3(C),4(A),5(A),6(C),7(C),8(A),9(C),10(B),11(C),12(A),13(A)

MBA-DE(Second Year)

Semester-Ill

MFI 308
MANAGEMENT OF FINANCIAL INSTITUTIONS

Lesson No. 14

AUTHOR:Dr. DHIRAJ SHARMA

PERFORMANCE EVALUATION OF MUTUAL FUNDS

STRUCTURE

14.0 Objectives
14.1 Fund Management by MF
14.2 Performance Evaluation of Mutual Funds
14.2 Summary
14.3 Questions for Review
14.4 Keywords
14.5 Suggested Readings
14.6 Self-check exercise (Answer key)

14.0 OBJECTIVES

The objectives of this lesson are to understand:

- Managing a Mutual Funds
- Fund/Portfolio Management Process
- Performance Evaluation of Mutual Funds

14.1 FUND MANAGEMENT BY MFS

Fund/Portfolio management involves four steps:

(a) Setting investment goal of scheme;
(b) Identification of specific securities;
(c) Portfolio designing; and d) Revising the portfolio.

(a) Setting Investment Goal of Scheme

The ultimate goal of a mutual fund scheme is to serve the investor in the best possible way. Thus, to set up its investment goals a mutual fund has to study its investors' perception and requirements. One class of investor may like to take higher risks and the other class of investors wants to play safe with an eye on appreciation too. The mutual fund manager has to evolve a portfolio and set investment goals through a process of compromising in a way which satisfies majority of clients which the scheme aims at. It is impossible for mutual funds to perfectly match the objectives of its portfolio design to the expectation and risk-taking capacities of each and every individual. That is why in such situation comparatively bigger investors go in for portfolio managers instead of mutual funds. This is one reason why mutual funds are said to be friendly with medium and small investors.

(b) Identifying Specific Securities

Once the goal of a scheme is clearly spelled out, the fund manager has to involve himself in security analysis to identify securities which can be combined to meet the goal requirements. For each security, risk and return characteristics are evaluated in broader perspective. In this process sometimes, the fund manager or advisor first analyses each industry and then identifies specific scrips in specific industry. In practice, it is impossible for a fund manager to evaluate each and every security. Therefore, they may restrict their analysis exercise to those securities which prima facie have a good chance of being included in the final portfolio.

(c) **Portfolio Designing**

For no two schemes same investment portfolio can be followed. So far as the broad portfolio mix is concerned it is specified by the fund manager while launching a scheme. But more important is the mix to be given shape practically, with shares, debentures etc. to be bought, how much and when are some of the very crucial questions to be answered. To answer these questions fund managers have to do a lot of research. Gathering reliable and dependable information is significant. Market participants that do nothing to enhance their knowledge of financial conditions and prospects of firms are certainly to be on the unprofitable side of trade vis-a-vis participants that update their information regularly. It is on the basis of this information they can chalk out their long-term and short-term investment strategies. Building the portfolio follows the identification of specific securities. A fund manager tries to create a well-diversified portfolio of securities to reduce significantly unsystematic risk. His effort is to associate expected returns on individual security and portfolio as a whole with market or systematic risk.

To maintain liquid resources in the scheme a part of the scheme corpus is invested in money market instruments. Daily surplus cash resources are earmarked after setting aside money for expenses and primary/secondary market purchases. These can be deployed in one market. Surplus which may not be required overnight are invested in other instruments like government securities, commercial papers, certificates of deposits, treasury bills etc.

Mutual funds in India are to some extent regulated even for building their portfolio. MFs can invest only in rated debt instruments. They cannot invest in unlisted securities. No mutual fund should own more than 10 per cent of any company's paid up capital carrying voting rights. Every scheme is permitted to invest in other schemes of the same MF but not exceeding 5 per cent of net asset value. Investment can be made only in transferable securities in money market or capital market. Till end 1997 Indian mutual funds were permitted to invest only in Indian markets but after RBI's green signal now mutual funds have been permitted to invest in foreign markets up to a prescribed limit without any prior permission.

(d) **Reviewing the Portfolio**

Once build up, portfolio may not be continued for all times to come since the risk return characteristics of all securities go on changing with time. In a dynamic investment world it is somewhat natural that once designed portfolio may not perform as desired. Further, new securities may be introduced in the market and old one may be shunted out. Thus, to stick to a portfolio by mutual fund is not desirable. To maximize the return on investment, all possible favorable opportunities are to be availed thus a turnover in the portfolio is a must. What should be the turnover is a difficult question to answer. In an income-oriented scheme, turnover may be lesser as compared to growth oriented scheme.

Depending on the perception of the investment committee or fund manager, a part of portfolio is fixed and remaining is used for trading. Whether the fund manager reviews the portfolio mix in routine or due to external factors, every time a fresh risk-return exercise is undertaken for the whole portfolio to evaluate the desirability of the mix.

14.2 PERFORMANCE EVALUATION OF MUTUAL FUNDS

Performance of a mutual fund should be measured against its stated objectives. If the fund's goal is to produce maximum current income, it will be the main factor for evaluation.

If the objective is obtaining capital gains without emphasis on dividend income, then this will be the important factor to be measured. Traditionally, the performance of a mutual fund is measured in India by summing the effect of two different things (1) changes in the net asset value (NAV) or market value, and (2) the amount of income dividends paid. This information is usually provided annually as an index of performance. This index may be compared to stock averages, or to an index of performance of other mutual funds. The periodic disclosures, annual reports and the prospectus of the mutual funds provide performance information in varying degrees of detail. Let us discuss some such parameters:

Net Asset Value (NAV)

NAV of a scheme indicates the intrinsic value of a unit under the scheme. It is the value which the unit holder can hope to get, if the scheme is wound up at the moment and all assets and liabilities are liquidated.

NAV per unit = (a - b) /c

Where:

a is total market value of investment portfolio, total written down value of fixed assets and the cost value of other current assets, b is Current liabilities

C is Number of outstanding units in that scheme.

NAV depends upon the valuation of the portfolio of the mutual fund. Higher valuation inflates NAV and under valuation lowers the NAV. NAV is relevant in the context of a particular date. Mutual funds in past have been playing with NAV figure favoring one set of investors and putting others at loss just by virtue of valuation practices. Thus, valuation criterion of the investment portfolio has been spelled out by SEBI in 1996 regulations. NAV is to be calculated every day for open ended scheme and at least once a week for close ended scheme.

Load Initial expenses incurred by a scheme are referred to as load of the scheme. If a scheme bears this load it is known as load scheme. It has been mentioned earlier SEBI permits every scheme to write off a maximum of 6 per cent of its corpus as initial expenses thus load can be up to 6 per cent only. On account of this load (say whole 6 per cent is load) Rs. 100 invested in a scheme give Rs. 94 to the fund manager to invest. As a result mutual fund units generally quote below par on listing. In a no load scheme this load is borne by the AMC and is not charged to the scheme. Thus, the entire amount mobilized gets invested in the scheme and is reflected in higher NAV. Hence 'no-load' schemes are gaining popularity.

Disclosures

Operational efficiency can also be disclosed through half yearly results and annual report. SEBI has spelled out for mutual funds the formats of Annual Report, Half- yearly financial results Report, Balance Sheet, Revenue Account (You may consult the Regulations). Distribution of annual reports of Scheme is obligatory. MFs are to disclose their portfolio to increase transparency in their operations. Investors are disclosed historical per unit statistics for three years by MFs. Facts regarding gross income per unit, per unit ratio of expenses to average net asset by percentage, per unit gross income to average net asset by percentage, etc., are also to be disclosed as desired by SEBI.

Returns

Mutual funds primarily serve the investors by providing returns on the investment by the latter. Returns are earned in form of (a) appreciation in value of investments made by mutual funds and (b) dividend or interest received on the investment made. Such returns of

Mutual funds are subject to expenses incurred, by them. SEBI, to protect interest of investors, desires through its regulations that such expenses incurred should be reasonable. These expenses can be trusteeship fee, management fee, administrative expenses, fund accounting fee, custodian fee, initial charges, etc.

