BANKING: CENTRAL BANKING AND DEVELOPMENT BANKING (DCM27)

(MCOM)

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Lesson 1

CENTRAL BANKING – AN INTRODUCTION

Objectives :

After studying this lesson you should be able to :

- understand the gradual evolution of central banking in various countries;
- examine its growth and objectives with which the establishment of the same had taken place;
- analyse various functions and techniques used by the Central banks to discharge their duties.

Structure :

1.1 Origin of Central Banking :

Prior to the commencement of the twentieth century there had been no clearly defined concept of central banking. A gradual evolution had been taking place in various countries over a long period of years. The temperament and discretion of individual managements had played the principal part in the decisions and operations of the bank which had become the centre of the monetary and banking system in each of several countries.

In many of the older countries like England, France, Sweden, Germany etc., one bank gradually came to assume the position of a central bank, due to its enjoying the principle right of note issue and acting as the government's banker and agent. They were not originally called central banks, but were generally known as banks of issue or as national banks. The regulation of note issue subject to the conditions imposed by the State, and the maintenance of the convertibility of their notes into gold or silver or both were the principal functions of these banks. In due course, such banks of issue acquired other functions, duties and powers until the term 'Central bank' came to be generally used and to have a more or less standardised meaning.

The oldest central bank is the Riksbank of Sweden which was established in 1656. But the Bank of England was the first bank of issue to assume the position of a central bank and to emulate the fundamentals of the art of central banking. The history of the Bank of England is thus universally accepted as the back ground of the evolution of central banking principles and techniques. The Bank of England came into being in 1694 by public subscription for the purpose of advancing money to the government: in return for the privilege of note issue conferred under a charter granted to it in an Act of Parliament. The Bank came to acquire at least a partial monopoly of note issue in England in the sense that only banking firms or partnerships of not more than six persons were also permitted to issue notes. On 1826 the Bank was also authorised to open branches in other parts of England. The successful working of the Bank of England stimulated the development of Central Banking in other parts of the world.

In various countries, during the course of the nineteenth century, the State either endowed an existing bank with the sole or principal right of note issue, or caused a new bank of issue to be established with special powers and privileges, accompanied by varying degrees of State Control and supervision.

The Riksbank of Sweden, which had sprung from a privately owned bank founded in 1656 and recognised a s a State bank in 1668, followed the footsteps of Bank of England and gradually developed into a central bank. During a large part of its earlier career it enjoyed a monopoly of note issue which was reaffirmed by legislation in 1809. But the other banks which were established from 1830 onwards took the liberty of issuing their own notes and later obtained legal authority for their issues. It was not until 1897 that the sole right of issue was finally restored to the Riksbank.

The Bank of France, which was founded in 1800 partly with the aid of State funds, but mainly with private capital, was closely connected with the State from the beginning. It became the government's banker and received the exclusive right of note issue in Paris. The Government claimed participation in the control of the Bank through the appointment of the Governor and two Sub-Governors, while the shareholders were represented by a board of fifteen Regents elected by the two hundred largest shareholders. In 1848 its scope and capital were enlarged as a result of the transformation of nine provincial banks with note issuing powers into branches of the Bank of France. In due course more branches were established and the Bank obtained a monopoly of note issue in the whole country of France.

The Bank of Netherlands was established in 1814 after the old Bank of Amsterdam has become discredited for various reasons. The need was felt for a bank of the new type which was developed in England, Sweden and France. It was accordingly granted the sole right of note issue and made the Government's banker. It was founded with private capital. But the President and Secretary of the Managing Board were appointed by the Government, while the other members of the Managing Board and Board of Directors were elected by the shareholders.

The National Bank of Austria was instituted in 1817 in order to restore order in the monetary position of Austria, which had seriously deteriorated as a result of the excessive issue and depreciation of Government paper money. Owing to wars and uprisings in which Austria was involved between 1847 and 1866 the Government again resorted to the issue of paper currency, and several loans had also to be made to the Government by the Bank. The Bank was reorganised as the Bank of Austria - Hungary in 1878, and subsequently steps were taken to retire the Government paper money and to place the monetary system on a sound basis.

The Bank of Norway, which was opened in 1817 was brought into being by private capital, but its Governor and Vice-Governor were appointed by the king and the directors were elected by the Legislature. It was accorded the sole right of issue and was made the Government's bankers, and its further development followed on much the same lines as the Riksbank of Sweden.

The National Bank of Copenhagen, now known as the National Bank of Denmark, was founded with private capital in 1818 to take over the business of the Ringsbank, a State bank which had been created in 1813 to withdraw the depreciated Government paper money from circulation and the issue bank notes in their place. The National Bank became the sole bank of issue and was called upon to recognise the monetary system. The only State control was in the form of the appointment by the government of two out of four or five managers, while the Board of Directors was elected by the shareholders.

The National Bank of Belgium was created in 1850 as the sole bank of issue and the financial agent of the Government. Prior to that date there were four banks of issue, and the notes of none of these banks had a national circulation, nor did they operate successfully as agents of Treasury. The National bank was a privately owned institution, but the Governor of the bank was to be operated by the Government.

The Bank of Spain which had sprung from a State Bank founded in 1829 was established under that name in 1856. At first it had to share the right of issue with the provinicial banks, and was not grauted a monopoly of note issue till 1873. Although the capital was raised by private subscription, the appointment of the Governer of the Bank rested with the Government.

The Bank of Russia was founded in 1860 as a State Bank with the declared object of consolidating the monetary circulation and the floating debt of the Russian Empire. The country had suffered greatly from the evils of depreciated Government paper money and from the lack of proper banking facilities. The Bank was granted the sole right to issue bank notes and was called upon to stabilize the currency and promote the development of commerce, industry and agriculture by means of short-term credits. The Governor and Deputy Governor were appointed by the Government, while a Council consisting of Treasury officials was instituted to supervise the operations of the Bank.

The Reichsbank of Germany was founded in 1875, whose ownership rested party with the state but mainly with private shareholders. At the time of the formation of the German Empire, there were thirty-three banks of issue, of which the Bank of Prussia was the most important. It was agreed that these banks should retain their right of issue subject to certain limitations and to a uniform set of regulations. Also agreed that there should be a central bank of issue which was also to act as banker to the Imperial Government and to pursue, like the Bank of England, a bank rate policy for protection of the gold reserve and the credit structure of Germany. The Bank of Prussia was taken as the nucleus of such a bank which was called the Reichsbank. The Prussian Government was paid out its share of the capital and surplus and the whole of the capital of the Reichsbank was obtained by private subscription. The Imperial Government, however, resumed to itself the power of appointing the Management Board; while the shareholders were to be represented by a council elected by themselves.

The Bank of Japan was set up in 1882 to restore order out of the chaos caused by the excessive issues of notes by the several national banks. These banks were ordered to with draw their notes with in a certain period, and the Bank of Japan detained the sole right of issue. It was joint stock company, but the whole directorate of the Bank consisting of Governor. Deputy Governor and four directors were to be appointed by the Government.

In such countries as Portugal, Roumania, Bulgaria, Serbia, Turkey, Java, Egypt and Algeria, banks with a monopoly of note issue were also brought into being during the nineteenth century.

Thus, by the end of the nineteenth Century almost every country in Europe, along with Japan, Java and Persia in the East, and Egypt and Algeria in Africa, has established a bank of issue with special privileges and powers. All these banks became the bankers and financial agents of the Governments of their respective countries; and in different ways or in varying degrees they also assumed the other functions which were developed by the Bank of England and which have come to be regarded as essential functions of central banks. At the beginning of the twentieth century, all the countries of the New World, and the countries of the Old World such as China and India, were still without central banks. In the United States of America, every bank established under the National Banking Act had the right to issue notes against deposit with the Federal Treasury of an equivalent amount of certain Government securities, and none of these banks acted exclusively as the banker or fiscal agent of the United States Government or as a lender of last resort. A more or less similar state of affairs prevailed in South and Central America and in Canada, Australia, South Africa, New Zealand, etc. A special commission was appointed to inquire into the decentralised banking and monetary system of the USA. The outcome of this was the establishment of Central banking system for the United States, in 1914, in the form of twelve Federal Reserve Banks, each having authority over a defined area, with a co-ordinating Federal Reserve Board at Washington. Provision was made for State participation in the administration of the Federal Reserve System through the appointment of the members of the Federal Reserve Board by the President of the United States, and then through the appointment by the Federal Reserve Board of three out of the nine directors of each Federal Reserve Bank, including the chairman.

The international Financial Conference which was held at Brussels in 1920 passed a resolution to the effect that all countries which had not yet established a Central Bank should proceed to do so as soon as possible, not only with a view to facilitating the restoration and maintenance of stability in their monetary and banking systems but also in the interest of world co-operation.

During the period immediately following the resolution of the conference, a number of central banks were established in different parts of the world. The establishment of the International Monetary Fund in 1944 facilitated the starting of Central banks in the new Afro-Asian countries. Today almost every independent country has a central bank.

The central banks were originally stated as privately owned joint stock banks. They were managed by the shareholders. The structure and organisation of the central banks were closely connected with the economic conditions which prevailed at the time of their establishment. They were privately owned because their object was to provide finance to the Government. Even then most of the central banks were subject to a certain degree of control by their Governments. Gradually the trend towards nationalisation of central banks gathered momentum. Central banks have now become important organs of the Government. They actually support the policy of the Government in the economic field. The changes in the economic conditions of each country raised the status of the central banks to the position of the leader of the entire banking system in the respective countries. It took nearly three centuries for the art of central banking to attain the present-day importance. In the words of M.H. De Kock "Central banks have developed their own code of rules and practices, which can be described as the art of central banking but which, in a changing world is still in the process of evolution and subject to periodical readjustment."

1.2 Definition of Central Banking :

It is very difficult to give a brief and accurate definition of a central bank. The definition is derived from the functions performed by the central bank. These functions have varied from country to country. The functions of a central bank have grown considerably with the passage of time. It can be said that central bank is one which acts as the banker to the government and the commercial banks, has the monopoly of note issue, operates the currency and credit system of the country and does not perform the ordinary commercial banking functions. Many writers were attempted to define a central bank by laying emphasis on one function or the other performed by the central bank. Hawtrey considers that the essential function of a central bank is to act as the lender of last resort. Veera Smith holds that the primary definition of central banking is a banking system in which a single bank has either a complete or a residuary monopoly in the note issue. Shaw considers that the one true, but at the same time all-sufficing function of a central bank is control of credit. Kisch and Elkin think that the essential function of a central bank is the maintenance of the stability of the monetary standard which involves the control of the monetary circulation. Jancey opines that clearing is the main operation of a central banking. In the Statute of the bank for International Settlements, a central bank is defined as the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in the country. The fact that several central banks have been named reserve banks, appears to show that in the opinion of some authorities the custody of bank reserves is the characteristic function of a central bank.

M.H. De Kock's definition of a central bank appears to be better than many of other definitions. In his definition he includes all the important functions of a central bank. The only criticism on the definition is that it is too long. According to him a central bank is a bank which "constitutes the apex of the monetary and banking structure of its country and which performs, as best as it can in the national economic interest, the following functions:

1. The regulation of currency in accordance with the requirements of business and the general public, for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof.

2. The performance of general banking and agency services for the Government.
3. The custody of the cash reserves of the commercial banks.
4. The custody and management of the nation's reserves of international currency.
5. The provision of credit facilities in the form of rediscounts or collateral advances, to commercial banks, discount houses, bill brokers and dealers, or other banking institutions, in its capacity as the bankers bank, and the general acceptance of the responsibility of lender of last resort.
6. The settlement of clearance balances between the banks, and the provision of facilities for the transfer of funds between all important centres.
7. The control of credit in accordance with the needs of business and the economy generally and for the purpose of carrying out the broad monetary policy adopted by the Government."

1.3 Nature of Central Banking :

The Significance of a central bank lies in its function of managing the monetary system of the country, internally as well as externally. By the nature of the its business, the central bank is intimately connected with the banking system and money market of the country and can definitely regulate the monetary system of the country in the general interest of the nation. A central bank can act in the public interest more effectively if it is guided by some principles. These are as follows.