SEBI has laid down limits on certain specific expenses and besides that an overall limit on expenses are fixed. AMC can charge management fee up to 1.25 per cent of weekly average net asset if such assets are up to Rs. 100 crore in a year and one per cent if these assets exceed Rs. 100 crore. This limit is increased up to additional one per cent if AMC is managing a no load scheme. Further, AMC cannot charge from mutual fund initial expenses of launching a scheme exceeding 6 per cent. SEBI, still further requires that over all expenses excluding expenses of issue or redemption shall not exceed 2.5 per cent on first Rs. 100 crore of average weekly net assets, 2.25 per cent on next Rs. 300 crores, 2 per cent on next Rs. 300 crores and 1.75 per cent on balance of the assets.

All these limits prescribed by SEBI are the maximum that mutual funds can charge but practice in India had been that they charge these as such assuming these to be the minimum limit. When investors are not provided sufficient returns, they blame AMC for charging fee and expenses irrespective of returns to them. But one should not forget that if AMC continues to charge maximum permissible fee without providing reasonable returns to investors, investors may not subscribe to their schemes in future. SEBI has permitted MFs to assure returns to investors provided AMC stands guarantee to it on its own or its sponsor.

A common way of measuring the performance of a mutual fund management is by comparing the yields of the mutual fund, i.e. the managed portfolio, with the market or with a random portfolio. The portfolio yield is also calculated like the holding period yield where; NAVx is net asset value per share at the end of year x,Dx is the total of all distributions per unit during the year x and NAVx-1 is net asset value per share at the end of the previous year, then the portfolio yield is :

$$\frac{(NAV + Dx)_1}{NAVxl}$$

For Instance, if NAV * is Rs.110/- DX is Rs.15, and NAV * - 1 is Rs.100.

The yield will be:

$$\frac{110+15}{100}$$

The so calculated yields of the mutual fund portfolio and unmanaged portfolio are then compared. The one which has the higher yield will be deemed to be the better managed portfolio.

Generally, the average investment returns increase as risk increases. Equities yield more than the bonds as they are riskier. Because of this, mutual funds with portfolios of equities should yield more than portfolios of bonds. Portfolio risk may be measured by the average beta and alpha of the portfolio. The recent trend in the measurement of mutual fund performance is towards risk adjusted performance.

While measuring the efficiency and reliability of a mutual fund's performance several models were conceived considering both risk and return. In some models characteristic regression lines of the portfolios are estimated with equations. Dr Michael C. Jensen modified the characteristic regression line to make it useful as one parameter of investment performance measure. The basic random variables in Jensen's model are risk premiums. In Jensen's characteristic line, the alpha intercept is a regression estimate of the excess returns

from a particular asset. This alpha estimates the excess returns averaged over the sample period used to estimate the characteristic line regression.

Beta is the beta coefficient arid is an index of systematic risk used for ranking the systematic risk of different assets. Beta measures how much the price of a given security is expected to rise and decline in case of rise or decline in the security market. Alpha measures whether the returns on the security are expected to be better or worse than the average security. Whenever portfolio performance is sought to be measured on a risk adjusted basis portfolio beta and alpha values are calculated. Then, a theoretical portfolio having beta and alpha characteristics close to those of the real portfolio is created. The performance of the real portfolio is compared to the theoretical portfolio. Since the risk characteristics of both are same, if the real portfolio returns exceed those of such theoretical portfolio, it can be assumed that the fund had performed well relative to its risk level.

14.3 SUMMARY

The basic purpose of mutual fund is to facilitate the investment process, especially of small investors besides acting as a mobilizing agent. To meet the varied needs of investors, different products/ schemes are offered. At initial stage mutual fund industry took the investors for granted but as investors became disillusioned, mutual funds started mending their ways. Their day-today working is regulated by SEBI regulations which have been revised as and when need was felt to ensure better service and protection to investors. NAV is the basic parameter to comment on efficiency of mutual funds. Primarily mutual funds should strive for better performance as an institutional investor as compared to performance what one average individual can attain. Efforts should be made by them to minimize the operating expenses to maximize the returns. Governance of mutual funds is a continuous challenge for the industry and AMFI.

Self check exercise

1. What is the first step in the fund/portfolio management process?

a) Portfolio Designing

b) Setting Investment Goal of Scheme

c) Identifying Specific Securities

d) Reviewing the Portfolio

2. Why do medium and small investors find mutual funds more favorable than portfolio managers?

a) Lower risk

b) Higher returns

c) Friendliness towards small investors

d) Better portfolio management

3. What is the primary goal of a mutual fund scheme?
a) Maximizing profits for investors
b) Meeting the expectations of every individual investor
c) Serving the investor in the best possible way
d) Matching objectives of portfolio design perfectly

4. What does the fund manager evaluate for each security during the identification phase?
a) Market conditions
b) Risk and return characteristics
c) Industry trends
d) Mutual fund regulations

5. What is the purpose of portfolio designing in mutual fund management?
a) To identify specific securities
b) To set investment goals
c) To create a well-diversified portfolio
d) To revise the portfolio

14.4 PRACTICE QUESTION

Short answer type question

1. Explain the following terms:
- Net Asset Value
- Close-ended Scheme
- Asset Management Company Mutual Funds

Long answer type question

1. What provisions do you think are there in SEBI regulations to protect the interest of investors?
2. Write a critical note on the growth of mutual funds in India.

14.5 KEYWORDS

- **NAV:** It is the intrinsic value (not face value) of a unit of a scheme.
- **Offer Document:** It is a document issued giving required details of a mutual fund scheme.
- **Open End Scheme**: A scheme which has no specific time frame for its operation.

Portfolio: A group of securities held together.

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14.7 Self check exercise (Answer key)

1(B),2(C),3(C),4(B),5(C)

MBA-DE(Second Year) **MFI 308**

Semester-Ill **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 15 **AUTHOR:Dr. DHIRAJ SHARMA**

INSURANCE SECTOR REFORMS IN INDIA

STRUCTURE

15 Objectives
15.1 Introduction
15.2. A Brief History
15.3. Insurance Sector Reforms in India
15.4. Impact of Liberalization
15.5. Insurance Industry In India
15.6 Summary
15.7 Keywords
15.8 Practice Exercise
15.9 Suggested Readings

15.10 Self check exercise (Answer key)

15.0 OBJECTIVES

After reading this lesson, you will understand:

- Insurance reforms in India
- Adverse selection and moral hazard in insurance
- Selling insurance
- Growth and organization of insurance companies.

15.1 INTRODUCTION

With such a large population and the untapped market area of this population Insurance happens to be a very big opportunity in India. Today it stands as a business growing at the rate of 15-20 per cent annually. Together with banking services, it adds about 7 per cent to the country's GDP .In spite of all this growth the statistics of the penetration of the insurance in the country is very poor. Nearly 80% of Indian populations are without Life insurance cover and the Health insurance. This is an indicator that growth potential for the insurance sector is immense in India. It was due to this immense growth that the regulations were introduced in the insurance sector and in continuation "Malhotra Committee" was constituted by the government in 1993 to examine the various aspects of the industry. The key element of the reform process was Participation of overseas insurance companies with 26% capital. Creating a more efficient and competitive financial system suitable for the requirements of the economy was the main idea behind this reform.

Since then the insurance industry has gone through many sea changes .The competition LIC started facing from these companies were threatening to the existence of LICsince the liberalization of the industry the insurance industry has never looked back and today stand as the one of the most competitive and exploring industry in India. The entry of the private players and the increased use of the new distribution are in the limelight today. The use of new distribution techniques and the IT tools has increased the scope of the industry in the longer run.

15.2. ABRIEF HISTORY

The origin of insurance is very old. The time when we were not even bom; man has

Sought some sort of protection from the unpredictable calamities of the nature. The basic urge in man to secure himself against any form of risk and uncertainty led to the origin of insurance.

The insurance came to India from UK; with the establishment of the Oriental Life insurance Corporation in 1818.The Indian life insurance company act 1912 was the first statutory body that started to regulate the life insurance business in India. By 1956 about 154 Indian, 16 foreign and 75 provident firms were been established in India. Then the central government took over these companies and as a result the LIC was formed. Since then LIC has worked towards spreading life insurance and building a wide network across the length and the breath of the country. After the liberalization the entrance of foreign players has added to the competition in the market.