1. A central bank is not primarily a profit seeking enterprise. Because the operations of the central bank are such as profoundly to effect the monetary and credit situation, they cannot be undertaken solely for the purpose of making profit. This does not mean that the central bank should suffer losses while working in national interest. What it implies is that the profit motive should only be a secondary consideration, and not the primary motive for central banking operations.
2. A Central banks acts as the leader of the money market and supervises, controls and regulates the activities of the commercial banking system. A central bank is recognised as the apex monetary institution or the highest financial authority whose main objective is to help control and stabilise the monetary and banking system of the country in the national economic interest. The central bank must be in a position to control the size of bank reserves as a means of controlling the volume of money in circulation.
3. There must always be a close relationship between the central bank and the national government. Although the central bank is normally endowed with the capacity to regulate the volume of bank notes and demand deposits, that capacity is subject to the policy and actions of the Government.

In the pre-war period some economists, like kisch and Elkin, argued in favour of political independence of central banks. But in the midst of post-war economic reconstruction, when monetary management became a condition precedent to economic planning, it was felt imperative that central banks should be one with the State. The Governments can now hardly be expected to surrender their power of policy formulation to the central banks. In the words of kent, "A close working relationship must continuously exist between the two institutions, so that one will not embark upon a course of action in direct conflict with the aims and objectives of the other."

1.4 Objectives of Central banking :

The traditional objective of a central bank is the maintenance of price and exchange stability. However, this is but a means to achieve economic progress rather than an end in itself. In the context of the developing countries, these objectives of policy of a central bank have to be fitted into the broader and more compelling urge for furthering economic growth. The need for a monetary expansion to take care of the growing economy is all the more necessary for economic growth.

The man objective of a central bank's monetary policy is to achieve "growth with stability" within the framework of the general economic policy of the State. For the sake of economic development, the central bank should provide sufficient quantity of money appropriate to growth process. A growing volume of production and investment cannot be maintained without an increasing supply of money and credit. The money supply should grow at least at a rate roughly equal to that of increase in real income. It may be essential to mobilise domestic savings for productive uses and the flow of funds has to be guided, Qualitatively as well as Quantitatively, to proper lines of investment. Thus one of the major objectives of a central bank is to support the gradual expansion and proliferation of commercial banks, saving banks, cooperative banks, investment banking, government bond marketing, bill market etc. for the purpose of meeting the requirements of economic development of the country.

In a developing economy, particularly, the central bank has important role to play in the process of development. The under developed economies have under-development markets, where banking system is not properly organised. There are institutional gaps in the money are capital markets which hinder economic growth. Thus, promotion of sound, organised, well-integrated institutions and agencies money and capital markets becomes the important objective of a central bank in a developing economy. The Planning Commission in India has stressed to developmental role of a central bank in these words; central banking in a planned economy can hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take a direct and active role, first, in creating or helping to create the machinery needed for financing development activities all over the country and secondly, in ensuring that the finance available flows in the directions intended."

Some vital factors, like agriculture, small industries, etc., in the developing economies have suffered due to unsatisfactory organisation for the supply of credit to these sectors. The central bank has the responsibility to improve the position by making special efforts for providing credit facilities to these priority sectors on relatively easier terms. The central bank is also required to make adequate arrangements for the expansion of long term finance for industries. Some separate institutions may have to be created for the purpose. The central bank also meets a part of the requirements of the government finance through deficit finance, the magnitude of which has to be decided carefully that economic stability is not greatly impaired.

In developing economies, in fact, the development aspect of central banking functions is of greater importance than its regulatory aspect. According to Edward Nevin, the usefulness of a central bank in a developing economy must be stressed primarily in terms of its, ability to assist the process of economic growth and capital formation; the contribution it can make to the regulation, direction and guidance of such credit institutions as exist at the time must be of secondary and lesser consideration.

The objectives of central banking policy in a developing economy may, thus, be stated as follows:

1. To assist the mobilisation of savings in the community and promote capital formation;
2. To promote the spread of monetisation and monetary integration through the development of an integrated commercial banking system.
3. To make adequate provision of credit necessary for fulfilment of the targets of production and trade.
4. To extend monetary support to the authorities in the central task of allocation of resources among different sectors in the economy.
5. To help in maintaining general price stability and preventing inflationary tendencies from getting out of hand.

1.5 The Universal necessity of central banks :

It has now become a universally accepted principle that a banking system requires a central bank at the top and all the countries today have central banks. However, there are some economists who hold that central bank is not such an essential institution that a country may not do without it. They argue that the importance and functions of a central bank are unnecessarily exaggerated by the supporters of central banking. It most celebrated functions of note issue, government's banker, bankers' banker etc. can easily be undertaken by any other institution or agency in the absence of a central bank. It is further argued that central bank is not a natural product of banking development and that it has been imposed from outside has been created by government legislation. Among the modern economists, Milton, Friedman and Mynts have argued that as a consequence of close connection between the central bank and the state, the central bank has come under the complete control of government and the treasury, and as such the need for its separate existence has disappeared.

Some economists like J.L. Fisher have contended that due to inadequate development of financial mechanism and money markets in under-developed countries, central banks have nothing to do in such economies and are therefore out of place. In his report on the desirability of establishing a central bank in Nigeria, Fisher argued that the financial environment in Nigeria was hardly suitable for the functioning of a central bank. To him, the establishment of a central bank would be a logical and useful step in due course only after an adequate development of financial mechanism and money market in the country.

There is no denying the fact that the influence of the government or the treasury on central bank has increased considerably during the recent years. But it is wrong and misleading to agree on this ground that the need for having a central bank has disappeared. A central bank remains a central bank even though it is influenced by the treasury. In fact, monetary management is the joint responsibility of the treasury and the central bank.

The central bank occupies an important position in the operation of financial markets. The powers accorded to it enable it to influence the rate of expansion of the banking system and the money market, and to act as banker and debt manager of the government, place it at the centre of the financial system. The central bank is naturally concerned that financial markets should function efficiently and act as channels through which the impact of monetary policy on the economy is transmitted and the savings of the community are transferred to the ultimate users. The expertise which a central bank can develop in financial markets is of considerable value not only in carrying out its own operations, but also in assisting the government. Obviously, the central bank, enables the monetary system to operate more acceptably than would be possible in the absence of a central bank.

In case of under-developed economies, a great deal of the effort of the central bank is required to improve the structure of the existing financial institutions and to set up new institutions so that the maximum amount of domestic savings may be mobilised for economically constructive purposes. Thus, in such countries a central bank's primary concern in not only the regulation, but also the development of the money market. The central bank has to create and foster a wide range of specialised activates like agricultural or rural banking, industrial banking and such other financial services which are found in the most rudimentary stage in these countries.

Ever, in the absence of a developed money market, the central bank has an important role to play as government's agent and adviser, as the banker's bank and as the controller of foreign exchange in under-developed economies. Central banks assist in economic planning by providing resources to the government through deficit financing or creation of money. It keeps a vigilant eye on banking trends and practices in the economy and helps the banking system in a number of ways. It administers the exchange stability of exchange rates.

Thus there is universal necessity of central banks for all types of countries – developed and developing, planned and without planning, 'old' as well as 'new'. But conditions and problems are not same in every country. The nature and functions of central banking should be determined for each country separately, keeping in view the type of financial climate and the institutional environment in which it has to work.

1.6 Functions of a Central Bank :

It is difficult to lay down any hard and fast rule regarding the functions of central bank. The functions of central banks vary from country to country. On the one hand, we see the state-owned, state-controlled Bank of England which follows the centralised system of central banking. On the other hand, we see the American system of Federal Reserve Bank owned by the Member Banks and coordinated by the Federal Reserve Board. However a careful study into the organisation and operative techniques of the various central banks would enable us to draw certain broad conclusions as to the general functions of a central bank. In this connection, the observations made by the Governor of the Bank of England before the Royal Commission on Indian Currency (1926) is highly illuminating. According to him a central bank should have the sole right of note issue and it should be the channel and sole channel for the output and intake of legal tender currency. It should be the holder of all the Government balances, the holder of all the reserves of all the government balances, the holder of all the reserves of the other banks and branches of banks in the country. It should be the agent through which the financial operation, at home and abroad, of the government would be performed. It should be the duty of a central bank to effect so far as it could, suitable contraction and suitable expansion, in addition to aiming generally at stability. When necessary it would be the ultimate source from which emergency credit might be obtained in the form of discounting of approved bills or advances on approved bills or advances on approved short securities or Government paper. To sum up, central bank a bank of issue, a bankers' bank and a lender of last resort, an agent, advisor and banker to the Government, a custodian of the nation's metallic reserves and controller of currency. The nature of these functions points out one basic fact, that the central banking is entirely different from commercial or other branches of banking and that its main aim is to serve in the public interest and not to secure profits.

The functions of a central bank and obligations resting upon it are of a very special character calling for skill, experience and judgement of a kind different from those which must be possessed by commercial banks. No banker can neglect the rules of prudence and safety, but the object of a commercial banker is to make a profit. The situation of a central bank is such that it must often undertake operations which are not only profitable, but result in losses, its aim must be the economic welfare of the country.

16.1 The Central Bank as the Bank of Issue : One of the most important functions of a central bank is the issue of legal tender currency. The central bank is entrusted with the responsibility of maintaining stability of the monetary unit and of controlling the currency and credit system of the country. To enable it to discharge this duty satisfactorily, it is given the monopoly of note issue. According to De Kock, "the privilege of note issue was almost every where associated with the origin and development of central banks. In fact, until the beginning of the twentieth century they were generally known as the banks of issue."

The main reasons for the concentration of note issue in a central bank may be stated as follows:

1. Concentration of note issue with the central bank brings about uniformity in the note circulation.
2. With the increasing use of deposit money created by commercial banks, the sole right of note issue enables the central bank to control the lending operations of the banks.
3. The concentration of note issue in one bank which enjoys the support of the State gives such notes a distinction and prestige. It has proved to be of great value in a crisis or in an emergency.
4. If the note issue is entrusted with one bank, it is easy for the government to have effective control over the activities of that bank.

5. The capacity to vary the total amount of legal tender currency according to the needs of the community forms the basis of monetary management in the country. The central bank has the powers of monetary management. These powers are incomplete without the monopoly of note issue.

6. The issue of note is a valuable source of profits. Since the government does not issue notes, it is found advantageous to concentrate the note issue in the hands of the central bank and provide for the participation of the government in the profits of the central bank.

Note-issue and the State : The privilege of the note issue is the prerogative of the State. But it does not undertake this function because of the several dangers associated with it. All over the world state has entrusted the note issue to the central banks. The separation of note-issue from the hands of State has been advocated mainly because of the danger of over issue. According to Kisch and Elkin, "if the government itself has the right of note-issue, either alone or in association with one or more banks, political considerations and pecuniary needs of the State rather than considerations of a sound monetary economy are likely sooner or later to become the determining factor." Instead of the State monopolising the note issue, it would be better if that right is entrusted to the central bank subject to the general supervision of the state. This would facilitate the function if the central banks as controller of credit. It is true that the State can bring pressure upon the central bank, for an over-issue. But the resistance which is usually offered by a central bank against unsound monetary and financial policies on the part of the State is atleast one advantage in favour of the central banks being the issuer of notes.

Principles of Note-issue : There are two different schools of thought regarding the principle of note-issue, viz, the currency principle, and the banking principle. According to the former, the amount of legal currency should be limited to the gold reserve kept by a central bank. This assumes full convertibility of notes. Since the note issue cannot exceed the quantity of gold lying with the central bank. the questions of over-issue does not arise. The fundamental defect in this principle is that it lacks elasticity, which is so indispensable a factor for meeting the exigencies of altered circumstances in the money market. It does not also take into account the power of the commercial banks to create credit.

The exponents of the banking principle hold that there is no need to keep a cent per cent reserve against the note issue. It is enough if a certain proportion of the outstanding note issue is converted by metallic reserves. This principle is derived from the experience of the bankers who maintain only a certain percentage of their deposit liabilities in cash with a view to meeting the demands of their customers. This principle insists that the total Quantity of notes should be maintained by assuring convertibility of notes. The great merit of this principle is that the currency system becomes elastic and responsive to the demand of trade and commerce. The total monetary circulation can be expanded or contracted according to the needs of trade. One important defect in this principle is that where only minimum reserves are held and the over-issue exceeds these reserves, the bank will find it impossible to convert the notes which are returned. This will lead to loss of confidence in the notes issued.

In conclusion it may be observed that both these systems are not worthy of adoption as they are. It is necessary to provide elasticity to the notes in circulation without shaking public confidence or creating monetary chaos. In a certain sense, the banking principle assures elasticity and the currency principle assures public confidence. At the same time, the former exposes the note-issue to the serious risk, monetary instability and the latter makes it inelastic. The solution will lie in a happy combination of two principles.