The General insurance business in India, on the other hand, can trace its roots to the Triton Insurance Company Ltd., the first general insurance company established in the year 1850 in Calcutta by the British. In 1957 General Insurance Council, a wing of the Insurance Association of India, frames a code of conduct for ensuring fair conduct and sound business practices. In 1972 The General Insurance Business (Nationalization) Act, 1972 nationalized the general insurance business in India with effect from 1st January 1973. It was after this that 107 insurers amalgamated and grouped into four companies viz. the National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd. and the United India Insurance Company Ltd. GIC incorporated as a company.

15.3. INSURANCE SECTOR REFORMS IN INDIA

Observing the trends the industry has been moving for the last two years, the commitment of the players to take the business forward is quite apparent. With the increase in awareness level about the insurance and the products, the day is not far off all the insurable population in the country would have been brought under the insurance net. The Governments resolve to continue with the reforms coupled with investor friendly IRDA's regulations will surely take the business far.

Last one decade of reforms in India have started yielding the results in the Indian economy. The Government's resolve to push the reforms measures further, less bureaucratic hurdles, absence of red tapism, investors' friendly business environment all put together have given tremendous boost to the industries in terms of FDI and investments from FIIs. Though the impact is felt in all the sectors, service sector is the one which is most benefited out of all those reforms and the contribution of service sector to the GDP of the country has grown manifold. New economy organizations are spreading their wings into service industry like banking, financial services, insurance, communication, entertainment, and telecom and so on. And no wonder why India is considered to be the most preferred nation in the world for Business Process Outsourcing (BPO). The service industry in India has achieved a phenomenal growth in the recent past and among them, Insurance is one sector, which has witnessed high decibel growth thanks to the investor friendly regulator in the name of Insurance Regulatory Development Authority (IRDA). The growth the market has achieved in terms of 18-20% in life insurance and 15-17% in non-life insurance stands testimony to that.

Looking back at the history, the ride had not been so smooth to the public sector players like LIC, GIC and its subsidiaries. For a long time, the insurance policies are not

bought but sold in the country because of so many odd reasons like low awareness level, aversion towards the products as such, superstitious beliefs and less diverse product portfolio. The monolith in the life insurance sector, Life Insurance Corporation of India had been basking in its past glory and enjoying the monopolistic situation in the market. Even the General Insurers like GIC and its subsidiaries were able to reach the people with very few products out of many products in their kitty offering little or no options to the customers. The rules of the game have started changing with the introduction of reforms towards liberalization and privatization. In fact private sector participation in insurance is not new in the Indian context. In 1956, when the Government of India nationalized the business of life insurance, there were 245 private insurance companies operating in the country. And sixteen years later, when the same happened to General insurance, there were 106. But the seeds were sown as far back as 1993, when the Malhotra Committee headed by former Finance Secretary and Ex-RBI Governor R.N.Malhotra was created to recommend the directions the Indian industry should take. By 1994, the Committee was ready with its report.

The committee came up with the following major provisions:

- Private Companies with a minimum paid up capital of Rs. L Lakh should be allowed to enter the industry
- Foreign companies may be allowed to enter the industry in collaboration with the domestic companies
- Only one State Level Life Insurance Company should be allowed to operate in each state.

The salient suggestions included those on the structure of the industry, competition and the necessity and role of a regulator. The Committee also recommended the opening up of the industry to private sector to increase the reach of the insurance products. Essentially Malhotra was laying the foundation for the creation of regulation and the liberalization process.

IRDA

It was after this committee came into affect the regulatory body for insurance sector was formed with the name of IRDA. In April 2000, Insurance Regulatory Development Authority (IRDA) came into being as a statutory body to regulate the industry and to keep a hawk's eye on the private players. The mission of IRDA is "to protect the interests of the policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto". The IRDA since its incorporation as a statutory body has been framing regulations and registering the private sector insurance companies. IRDA being an independent statutory body has put a framework of globally compatible regulations.

What happened after April 2000 is well known in terms of new entrants in the field, the market growth rate and the achievements of new players within a short span of two to three years.

15.4. IMPACT OF LIBERALIZATION

The introduction of private players in the industry has added to the colors in the dull industry. The initiatives taken by the private players are very competitive and have given immense competition to the on time monopoly of the market LIC.Since the advent of the private players in the market the industry has seen new and innovative steps taken by the

players in this sector. The new players have improved the service quality of the insurance. As a result LIC down the years have seen the declining phase in its career. The market share was distributed among the private players. Though LIC still holds the 75% of the insurance sector but the upcoming natures of these private players are enough to give more competition to LIC in the near future. LIC market share has decreased from 95% (2002-03) to 81 %(2004-05).The following companies has the rest of the market share of the insurance industry.

Name of the Player	Market Share (%)
LIC	82.3
ICICI Prudential	5.63
Birla Sun Life	2.56
Bajaj Allianz	2.03
SBI Life	1.80
HDFC Standard	1.36
Tata AIG	1.29
Max New York	0.90
Aviva	0.79
Om Kotak Mahindra	0.51
ING Vyasa	0.37
AMP Sanmar	0.26
Metlife	0.21

15.5. INSURANCE INDUSTRY IN INDIA

India with about 200 million middle class household shows a huge untapped potential for players in the insurance industry. Saturation of markets in many developed economies has made the Indian market even more attractive for global insurance majors. The insurance sector in India has come to a position of very high potential and competitiveness in the market.

Innovative products and aggressive distribution have become the say of the day. Indians, have always seen life insurance as a tax saving device, are now suddenly turning to the private sector that are providing them new products and variety for their choice. Life insurance industry is waiting for a big growth as many Indian and foreign companies are waiting in the line for the green signal to start their operations. The Indian consumer should be ready now because the market is going to give them an array of products, different in price, features and benefits. How the customer is going to make his choice will determine the future of the industry.

Customer Service

Consumers remain the most important centre of the insurance sector. After the entry of the foreign players the industry is seeing a lot of competition and thus improvement of the customer service in the industry. Computerization of operations and updating of technology has become imperative in the current scenario. Foreign players are bringing in international best practices in service through use of latest technologies. The one time

Monopoly of the LIC and its agents are now going through a through revision and training programmes to catch up with the other private players. Though lot is being done for the increased customer service and adding technology to it but there is a long way to go and various customer surveys indicate that the standards are still below customer expectation levels.

Distribution Channels

Till date insurance agents still remain the main source through which insurance products are sold. The concept is very well established in the country like India but still the increasing use of other sources is imperative. It therefore makes sense to look at well- balanced, alternative channels of distribution.

LIC has already well established and have an extensive distribution channel and presence. New players may find it expensive and time consuming to bring up a distribution network to such standards. Therefore they are looking to the diverse areas of distribution channel to have an advantage. At present the distribution channels that are available in the market are:

- Direct selling
- Corporate agents
- Group selling
- Brokers and cooperative societies
- Bancassurance

To make all these channels a success the companies have to be very alert and skillful to know how to use these channels in a proper way. Bancassurance is one of the most upcoming channels of distribution and therefore is being discussed in details. Bancasurance

India has an extensive bank network established over the years. What Insurance companies have to do is to just take advantage of the customers' long-standing trust and relationships with banks. This is a mutually beneficial situation as banks an also expand their range of products onoffer to customers, while the insurance company will also earn profits from the exposure.Anotheradvantage is that banks, with their network in rural areas, help to fulfill rural and social obligations stipulated by the Insurance Regulatory and Development Authority (IRDA) recently. Insurance companies should see ban assurance as a tool for increasing their market penetration in India. It is also good for the one who sees ban assurance in terms of reduced price, high quality product and delivery at doorsteps. Everybody is a winner here. The creation of ban assurance operations has made an important impact on the financial services industry at large. This is though a new concept but it has gained a lot of importance in the industry at present and has a great future.

Product Innovation

There has been a plethora of new and innovative products offered by the new players. Customers have tremendous choice from a large variety of products from pure term (risk) insurance to unit-linked investment products. Customers are offered unbundled products with a variety of benefits as riders from which they can choose. More customers are buying products and services based on their true needs and not just traditional moneyback policies, which is not considered very appropriate for long-term protection and savings. There is lots of saving and investment plans in the market. However, there are still some key new products yet to be introduced - e.g. health products.

Rural Marketing

Rural India seems to have an appetite for mobile phones, computers, and cars and to add to it we have insurance. In India with the private players having entered into the insurance industry, the expected explosion in job opportunities may not actually happen but for them the catchments area is the opportunities in the rural India. In India the insurance business can be said to be "a marathon, not a sprint". This is because of the nature of the business being long term. With merely two years of the industry being opened, not surprisingly, the new comers are making losses. The public sector companies, notably the LIC, have gained in strength, thanks to the deepening of the market consequent to the awareness created by the new companies. However this does not deterred the private sector, which knows know that the race is a marathon, not a sprint. However it seems that they if not anything, are only increasing their spending, though only out of the capital. Today, there are 18 insurance companies in India excluding the PSU's, with 12 in the life insurance business and the rest in non-life. As insurance companies go more and more rural in search of business, there will be opportunities in the rural sector.

The rural consumer is now exhibiting an increasing propensity for insurance products. A research conducted exhibited that the rural consumers are willing to dole out anything between Rs 3,500 and Rs 2,900 as premium each year. In the insurance the awareness level for life insurance is the highest in rural India, but the consumers are also aware about motor, accidents and cattle insurance. In a study conducted by MART the results showed that nearly one third said that they had purchased some kind of insurance with the maximum penetration skewed in favor of life insurance. The study also pointed out the private companies have huge task to play in creating awareness and credibility among the rural populace. The perceived benefits of buying a life policy range from security of income bulk return in future, daughter's marriage, children's education and good return on savings, in that order, the study adds.

Regulatory and Development Authority (IRDA) have set stiff rural targets for insurance companies. For the life sector, in the first year, 5 per cent of the total policies written should come from the rural sector. This will go up to 15 per cent in five years. Similarly, for the nonlife sector, two per cent of the total gross premium income should come from the rural sector going up to 5 per cent in five years, according to the regulation. All these moves will make the investment the rural area a big start.

Information Technology and Insurance

In the insurance industry today, there is a clear trend away from selling a broad range of products to a large volume of customers in a one -size-fits-all manners. Instead of focusing on their different products lines as silos (i.e., life, property and casualty etc) insurers are looking for ways to offer highly targeted insurance products that are tailored to the individuals customers with the highest propensity to buy them.

There is a evolutionary change in the technology that has revolutionized the entire insurance sector. Insurance industry is a data-rich industry, and thus, there is dire need to use the data for trend analysis and personalization.

With increased competition among insurers, service has become a key issue. Moreover, customers are getting increasingly sophisticated and tech-savvy. People today don't want to accept the current value propositions, they want personalized interactions and they look for more and more features and add ones and better service.

Self check exercise

MCQ 1. What was the key element of the insurance reform process in India in 1993?

a. Nationalization of insurance companies

b. Participation of overseas insurance companies with 26% capital

c. Formation of the Malhotra Committee

d. Introduction of the Insurance Regulatory Development Authority (IRDA)

2. When did the Oriental Life Insurance Corporation, the first life insurance company, establish itself in India?

a. 1818

b. 1912

c. 1956

d. 1993

3. What was the main objective behind the formation of the Malhotra Committee in 1993?

a. To regulate the banking sector

b. To examine various aspects of the insurance industry

c. To promote foreign investments in India

d. To facilitate the privatization of insurance companies

4. Which regulatory body was formed in April 2000 to regulate the insurance industry in India?

a. RBI (Reserve Bank of India)

b. SEBI (Securities and Exchange Board of India)

c. IRDA (Insurance Regulatory Development Authority)

d. FICCI (Federation of Indian Chambers of Commerce and Industry)

5. What impact did liberalization have on LIC's market share from 2002-03 to 2004-05?

a. Increased from 95% to 98%

b. Decreased from 95% to 81%

c. Remained constant at 95%

d. Increased from 75% to 82.3%

6. What has been the impact of liberalization on the insurance industry's growth rate in India?

a. Decline in growth rate

b. Stagnation in growth rate

c. Increase in growth rate

d. Irrelevant to the growth rate

The insurance companies today must meet the need of the hour for more and more personalized approach for handling the customer. Today managing the customer intelligently is very critical for the insurer especially in the very competitive environment. Companies need to apply different set of rules and treatment strategies to different customer segments. However, to personalize interactions, insurers are required to capture customer information in an integrated system.

With the explosion of Website and greater access to direct product or policy information, there is a need to developing better techniques to give customers a truly personalized experience. Personalization helps organizations to reach their customers with more impact and to generate new revenue through cross selling and up selling activities. To ensure that the customers are receiving personalized information, many organizations are incorporating knowledge database-repositories of content that typically include a search engine and let the customers locate the all document and information related to their queries of request for services. Customers can hereby use the knowledge database to manage their products or the company information and invoices, claim records, and histories of the service inquiry. These products also may be able to learn from the customer's previous knowledge database and to use their information when determining the relevance to the customers search request.

The insurance sector remains a very competitive market and those companies that are able to best utilize their data and provide their customer with the most personalized options will have the distinct competitive advantage. The insurers that come up to the top will be those who leverage the appropriate technology solutions effectively in order to foster customer loyalty, attract new customers and improve operational efficiency by providing common information across their lines of business.

Mergers and Acquisitions

This is an era of mergers and acquisitions. Private companies including MNC's are amalgamating the world over to get more competitive edge. Currently, the general insurance industry has been opened up. The question here is that for over two years, eight private companies have operated and has the size of the cake expanded. We here find that this is not true. The insurers are doing enough to raise the level of risk awareness or sire they merely content to compete in the markets organized and established.

However sooner or later the private sector players will have to put in place strategies aimed not at winning the existing accounts of the public players but at diversifying markets penetration as a whole. The private players in the future would have to turn their attention to working in the unorganized and underserved markets.

What is likely to happen is that the private players would continue to skim the profitable segments of the already organized business in the urban areas. The time has already come for the government of India to evaluate the performance of private companies' vis-a-vis their declared objective of opening up the industry.

However it is high time for the government to realize that importance of merging the public sector general insurance companies into single entity. The resent scenario calls for a better performance from part of each of the public sector insurance companies against each other; or in other words a competition to be the best. The result what we see is the undercutting of premium to retain or wrest business and quoting an uneconomical rate of premium. While this allows one of the Public Sectors Company to win a business form another

in this manner. The others suffer a loss and the resultant effect is a cannibalization with a fall in the average premium of the public sector itself. This at many times brings advantage to the private players who grab the business because of the unethical competition among the public players.

The purpose of having four companies all subsidiaries of General Insurance Corporation of India (GIC)- National Insurance Company, New India Assurance Company, Oriental Insurance Company, And The United India Insurance Company; at the time of nationalization was to have competition among themselves -in service and products at the same price. The service provided by them was also equally good or bad depending on the experience of the customers.

Now with real competition coming in with most of the global insurance players setting footprints here, it is felt that the time for merger has come and to enjoy the benefits if the size. It is to be sated that size does matter in insurance business. All over the world's mergers and acquisitions in the risk-underwriting sector is common. The benefits if the four insurance companies merge will be enormous. The merged entity will enjoy higher underwriting and risk retention capacity; increase in reinsurance premium, reduction in reinsurance outflow, healthy solvency margins, setting right the asset -liability mismatch and reduction in cost. The insurance market thus becomes a gambling place. Had the public sector companies made into a single entity, perhaps the total premium of the four public sector companies in the year 2003-04 would have gone up but 25 percent. But the public sector alone is forced to underwrite the loss making motor third party liability (TPL) insurance. The public insurance companies insured a loss of Rs 1943 crore on this portfolio on just one year (2003-04). The cumulative loss under this portfolio is astronomical. The loss of profitable business in view of undeserved competition among the public sector companies is hampering the subsidization of social insurance including the motor TPL.