Combining the merits of both the banking and the currency principles, different systems of note issue have been evolved to regulate note issue. They are the partial or fixed fiduciary system, maximum fiduciary system, proportional reserve system, minimum reserve system and the foreign exchange reserve system.

The necessity and the purpose of prescribing certain reserve requirements against the note issue are Questioned by many authorities. It is Questioned as to whether the reserve requirements add to the security of the currency or increase public confidence in the notes issued by the central bank. The purpose of maintaining gold reserve are to create confidence in the public, to maintain stability in the value of the currency, to regulate the volume of the note issue and to meet international obligations arising out of adverse balance of payments. It is not correct to say that the people's confidence in the currency mainly depends on gold reserves held against the note-issue. No modern central bank is likely to become a bankrupt except in the event the bankruptcy of the Nation itself. It has now been realised that there is no longer any need to have rigid relationship with gold. The people who favour the idea of keeping adequate gold reserves state that the reserve requirements will act as a brake on any inflationary over-issue of currency by the central bank. It has been the experience of the government and the central banks that the success of a central bank in checking inflationary conditions depends more on the credit policy pursued by the central bank rather than the statutory gold reserves held by it. If the reserve requirements are very rigidly fixed, the central bank may find it difficult to expand currency when the same is necessary in the interests of the Nation.

It may be said that it is not necessary to link note issue with gold reserve. The system of note issue must be sufficiently elastic and it must meet the needs of trade and commerce. Apart from the fact that gold is used as a cover against note issue, gold is also demanded for the purposes of export to meet the international obligations. If a bank can provide foreign currencies to meet the international obligations, maintenance of gold reserves become unnecessary. It is always desirable to give freedom to the central bank in the matter of maintaining gold reserves. The amount of gold reserves should depend on international obligations, the nature of trade and the method of foreign payments and not on volume of notes. Taking into account the conditions of foreign trade, the central bank should be allowed to formulate its own policy regarding gold reserves.

1.6.2 Central Bank as a Banker to the Government : The central bank acts as a banker to the state, not because the lather find it convenient and economical but because of the close relationship between public finance and monetary affairs. The central bank acts as the banker, agent and adviser to the government. As the governments' banker the central bank conducts the banking account of government departments, boards and enterprises. It makes temporary advances to the government in anticipation of the collection of taxes or raising of loans from public, and extra ordinary advances during a depression, war or other emergency and it carries out the governments' transactions involving purchases and sales of foreign currencies. The central bank is also called upon to perform various services as the Governments' financial agent, and it acts generally as a financial adviser of the government.

In every country the government receives and spends enormous sums through its taxation and expenditure policy. The manifold financial operations of the government are likely to have a disturbing influence on the money market. The central banks gives appropriate advice to the government and takes necessary remedial measures to minimise the effects of the financial operations of the government. This is perhaps the main reason for concentrating the financial operations of the government in the hands of the central bank.

The central bank acts as the financial agent of the government. It is the agency through which new loans and treasury bills are issued to the public. It assumes all the duties and responsibilities connected with the administration and management of the public debt. For this purpose the central bank in many countries maintains a separate public debt department. It maintains a separate register of the government stock holders, pays interest on the national debt, records all transfer in respect of government stocks and makes all arrangements in connection with the floatation, conversion or redemption of the government loans, treasury bills, etc.

Another useful service rendered by the central bank is that it acts as the adviser to the government. It advises the government on all financial matters. Its role as an adviser has great significance because of its unique position in the monetary set-up of each country. It is in intimate contact with the money market and it is the best judge of the general financial situation in the country. Most central banks have separate departments to study the market trends and to formulate appropriate policies in conformity with the changing circumstances.

1.6.3 Central Bank as Bankers' Bank : As the bank of issue and the governments' bank, the central bank stands in a priviliged position in the money market. It is also entrusted with the responsibility of securing orderly development of banking in the country. The commercial banks recognise the supremacy of the central bank and accept it as their friend philosopher and guide. There must be close relationship between the central bank and the commercial banks. The central bank is also endowed with statutory powers to ensure orderly development of banking in the country. It has the power, to call for any information from the commercial banks and issue instructions to them.

As the bankers' bank the central bank performs a number of useful functions. It acts as the guardian of the reserves of the commercial banks. The commercial banks deposit their surplus funds with the central bank. It acts as the clearing house for settling the inter-bank indebtedness. It helps the commercial banks in times of emergencies by extending financial help. In most countries, the commercial banks deposit their surplus funds with central banks. The central bank has become the custodian of the cash reserves of the commercial banks by a process of evolution. It was closely associated with its functions as the bank of issue and the governments bank. The concentration of cash reserve in the central bank is a source of great strength to the banking system of any country. Centralised cash reserve can at least serve as the basis of a larger and more elastic credit structure than if the same amount were scattered among the individual banks. It is obvious that, when bank reserves are pooled in one institution which is charged with the responsibility of safe guarding the national economic interest, such reserves can be employed to the fullest extent possible and in the most effective manner during periods of seasonal strain and in the financial crisis or general emergencies.

1.6.4 Central Bank as the custodian of the Nation's Reserves : The central bank is generally entrusted with the custody of nation's reserves. This function is derived from its other two functions, viz, the right to issue notes and the custody of the cash reserves of commercial banks. Under the gold standard the central banks were required to maintain gold reserves against note-issue.

These reserves are to be used to correct any adverse balance of payments and to maintain the external value of the currency. To the extent that a central bank is required by law to maintain a minimum reserve against its note issue or against its note and deposit liabilities, its holding of gold and foreign exchange is immobilised and not available for the purpose of balancing international accounts. The existence of a reserve requirement renders it necessary for a central bank to hold two different kinds of reserves, the one an internal reserve and the other an external or free reserve. The internal reserve is the statutory reserve to be maintained against the note issue. The external reserve is the reserve that is freely available for use as international currency. The reasons for keeping the reserves are to maintain confidence in the currency at home and abroad and to set a limit to the expansion of credit.

1.6.5 Central Bank as the Lender of Last Resort : The central bank acts as the lender of last resort. This function developed out of the special position of the central bank in the banking system of the country. The monopoly of note issue and the custody of the reserves of the commercial banks and the nation have added strength to the capacity of the central bank to act as the lender of last resort. The central bank plays its role as lender of last resort by assuming responsibility to meet directly or indirectly all reasonable demands of commercial banks, discount houses and other credit institutions for financial accommodation in times of need or crisis. The essential duty of the central bank as the lender of last resort is to made good shortage of cash among the competitive banks.

The Central bank is extending financial accommodation mainly through rediscount of first class bills of exchange, government securities and such other eligible papers. As observed by De Kock, the central bank's function of lender of last resort developed out of the rediscount function and was primarily associated with the latter. It implied the assumption of the responsibility of meeting, directly of indirectly, all reasonable demands for accommodation from commercial banks, discount houses and other credit institutions, subject to certain terms and conditions which constitute the discount rate policy of the central banks.

The function of rediscount is considered a very important function of the central bank because it increase the elasticity and liquidity of the credit structure. The provision of rediscount facilities by the central bank promotes economy in the use of bank cash and makes it possible for the banks individually as well as collectively to conduct their business with smaller cash reserves than if they were to depend only on their own resources and on such money market facilities as were available. Again, the full acceptance of this responsibility by the central bank works, other things being equal, in the direction of encouraging the commercial banks to maintain relatively stable cash ratio, and this is of great importance to the central bank in performing its general function of credit control.

1.6.6 Central Bank as the bank of Central Settlement : The central bank acts as the clearing house for settlement of outstanding balances between the commercial banks which keep their surplus funds with it. Since the central bank is the custodian of the cash reserves of the commercial banks. It is easy for it to assume the duty of acting as the settlement bank or clearing house for the other banks. It is for the central bank to setup an expeditious and economical machinery for the clearance of drafts and settlement of accounts because as holder of the balances of commercial banks a central bank is specially qualified for this duty. in the absence of a central agency for clearance and settlement each bank has to enter into a separate clearance and settlement transaction with the other banks individually. The system of clearing by the central banks is not only a means of economising cash and capital, but is also a means of testing at any time the degree of liquidity which the banking community is maintaining.

1.6.7 Central Bank as the Controller of Credit : The most important function of the Central bank is to control the credit creation power of commercial banks in order to control inflationary and deflationary pressures within economy. Commercial banks have the power to alter the total amount of money in circulation through the mechanism of credit creation. Thus the total amount of money in circulation has a relationship with the creation of credit, of course, commercial banks are not the only persons having the power. There are other forms of credit. Businessmen and industrial enterprises can acquire goods and services without paying for them immediately. Thus credit has come to play a predominant part in the settlement of business transactions of all kinds. In fact, all countries have come to be based on a credit economy rather than a money economy. Fluctuations in the volume of credit cause wide fluctuations in the purchasing power of money which has grave social and economic consequences. The experience of the past several years has emphasised the need for the control of credit in one form or other.

As to the main objective of credit control there are differing opinions. Some economists are of the opinion that credit control should mainly aim at exchange stability while some others are of the opinion that credit control should mainly aim at internal price stability. There are certain others who consider the elimination of business cycle as the primary objective of credit control. As observed by De Kock, the most recent tendency in official monetary circle is to combine the objective of international exchange stability with that of promoting and maintaining high levels of employment and real income.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce. Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks. They are the issuing of licences; the regulation of branch expansion; to see that every bank maintains the minimum paid up capital and reserves as provided by law; inspecting or auditing the accounts of banks; to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; to control and recommend merger of a weak banks in order to avoid their failures and to protect the interest of depositors; to recommend nationalisation of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc.

1.7 Techniques used by Central Banks to Control Credit :

The most important function of the central bank is to control the credit creation power of commercial banks in order to control inflationary and deflationary pressures within economy. For this purpose, it adopts Quantitative methods and Qualitative methods. Quantitative methods aim at controlling the cost and Quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods, the central bank tries to influence and control credit creation by commercial banks in order to stabilise economic activity in the country.

1.7.1 Methods of Credit Control : In the words of De Kock, the following are the principal methods or techniques which may be used by central banks for the control or adjustment of credit:

1. The lowering or raising of their discount and interest rates with a view to lowering or raising money rates generally and encouraging the expansion or contraction of credit.
2. The buying or selling of securities or bills of exchange in the open-market with a view to putting additional funds into the market or withdrawing funds there from and thus expanding or contracting credit;
3. The rationing of credit as an alternative or as an addition to raising discount and interest rates;
4. The taking of direct action either in the form of coercive measures against any offending bank or other financial institution or in the form of directives to banks generally concerning their lending and investment operations, in order to assist the central bank in controlling the Quantity of credit as well as securing a better Qualitative distribution of credit;
5. The lowering or raising of the minimum cash reserves to be maintained by the commercial banks, as an additional means of enabling the central bank to expand or contract their capacity to create credit;
6. The imposition of minimum secondary reserve requirements to be maintained by the commercial banks in the form of government securities and other specified assets, in order to restrict their capacity to extend credit for general business purposes.
7. The regulation of the terms and conditions under which credit repayable in instalments may be granted for purchasing or carrying consumers' durable goods, as a means of exercising some direct control over the volume of outstanding consumer credit;
8. The regulation of margin requirements in connection with purchases of stock exchange securities, as an instrument for exercising some direct control over the volume of credit used in the security markets; and
9. The use of moral suasion and publicity to achieve the desired objectives.

1.7.2 Objectives of Credit Control : Credit Control is the means to control the lending policy of commercial banks by the central bank. The central bank controls credit to achieve the following objectives.

1. **To stabilise the internal price level.** One of the objectives of controlling credit is to stabilise the price level in the country. Frequent changes in the price adversely affect the economy. Inflationary or deflationary trends need to be prevented. This can be achieved by adopting a judicious policy of credit control.

2. **To stabilise the rate of foreign exchange.** With the change in the internal price level, exports and imports of the country are affected when prices fall, exports increase and imports decline. Consequently, the demand for domestic currency increases in the foreign market and its exchange rate rises. On the country a rise in the domestic prices leads to a decline in exports and an increase in imports. As a result, the demand for foreign currency increases and that of domestic currency falls, thereby lowering the exchange rate of the domestic currency. Since it is the volume of credit money that affects prices, the central bank can stabilise the rate or foreign exchange by controlling bank credit.

3. **To protect the outflow of gold**. The central bank holds the gold reserves of the country in its vaults. The expansion of bank credit leads to rise in prices which reduce exports and increase imports, thereby creating an unfavourable balance of payments. This necessitates the export of gold to other countries. The central bank has to control credit in order to prevent such outflows of gold to other countries.