It is thus clear that it is good for the public sector companies to merge immediately when they are still strong, lest a merger becomes inevitable later after the independent public sector companies fail one after another. This does not bid well for the public sector, nor for the insuring public and not for the economic development either. For a progress me require merger of strong public sector companies. Else it would render public sector companies weak and destroy them.

Present Scenario

The size of the market has grown and the size of the insurable population in India is indeed vast and the existing player has managed to cover about one-fourth of it. The opportunities before the players are therefore a plenty in terms of target audience. The falling interest rates, the collapse of many small-time financial institutions, the scope for entering related areas like banking and pensions in a bid for synergy and the promise of e-commerce are some of the other opportunities knocking at the doors of the insurance majors.

There is a probability of a spurt in employment opportunities. A number of web-sites are coming up on insurance, a few financial magazines exclusively devoted to insurance and also a few training institutes being set up hurriedly. Many of the universities and management institutes have already started or are contemplating new courses in insurance. Health insurance, which is still in its infancy, is also likely to get a major boost, ultimately leading to improvement in the quality of medical treatment and facilities in the country.

Life insurance has today become a mainstay of any market economy since it offers

plenty of scope for garnering large sums of money for long periods of time. A well-regulated life insurance industry which moves with the times by offering its customers tailor-made products to satisfy their financial needs is, therefore, essential if we desire to progress towards a worry-free future.

15.6 SUMMARY

The present lesson discusses the insurance sector reforms in India. Observing the trends the industry has been moving for the last two years, the commitment of the players to take the business forward is quite apparent. With the increase in awareness level about the insurance and the products, the day is not far off all the insurable population in the country would have been brought under the insurance net. The Governments resolve to continue with the reforms coupled with investor friendly IRDA's regulations will surely take the business far. Last one decade of reforms in India have started yielding the results in the Indian economy. The Government's resolve to push the reforms measures further, less bureaucratic hurdles, absence of red tapism, investors' friendly business environment all put together have given tremendous boost to the industries in terms of FDI and investments from FIIs. Though the impact is felt in all the sectors, service sector is the one which is most benefited out of all those reforms and the contribution of service sector to the GDP of the country has grown manifold. New economy organizations are spreading their wings into service industry like banking, financial services, insurance, communication, entertainment, and telecom and so on. And no wonder why India is considered to be the most preferred nation in the world for Business Process Outsourcing (BPO). The service industry in India has achieved a phenomenal growth in the recent past and among them, Insurance is one sector, which has witnessed high decibel growth thanks to the investor friendly regulator in the name of Insurance Regulatory Development Authority (IRDA). The growth the market has achieved in terms of 18-20% in life insurance and 15-17% in non-life insurance stands testimony to that.

15.7 Keywords

- **Lien:** Lien is the right of the banker to retain all securities of the customer, until the general balance due from him is hot repaid.
- **Documents of title to goods;**these are the documents which represent the goods in the possession of some other person. For example a warehouse receipt or a railway receipts. By endorsing such documents in favor of the banker, the borrower entitles the banker to take delivery of the goods from the warehouse or railway, if he does not repay the advance.
- **Credit Worthiness:**Creditworthiness indicates the quality of the borrower. It denotes the amount for which a borrower is considered worthy for borrowing from a bank. It depends upon his ability and willingness and is judged on the basis of character, capacity and capital of the borrower.

15.8 Practice Exercise

Short answer type question

1. What are the fundamentals of insurance?
2. Discuss the adverse selection and moral hazard in insurance.

Long answer type question

3. What is selling insurance?
4. Discuss Growth and organisation of insurance companies?

15.9 SUGGESTED READINGS

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15.10 Self check exercise (Answer Key)

1(B),2(A),3(B),4(C),5(B),6(C)

MBA-DE(Second Year) **MFI 308**

Semester-Ill **MANAGEMENT OF FINANCIAL INSTITUTIONS**

Lesson No. 16 **AUTHOR:Dr.RATINDER KAUR**

OPERATIONAL POLICIES AND FUNDS MANAGEMENT IN INSURANCE COMPANIES

STRUCTURE

16 Objectives

16.1 Introduction

16.2 Present Status

16.3 Performance of Indian Insurance Companies During Post Reform Period

16.4 Issues and Challenges of Indian Insurance Industry

16.5 Operational Policies

16.6 Funds Management

16.7 Summary

16.8 Practice exercise

16.9 Further Readings

16.10 Self check exercise (Answer key)

16.0 OBJECTIVES

After studying this chapter, you should be able to understand:

- The history of insurance.
- A broad overview of Insurance sector reforms in India.
- Operational Policies and Funds Management of Insurance Companies.

16.1 INTRODUCTION

The insurance sector in India plays a very important role in the process of economic growth of Indian economy. It has direct relationship with the levels of growth and development of economy. The conventional agricultural and manufacturing sector of the economy has taken a back seat and now service sector is booming and insurance has big share in this.

The service sector now accounts for more than half of the India's GDP. The Indian service sector is now growing the fastest across the countries in the world. The business of organized life insurance in India started with the opening of Oriental Life Assurance Company in 1818 in Calcutta followed by Bombay life in 1823 and Madras Equitable in 1829.

The industry actually gained momentum after independence actually. There were 245 insurance companies and provident societies but actual growth started after nationalization of insurance industry in India. The incorporation of LIC with the enactment act 1956 changed the insurance scenario totally in insurance world. Similarly in 1972, 107 general insurance were nationalized through the passing of General Insurance business (Nationalization) Act 1972. The existing 107 insurances were amalgamated and grouped into five companies viz., National Insurance (NIC) New India Assurance (NIAC), Oriental Insurance Co. (OIC) and United Insurance Company (UIIC) and General Insurance Corporation (GIC).

16.2 PRESENT STATUS

Since 1991, Indian economy has been going through a phase of financial reforms.

Consequent to the implementation of landmark reforms in the financial sector, the insurance sector in India has a sea change.

The Govt, of India appointed a committee on reforms in the insurance sector in April 1993 under the chairmanship of Shri R.N.Malhotra, former finance secretary and RBI Governor and committee was asked to look into the structure of insurance industry for creating an efficient and viable industry that would serve the customers and would cover a larger part of society. It suggested various structural changes in LIC and GIC. With regard to Insurance surveyors, it was suggested that Insurance surveyors should be abolished and Insurance companies should be granted permission to recruit the surveyor of their own. Insurance companies should be permitted to settle the claim up toRs. 1 lakh on primary survey basis.

On the recommendations of committee govt, implemented major reforms in the insurance sector. Major recommendations are given as follows:

Liberalization of insurance industry: The committee has recommended for liberalizing insurance industry

- The private sector should be permitted in insurance sector but same co. should be allowed either in Life insurance or General Insurance business.
- Private companies with a minimum paid up Capital of Rs.100 Crore. Should be allowed to enter the industry.
- Foreign companies may be allowed to enter the industry in collaboration with the domestic companies.
- Cooperative societies at state level should be allowed to perform business with minimum paid up capital of Rs. 100 Crore.
- Only one state level insurance company should be allowed to operate in each state.

Committee also put recommendations for restricting insurance industry. Thesewere:

- The existing capital of GIC should be increased from Rs. 107.5 Crore to Rs. 200 Crore, which should include 50% share of Govt, and rest should be opened for general public.

Committee also recommended regulation of insurance business: Suggestions are as follows:

- All old and new insurance cos. should be regulated under similar rules.
- Controller of insurance should be given all the responsibilities under insurance Act.
- Insurance Regulatory Authority (IRA) should be established in Insurance Sector on the lines of SEBI & IRA should be granted complete functional autonomy.

Regarding Rural Insurance Committee recommendations are following:

- New Insurance Companies entertaining into insurance industry should perform a minimum predetermined insurance in rural sector and they should attain this limit compulsorily.
- Postal Life Insurance should be used to promote life Insurance business in rural areas.