4. **To Control business Cycles.** During the prosperity period of business cycle, there is a large expansion in the volume of credit production, employment and prices rise. During depression, credit contracts and production, employment and prices fall. The central bank can counter act such cyclical fluctuations through contraction of bank credit during boom periods and expansion of bank credit during depression.

5. **To meet business needs.** According to burgess, one of the important objectives of credit control is the adjustment of the volume of credit to the volume of business. Credit is needed to meet the requirements of trade and industry. As business expands, larger quantity of credit is needed and when business contracts less credit is needed. Therefore, it is the central bank which can meet the requirements of business by controlling credit.

6. **To have growth with stability.** In recent years, the principle objective of credit control is to have growth with stability. The other objectives such as price stability, foreign exchange rate stability, etc., are regarded as secondary. The aim of credit control is to help in achieving full employment and accelerated growth with stability in the economy without inflationary pressures and balance of deficits.

1.7.3 Techniques of Credit Control : The central bank adopts two types of methods of credit control. They are the quantitative and Qualitative methods. The Quantitative methods aim at controlling the cost and quantity of credit by adopting such techniques as variations in the bank rate, open market operations and variations in the reserve ratios of commercial banks. On the other hand, the Quantitative methods control the use and direction of credit. These involve selective credit controls and direct action.

1. **Bank Rate Policy :**

The bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The central bank controls credit by making variations in the bank rate. If the need of the economy is to expand credit, the central bank lowers the bank rate. Borrowing from the central bank becomes cheap and easy. So the commercial banks borrow more. They in turn, advance loans to customers at a lower rate. The market rate of interest is reduced. This encourages business activity and expansion of credit follows which encourages the rise in prices. The opposite happen when credit is to be contracted in the econom ,. The central bank rises the bank rate which makes borrowing costly from it. So the banks borrow less. They, in turn, raise, their landing rates to customers. The market rate of interest also rises because of the tight money market. This discourages fresh loans and puts pressure on borrowers to pay their past debts. This discourages business activity. There is contraction of credit which depresses the rise in prices. Thus lowering the bank rate offsets deflationary tendencies and raising the bank rate controls inflation.

Limitations of Bank rate policy : The efficacy of the bank rate policy as an instrument of controlling credit is limited by the following factors:

1. The success of bank rate policy depends upon the extent to which other market rates of interest change along with the bank rate. The theory of bank rate policy pre-supposes that other rates of interest prevailing in the money market change in the direction of the change in the bank rate. If this condition is not satisfied, the bank rate policy will be totally ineffective as an instrument of credit control.

2. The success of the bank rate policy requires elasticity not only in interest rates but also in wages, costs and prices. It implies that when suppose the bank rate is raised, wages costs, and prices should automatically adjust themselves to a lower level. But this was possible only under the gold standard. Now a days the emergence of strong trade unions have made wages rigid during deflationary trends. And they also lag behind when there are inflationary tendencies because it takes time for unions to get a wage rise from employers. So the bank rate policy cannot be a success in a rigid society.

3. The effectiveness of the bank rate policy as a tool of credit control is also limited by the behaviour of the commercial banks. It is only if the commercial banks approach the Central bank of rediscounting facilities that this policy can be a success. But the banks keep with them large amount of liquid assets and do not find it necessary to approach the central bank for financial help

4. As a corollary to the above, the effectiveness of the bank rate policy demands on the existence of eligible bills of exchange. In recent years, the bill of exchange as an instrument of financing commerce and trade has fallen into disuse. Businessmen and banks prefer cash credit and overdrafts. This makes the bank rate policy less effective for controlling credit in the country.

5. The efficacy of the bank rate policy also depends on waves of pessimism or optimism among businessmen. If the bank rate is raised, they will continue to borrow even at a higher rate of interest if there are boom conditions in the economy, and prices are expected to rise further. On the other hand, a reduction in the bank rate will not induce them to borrow during periods of falling prices. Thus businessmen are not very sensitive to changes in interest rates and they are influenced more by business expectations.

6. Another limitation of the bank rate policy is that power of a central bank to force a reduction in the market rates of interest is limited. For instance, a lowering of the bank rate below 3 per cent will not lead to decline in the market rates of interest below 3 per cent. So the bank rate policy is ineffective in controlling deflation. It may, however, control inflationary tendencies by forcing an increase in the market rates of interest.

7. The efficacy of the discount rate policy as an instrument of credit control depends upon its level in relation to the market rate. If in a boom the bank rate is not raised to such as extent as to make borrowing costly from the central bank, and it is not lowered during a recession so as to make borrowing cheaper from it, it would have a destabilising effect on economic activity.

2. Open Market Operations : Open market operations are another method of Quantitative credit control used by a central bank. This method refers to the sale and purchase of securities, bills and bonds of government as well as private financial institutions by the central bank. But in its narrow sense it simply means dealing only in government securities and bonds.

There are two principle motives of open market operations. One, to influence the reserves of commercial banks in order to control their power of credit creation. Two, to affect the market rates of interest so as to control the commercial bank credit. Another aspect of the open market policy is that even the supply of money changes as a result of open market operations, the market rates of interest also change. A decrease in the supply of bank money through the sale of securities will have the effect of raising the market interest rates. On the other hand, an increase in the supply of bank money through the purchase of securities will reduce the market interest rates. Thus open market operations have a direct influence on the market rates of interest also.

Limitations of open market operations : The effectiveness of open market operations as a method of credit control is dependent upon the existence of a number of conditions, the absence of which limits the full working of this policy.

1. The first condition is the existence of a large and well organised security market. This condition is very essential for open market operations because without a well developed security market the central bank will not be able to buy and sell securities on a large scale, and thereby influence the reserves of commercial banks. Further, the central bank must have enough saleable securities with us.

2. The success of open market operations also requires the maintenance of a stable cash-reserve ratio by the commercial banks. It implies that when the central bank sells or buys securities, the reserves of the commercial banks decrease or increase accordingly to maintain the fixed ratio. But usually the banks do not stick to the legal minimum reserve

ratio and keep a higher ratio than this. This makes open market operations less effective in controlling the volume of credit. This has been the practice with the commercial banks in a number of developed countries like the USA. As a matter of fact, the commercial banks vary the reserve ratio within wide limits so as to expand or contract credit in accordance with the prevailing economic conditions of the country.