The Govt., of India implemented the most important recommendations of the Malhotra committee by setting up IRDA through parliament the IRDA Act in 1999 to ensure

regulation, development's growth of Insurance business in India. IRDA has been given a dual role of independent regulator and development organization. IRDA is an autonomous body similarly on the lines of SEBI which enjoys full functional freedom IRB to perform its duties in a fair and efficient manner that will lead to stimulate the public trust in regulatory process. Though, because of competitive environment IRDA has preferred to follow competitive path but credit is given for professionalizing the industry and facilitate its growth and development.

Check your progress 1

Q. Clearly state various Insurance Sector Reforms in India.

CRITICAL EVALUATION OF MALHOTRA COMMITTEE S RECOMMENDATIONS

The nature of Insurance business is not like an ordinary business. The insurance company has to undertake risks of livestock and life, loss by fire etc. Insurance sector is also entered into new area like, health insurance, wedding insurance etc. So, different approach is required for insurance industry.

According to committee foreign companies are allowed to have their business in India. It has been observed that these companies have concentrated on urban areas rather than rural areas, which are very important for real development of country. There are many countries which prohibits foreign companies to do business in their nations. The main prohibitions against foreign insurers are to provide the domestic industry with the largest possible volume of business so as to enhance the capacity to indemnify losses and remain solvent in the process. So, there is feeling that giant companies are swallowing the small companies and rural sector had been ignored.

16.3 PERFORMANCE OF INDIAN INSURANCE COMPANIES DURING POST REFORM PERIOD

The insurance industry has come a long way in terms of innovative insurance products offered; quality of services rendered and has also tapped unexplored market. Today there are 16 players in comparison to one (LIC).There has been tremendous growth in the insurance sector with current size of Rs. 50000 crore, recording a compound annual growth rate of about 175% during the last few years. Indian insurance sector is likely to register unprecedented growth of 200% and attained a size of Rs. 2000 billion ($51.2 billion) by 2009-10, in which a private sector insurance business will achieve a growth rate of 140% as a result of aggressive marketing technique being adopted by them against 35-40% growth rate of state owned insurance companies. Though the market share of state owned insurance companies like GIC, LIC and others have come down to 70% in last 4-5 years from over 97%.

It is estimated that the potential of the Indian insurance market from the perspective of macro-economic variables such as the ratio of premium to GDP, India's life insurance premium, as a percentage of GDP is 1.8% against 5.2% in the US, 6.5% in the UK or 8% in South Korea. It shows that rigorous efforts are required to create insurance as strong sector in economy.

16.4 ISSUES AND CHALLENGES OF INDIAN INSURANCE INDUSTRY

The future growth of the insurance industry depends on continuing macroeconomic steadiness, sound rules and prevention of company failures and scandals. The companies

Are doing their maximum efforts to come up with new, innovative insurance products. Companies are recognizing consumer's needs and have brought a number of innovative features in response to the needs the needs of policy holders and expanded the business in urban and rural areas alike. Further the policies were designed to the new and growing segments of young families.

Two new draft insurance bills are under deliberation. These intend to bring up to date the legal framework and concentrate on most of the current gaps in regulation and supervision. They introduce new regulations on corporate governance and the responsibilities of directors, on internal control and risk management systems, and on duties of actuaries and auditors. The following are the some challenges before the insurance sector.

Detailed Standards

Because of competitive environment and changing needs of investors and companies, there is need to constitute detailed methods of calculation of reserves and provisions and the amount of credit for amounts recoverable under reinsurance arrangements. Though IRDA has played a very responsible role in constituting internationally benchmarked regulatory architecture. There is a need to focus on issues like Risk Management, asset protection and Asset Liability .Management, cost controls.

Under Market Penetration

A serious issue facing the insurance industry is untapped insurance market. Insurance penetration or premium volume as a share of a country's GDP for the year 2005 stood at 2.53% for life insurance and 0.62% for non-life insurance. The level of penetration tends to rise as income increases, particularly in life insurance. India, with its huge middle class households, has exhibited potential for the insurance industry. This has made international players to look at the Indian market. Moreover, saturation of markets in many developed economies has made the Indian market all the more attractive for global insurance majors. Under the circumstance the IRDA has to direct the insurers to gradually increase their coverage of the rural sector to 15.0 percent of total policies within direct by the third year in respect of a general insurer besides covering 20,000 lives in the economically weaker social sector by the fifth year in the case of all insurers.

Capital Adequacy Standards

Insurance companies are facing a biggest problem of lack of capital in this industry. It is not possible for insurance companies to generate funds through IPO before 10 years. It takes 10 years for insurance companies to settle its operations while insurance business requires regular flow of funds. Therefore, the capital adequacy standards should be brought in line with the best international practice.

To inject flow of capital in insurance, govt., has decided to place an amendment to the Insurance Act to raise the ceiling oil Foreign Direct Investment (FDI) in the insurance
Sector to 49% from the current 26% in the current winter session.

Risk Management

The biggest challenge before insurance industry is to promote sounder competition and greater safety. Risk Management is one of the important functions of any insurance company. The risk before insurance industry is, insurance risk, credit risk, business market risk and operational risk. The risks can be managed through identification,

Assessment, and monitoring and control process. By raising the level of minimum capital, introducing risk-based capital requirements as well as by encouraging small firms (in terms of capital adequacy) to merge with other big firms.

Human Resource Challenge

Tremendous growth in insurance industry has created a shortage of able human resources in industry. Because of work pressures in this industry, employment seekers are less attracted towards this industry. There is demand for two lakh agents every year to add to Rs. 15 lakh already into industry. There is also a need to provide proper training to manpower.

Distribution Network & Product Development

Another challenge before insurance company is to develop new innovative products and distribution channels to capture wider market to provide cost effective services to policy holders. Besides traditional intermediaries as corporate agent, brokers and new methods like ban assurance, direct marketing, telemarketing, independent financial intermediaries and sale of policy through internet may play an important role in penetrating insurance market.

Check your progress 2

Q. Write in detail various challenges before insurance industry.

16.5 OPERATIONAL POLICIES

Insurance is a social institution, provides a protection to policy holders. Institutions like LIC, GIC, and ICICI Prudential & HDFC LIFE Insurance have following objectives of insurance:

- To provide a financial security to the individuals. The insurance company assumes on the behalf of individuals, the risk of large but uncertain losses.
- Insurance business is providing assistance to business organizations by safeguarding their businesses against any loss due to accident, fire etc.
- It mobilizes funds of people and provides them adequate returns by deploying funds in appropriate portfolios or investments.
- To act as trustees of the investors.

16.6 INVESTMENT POLICIES

Every insurer carrying on life insurance business shall invest and will keep invested funds in the following manner:

(a) Controlled Fund

i. Government Securities- 25%

ii. Government Securities and other approved securities (including government securities)- not less than 50%

iii. Approved investments

- Infrastructure and social sector- not less than 15%
- Others- not exceeding 35%

(b) Pension and General Annuity Business

i. Government Securities- not less than 20%

ii. Government Securities and other approved securities including (i) above- not less

than 40%

iii. Balance to be invested in approved investments not exceeding 60%

(c) Unit Linked Life Insurance Business

Total investments in other than approved category of investment are not to exceed 25% of fund.

Along with the above guidelines, Insurance companies have to safeguard and promote the interests of policyholders. Insurance companies are required to diversify while investing their funds in different securities. Generally companies does not acquire more than 30 percent share of company. Insurance companies are acting as agents of investors and providing them benefits of temporary swings in the market prices.

The IRDA act 1999 has allowed all insurance companies to invest more in equity and debt instruments. Act also allows companies to invest in venture capital funds. The act has agreed to 2:1 debt equity ratio for convertible debenture but in case of capital investment project higher ratio of 4:1 would be considered. IRDA made particular to companies for regular reviews of their investments and make changes in its circumstances. It is also made clear under the act that company would not participate in management of any concern in which it has interest as an investor.

16.6 FUNDS MANAGEMENT

The insurance companies are facing a difficult challenge to provide returns as compared to other options. There is acute pressure on insurance companies especially when return on investments is going down. Twenty Insurance guidelines of OECD Rule No. 13 define it as "investment regulation should ensure that both security and profitability requirements are respected. It should promote the diversification, spread and liquidity of investment portfolios as well as the maturity and currency matching of assets and liabilities. Regulations must include a list of admitted assets on which ceilings may be set and requirements on the way in which investment should be valued." Public sector insurance companies are investing in government securities. Equity is considered better option when market is bullish.

As far as General insurance companies' fund management is concerned, they believe in investing in two categories, (i) Securities traded in stock Exchange and (ii) loan securities. Investments are made in India or in outside India in stock Exchanges, state govt., and other approved securities, foreign govt., securities, Municipal loans etc. Shares and debentures of companies and cooperatives and investments in mutual funds and the loans cover special deposits in government of India, loans to companies, loans to housing sector, deposit with non banking companies, loan of mortgage of property are other avenues, where insurance companies are investing. It is observed under present scenario, insurers are facing problems of good management opportunities. So, there is need to replace of traditional approach of investment with the dynamic quality initiatives.

Check your progress 4

Q. Write in detail various Operational Policies and Fund Management.

16.7 SUMMARY

The insurance sector in India plays a very important role in the process of economic growth of Indian economy. The industry actually gained momentum after independence. Actually. The Govt., of India appointed a committee on reforms in the insurance sector in April 1993 under the chairmanship of Shri R.N.Malhotra, Committee recommended suggestions on privatization, structural changes of LIC and GIC. No doubt that after reforms, insurance sector has shown a tremendous growth but still rigorous efforts are required to create insurance as a strong sector in economy.

MCQ.1 What was the year of the establishment of the Oriental Life Assurance Company, marking the beginning of organized life insurance in India?
A) 1818
B) 1823
C) 1829
D) 1956

2. Which committee was appointed by the Government of India in 1993 to recommend reforms in the insurance sector?
A) Malhotra Committee
B) SEBI Committee
C) Insurance Regulatory Committee
D) Financial Reforms Committee

3. What was the major recommendation regarding the capital of General Insurance Corporation (GIC) by the Malhotra Committee?
A) Increase to Rs. 50 Crore
B) Increase to Rs. 200 Crore
C) No change
D) Decrease to Rs. 75 Crore

4. In which year was the Insurance Regulatory and Development Authority (IRDA) established in India?
A) 1991
B) 1999
C) 1972
D) 1956

5. What is the current size of the Indian insurance sector, as mentioned in the provided information?
A) Rs. 10,000 crore
B) Rs. 50,000 crore
C) Rs. 1,00,000 crore
D) Rs. 2,00,000 crore

6. According to the information, what is the estimated growth rate of the private sector insurance business by 2009-10?
A) 50%
B) 100%
C) 140%
D) 200%

16.8 PRACTICE EXERCISES

Short answer type question

1. Discuss briefly Fund Management policies of insurance companies.
2. What is the permissible limit for companies acquiring shares in another company, as mentioned in the provided information?

Long answer type question

3. Write in detail operational policies of insurance companies.
4. Explain the key provisions of the IRDA Act 1999 regarding the investment activities of insurance companies.

16.9 FURTHER READINGS

1. Bhole, L.M., *Financial Institutions and Markets,* Tata McGraw-Hill, New Delhi 2004, Ch. 6. pp 6.1-6.39.
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3. Srivastva, R.M., *Nigam Divya, Management of Indian Financial Institutions,* Himalaya Publications, Ch. 30-31,531-551.
4. Bansai, Sandeep, Bansal Rama, *Management of Banking and Financial Institutions,* Kalyani Publishers, Ch. 16, 16.1-16.31.

16.10 Self check exercise (Answer key)

1(A),2(A),3(B),4(B),5(B),6()

Lesson No. 17 **AUTHOR:Dr. RATINDER KAUR**

RISK MANAGEMENT IN FINANACIAL INSTITUTIONS

STRUCTURE

17.0 Objectives
17.1 Introduction
17.2 Meaning of Risk
17.3 Types of Risk
17.4 Summary
17.5 Practice exercise
17.6 Reference
17.7 Self check exercise (Answer key)

17.0 AIMS AND OBJECTIVES

After studying this chapter, you should be able to understand:

- Understand the concept of Return & Risk in Financial Management
- Different Kinds of risk in holding securities and their Management.

17.1 INTRODUCTION

One of the main functions of Finance Manager of a company is to invest the surplus available funds in different type of securities. The sum total of all securities is referred as portfolio. The Finance Manager manages this portfolio. Basically, a Portfolio Management is the process of selecting a bundle of securities that will provide the company maximum return for a given level of risk or ensure minimum risk for a given level of return.

Return comprises the income which, is in the form of dividend or interest and the capital gain (Loss). Return is calculated with the help of following ratio:

$$\text{Return} = \frac{\text{Value of securities at the end of the year - Value of securities at the beginning of the year + Dividend Received}}{\text{Value of securities at the beginning of the year}}$$

Example:

If an asset is purchased for Rs. 8,00,000 today and will have a Market value of Rs. 9,00,000 in one year. During the year, the asset will generate cash inflows of Rs. 50,000 to the holder. What is the rate of return on investment?

Return =

$$\frac{9,00,000 - 8,00,000 + 50,000}{8,00,000}$$

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17.2 WHAT IS RISK?

Risk refers to the possibility that the expected return may not materialize. There may be loss of capital i.e. investment has to be sold for an amount less than paid for it. There may be no income from investment or the income may be less than the expected. The natural query is "why the investor goes for risky investment"? The answer is that the desire for higher return entices them to go for risky investment.

Risk is influenced by internal and external factors. Internal factors mean risk due to such as Labour Strike, Change in management, Consumer preference etc. influencing a particular industry. These risks can be reduced with the help of diversification i.e. instead of investing in the shares of one company; one may invest in the shares of various companies.

Risk due to external factors such as level of economic activities recession or boom, inflation, political development, Change in credit policies, etc also affect the return on investment. These risks are non-diversifiable. It cannot be reduced through diversification. All equity investors have to bear these risks.

Check your progress 1

Types of Risk

Generally risks which a businessman faces have been categorized as:
vK Foreign Exchange Rate Risk
Interest Rate Risk ^
xji. Liquidity Risk
j(. Credit Risk^

Market Risk
5. Operational Risk
^Z/. Technology Risk

Foreign Exchange Rate Risk

When companies conduct business across borders, they may deal in foreign currencies. Different countries have different currencies and different currencies have different values. The rate of conversion i.e. the rate at which the exchange between two currencies taken place is known as exchange rate. Foreign exchange risk arises out of the fluctuation in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.

Types of Foreign Exchange Risk

- Transaction Risk
- Real Operating Risk
- Translation Risk

Transaction Risk :

1t involves the possibility of exchange loss or gain when domestic currency is exchanged for a foreign currency in relation to business to be undertaken.

Example:

An Indian Company enters into a contract for the purchase of machinery with an American supplier, payment to be made after 3 months. Exchange rate at the time of contract was 50.00/$l. Value of machinery is $50,000. The value of Indian rupee declines to $52.00/ $1 after 3 months.

Amount to be paid to US exporter at the time of contract (US $) = $ 50,000

Amount required for purchasing (US $) 50,000, if the payment had to be made immediately (at spot rate) = $50,000*Rs.50 = Rs. 25, 00,000

Amount paid to US exporter at future rate (after 3 Months) = $50,000*Rs. 52 = Rs.26, 00,000

Therefore, loss due to exchange rate = Rs. 26, 00,000- 25, 00,000 = Rs. 1, 00,000

Real Operating Risk:

It refers to the change in exchange rates alter future operating revenues and cost streams which changes the value of the firm.

Example:

A Software Indian company has clients abroad. If the Company's major operating revenue are in the form of USD then any variation in the exchange rate will affect the operating cash flows of the company, this resulting would affect the value of the firm.

Translation Risk

This risk occurs on consolidation of financial statement of different units of MNCs. This risk arises from the difference in exchange rates at the beginning and the end of the year. It is only an accounting risk and do not affect the cash flows of the company.

Example:

An Indian company has its business in India and America. Its Indian co. alone has a return on investment 20%. Indian -American co. performing same operations, based on its foreign currency on similar lines with same rate of return (20%). At the time of its consolidation (in Rs), because of change in exchange rate, return on investment comes 18%. So, the decrease in rate of return will automatically decrease the value of the firm.

Foreign Exchange Risk can be reduced through:

1. Forward Contract
2. Future Contract
3. Currency Options
4. Money Market Operation
5. Currency Swaps

Interest Rate Risk

Interest rate risk is simply the risk to which an institution is exposed because future interest rates are uncertain.

The assets and liability of a financial institution have different maturity and liquidity. Financial institutions create assets and at the same time create liabilities. These loans are invested by the financial institution at a certain rate of interest and similarity interest cost has to be paid to the lenders of deposit. The mismatches of interest's rates of the assets and liabilities expose to interest rate risk.

Example:

An Indian Bank borrows Rs.200 crores from the market for 4 years @ 10% (Floating p.a) and creates a loan asset of the same amount for 4 Year period @ 13% (Fixed p.a). If, there is a an upward trend of interest rate after 2 years and the rate of interest goes up to 15% then Interest Loss

4 crores =200(15% - 13%)

Interest rate Risk can be controlled through:

1. Investing securities which are mature in short run.
2. Investment in variable interest rate securities rather than fixed interest rate securities.
3. Purchase interest rate derivatives.

Liquidity Risk

Liquidity risk refers to the bank's ability to meet its cash obligation to depositors and borrowers. It stems out of mismatches in the maturity patterns of assets and liabilities. Gap analysis is the most important technique used to manage liquidity risk. Under this method Assets and Liability are arranged according to their maturity within a predetermined period. The gap is the difference between the maturity assets to the maturity liabilities.

Example of:

Liquidity Gap Model

Assets Liability Management

Maturity Pattern of Assets and Liabilities

	Next day	**2 to 28 days**	**29 days to 3 month**	**Over 3 months & up to 6 months**	**Over 6 months & up to 1 year**	**Over 1 year & up to 3 Years**	**Over 5 Years**
Total Cash inflows (Maturing Assets) (A)							
Total Cash Outflows (Maturing liabilities) (B)							
Gap (A - B)							

A positive gap indicates that maturity of assets is sufficient to meet maturity of liabilities. A Negative gap indicates that maturity of assets is not sufficient to meet the maturity of liabilities. Negative gap indicate that some rearrangement of funds will have to be done during that time-bracket.

Credit Risk

Credit risk arises when a financial institution cannot get back the money from loan or investment. The main reason for bank or financial institution is bad loans. To reduce the chance of defaults, banks or financial institution should do following:

1. Raise their credit standards
2. Monitor and collect information about borrowers on regular basis
3. Guarantees and collaterals
4. Standardized loans
5. Setting up internal credit monitoring process, appraisal system and loan review mechanism.

Market Risk

It refers to variability in return on investment due to market factor that affect all investment in a similar fashion. Such factors may be:

(1) Change the interest rate policy by govt.
(2) Rising inflation,
(3) Political development, Wars, Earthquakes
(4) RBI’s Change in credit policy
(5) Govt., tax withdrawal of tax exemption on dividend payment by companies.

These risks cannot be reduced or eliminated through diversification. The portfolio manager has to bear these risks, as these are market related risks, which is beyond one’s control.

Beta is a measure of Market risk. It measures systematic risk associated with an

Investment in relation to total risk attached with market portfolio. A security with Beta greater than one is called aggressive security, with Beta less than one is called defensive security, and with Beta one is called neutral security.

$$\text{Beta} = \frac{\text{Co - relation Co - efficient of Portfolio with Market} \times \text{Standard deviation of Securities}}{\text{Standard Deviation Market}}$$

If Beta is equal to one it indicates that the securities is equally more risky as compared to market i.e. If the market fluctuates by 1% then the return on security will also fluctuate by 1%.

If Beta is more than one it indicates that the security is riskier than the market. Suppose Beta is equal to 1.4, it means if the market fluctuation is 1% then the expected return on security will fluctuate by 1.4%.

Example

From the following information calculate Beta.

Standard Deviation of an Asset	3.0%
Market Standard Deviation	2.2%
Co-relation Co-efficient of Portfolio with Market	0.8

$$\text{Beta} = \frac{\text{Co - relation Co - efficient of Portfolio with Market} \times \text{Standard deviation Assets}}{\text{Standard Deviation Market}}$$

Operational Risk

Operational risk is the most important risk for an organization. Operational risk may result from Inadequate or failed internal processes, people and systems or from external events.

The following lists defined event types with some examples for each category:

1. Internal Fraud - misappropriation of assets, tax evasion, Payment without consideration, theft and embezzlements
2. External Fraud - theft of information, third-party theft and forgery
3. Employment Practices and Workplace Safety- discrimination, workers compensation, employee health and safety
4. Customer, Products & Business Practice - market manipulation, improper trade, product defects,
5. Loss to Physical Assets - Theft, natural disasters, terrorism, fire
6. Systems Failures- software failures, hardware failures
7. Execution, Delivery, & Process Management - data entry errors, accounting errors, failed mandatory reporting,

In order to reduce the operational risk technology adoption has a backbone of banking operation. The technology plays a very important role in following activities such as account reconciliation, electronic fund transfer, e-commerce, ATM, debit or credit card, on line banking etc.

Technology Risk

Technology and operational risk are closely interred related and every financial institutions requires to handle it effectively. The purpose of technology expansion is to increase operations efficiencies and reduce operations costs. Technology risk occurs when a type of technology is unable to give expected results in order to achieve objectives of cost

reduction and operational efficiency. In case of idle technology financial institutions suffers because of diseconomies of scale and have a very negative impact on growth of organization.

17.4 SUMMARY

Financial Institutions and companies are exposed to various types of risks. It happens because of mismatch Assets and liabilities. Financial institutions are exposed to market risk, credit risk, operations risks etc. So, to manage risk, there is a need to develop a proper understanding of Gap Analysis, Future Contracts, Forward Contracts, Currency Options, and Derivatives.

Self check exercise

MCQ1: What is the main function of the Finance Manager in a company, as discussed in the chapter

A. Marketing Management

B. Human Resource Management

C. Portfolio Management

D. Operations Management

2: How is Return calculated in the context of investment, as mentioned in the chapter?

A. Initial investment - Final investment + Dividend Received / Initial investment

B. Final investment - Initial investment + Dividend Received / Initial investment

C. Final investment - Initial investment + Dividend Received / Final investment

D. Initial investment - Final investment - Dividend Received / Initial investment

4.What are the two types of risk mentioned in the chapter?

A. External and Internal Risk

B. Diversifiable and Non-diversifiable Risk

C. Market and Operational Risk

D. Short-term and Long-term Risk

17.5 PRACTICE EXERCISE

Short answer type question

1. Distinguish between Transaction and translation risk, giving examples.
2. Machinery purchased for USD 1, 00,000today, settlement to be done three months later. Exchange Rate today is Rs 40 per USD. Exchange rate is Rs 42 per USD after three Months. You are required to calculate the expected loss due to change in exchange rate.

Q.3 Explain in detail various types of risk. Also explain methods to manage these risks.

Long Answer type question

Q.1 A Bank borrows Rs.100 crores from the market for 5 years @ 8% (floating p.a) and create an loan asset of the same amount for 5 Year period @ 10% (Fixed p.a)

You are required to calculate the Loss to bank If, there is a an upward trend of interest rate after 3 years and the rate of interest goes up to 12%.

Q.2.Calculate Beta from the following information.

Risk free rate of interest	5.2%
Standard deviation of an asset	4.0%
Expected return of Market portfolio	9.8%
Market Standard deviation	2.9%
Co-relation Co-efficient of portfolio with Market	0.7

17.6 References

1.Bhole, L.M.Pandey, I.M., *Financial Management,*Vikas publishing House,Noida 2004, Ch. 4, pp. 70-80.

2. Asthana P.N &Vivek, *Financial Risk Management,* Himalaya publishing House, Mumbai Ch. 3, pp. 19-32.

3. Donald E. Fischer & Ronald J. Jordan, *Security Analysis & Portfolio Management,* Prentice Hall of India Private limited, New Delhi, Ch. 3, pp. 65-99.

17.7 Self check exercise (Answer key)

1(C),2(B),3(C)