3. One of the necessary conditions for the success of open market operations is a penal bank rate. If there is no penal discount rate fixed by the central bank, the commercial banks can increase their borrowings from it when the demand for credit is strong on the part of the latter. In this situation the sale of securities by the central bank of restrict monetary expansion will be unsuccessful. But if there is a penal rate of discount, which is a rate higher than the market rates of interest, the banks will be reluctant to approach the central bank for additional financial help easily.
4. Open market operations are successful only if the people also act the way the central bank expects them. When the central bank sells securities, it expects the business community and financial institutions to restrict the use of credit. If they simultaneously start dishoarding money, the act of selling securities by the central bank will not be a success in restricting credit. Similarly, the purchase of securities by the central bank will not be effective if people start hoarding money.
5. Pessimistic or optimistic attitude of the business community also limits the operation of open market policy. When the central bank purchases securities and increases the supply of bank money, businessmen may be unwilling to take loans during a depression because of the prevailing pessimism among them. If the businessmen are optimistic during a boom, the sale of securities by the central bank to contract the supply of bank money and even the rise in market rates cannot discourage them from getting loans from the banks. On the whole this policy is more successful in controlling booms than depressions.
6. The success of open market operations depends upon a constant velocity of circulation of bank money. But the velocity of credit money is not constant. It increases during periods of brisk business activity and decreases in periods of falling prices. Thus a policy of contracting credit by the sale of securities by the central bank may not be successful by increased velocity of circulation of bank credit.

Despite these limitations open market operations are more effective than other instruments of credit control available with the central banks. This method is being successfully used for controlling credit in developed countries where the securities market is highly developed.

3. Variable Reserve Ratio : Variable reserve ratio (or required reserve ratio or legal minimum requirements), as a method of credit control was first suggested by Keynes in his Treatise on Money (1930) and was adopted by the Federal Reserve System of the United States in 1935.

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. The minimum amount of reserve with the central bank may be either a percentage of its time and demand deposits separately or of total deposits. What ever the amount of money remains with the commercial bank over and above these minimum reserves is known as the excess reserves. It is on the basis of these excess reserves that the commercial bank is able to create credit. The larger the size of the excess reserves, the greater the power of a bank to create credit, and vice versa. It can also be said that the larger the required reserve ratio, the lower the power of a bank to create credit, and vice versa.

When the central bank raises the reserve ratio of the commercial banks, it means that the latter are required to keep more money with the former. Consequently, the excess reserves with the commercial banks are reduced and they can lend less than before.

On the contrary, if the central bank wants to expand credit, it lowers the reserve ratio so as to increase the credit creation power of the commercial banks. Thus by varying the reserve ratio of the commercial banks, the central bank influences their power of credit creation and thereby controls credit in the economy.

Limitations of variable Reserve Ratio : The variable reserve ratio as a method of credit control has a number of limitations.

1. The commercial banks usually possess large excessive reserves which make the policy of variable reserve ratio ineffective. When the banks keep the excessive reserves which make the policy of variable reserve ratio ineffective. When the banks keep excessive reserves, an increase in the reserve ratio will not affect their lending operations. They will stick to the legal minimum requirements of cash to deposits and at the same time continue to create credit on the strength of the excessive reserves.
2. It is a clumsy method of credit control as compared with open market operations. This is because it lacks definiteness in the sense that it is inexact and uncertain as regards changes not only in the amounts of reserves but also the place where these changes can be made effective. The changes in reserves involve far larger sums than in the case of open market operations.
3. It is discriminatory and affects different banks differently. A rise in the required reserve ratio will not affect those banks which have large excess reserves. On the other hand, it will hit hard the banks with little or no excess reserves. This policy is also discriminatory in the sense that non-banking financial intermediaries like cooperative societies, insurance companies, building societies, development banks, etc. are not affected by variations in reserve requirements, though they compete with the commercial banks for lending purposes.
4. This policy is inflexible because the minimum reserve ratio fixed by the central banks is applicable to banks located in all regions of the country. More credit may be superfluous in the other region. Raising the reserve ratio for all banks is not justified in the former region though it is appropriate for the latter region.
5. The success of this method of credit control also depends on the business climate in the economy. If the business men are pessimistic about the future, as under a depression, even a sizable lowering of the reserve ratio, will not encourage than to ask for loans. Similarly, it they are pessimistic about profit expectations, a considerable rise in the variable ratio will not prevent them from asking for more loans from the banks.

6. The effectiveness of this technique depends upon the degree of stability of the reserve ratio. If the commercial banks are authorised to keep widely fluctuating ratios any change in the upper of lower limit will have no effect on the credit creation of power of the banks.

7. The reserve ratio held by the commercial banks is determined not only by legal requirements but also by how much they want to hold in relation to their deposits in addition to such requirements. This will depend upon their expectations about future developments, their competition with other banks, and so on.

8. The variable reserve ratio has been criticised for exercising a depressive effect on the securities market. When the central bank suddenly directs the commercial banks to increase their reserve ratios, they may be forced to sell securities to maintain that ratio. This wide spread selling of securities will bring down the prices of securities and may even lead to an utter collapse of the band market.

9. It can not be used for day-to-day and week to week adjustments but can be used to bring about large changes in the reserve positions of the commercial banks.

The variable reserve ratios as a method of credit control is a very delicate and sensitive tool which not only produces a state of uncertainity among the banks but also adversely affects their liquidity and profitability. Therefore, it should be used with moderation and discretion and only under obvious abnormal conditions.

4. Selective Credit Controls : Selective and Qualitative methods of credit control are meant to regulate and control the supply of credit among its possible users and uses. They are different from Quantitative or general methods which aim at controlling the cost and Quantity of credit unlike the general instruments, selective instruments do not affect the total amount of credit but the amount that is put to use in a particular sector of the economy. The aim of selective credit controls is to channelise the flow of bank credit from speculative and other undesirable purposes to socially desirable and economically useful uses. They also restrict the demand for money by laying down certain conditions for borrowers. They embody the view that the monopoly of credit should in fact become a discriminating monopoly. Prof. Chandler defines selective credit controls as those measures "that would influence the allocation of credit, at least to the point of decreasing the supply and raising the cost of credit for all purposes". The main types of selective credit controls generally used by the central banks in different countries are discussed below:

A) <u>Regulation of Margin Requirements:</u> This method is employed to prevent excessive use of credit to purchase or carry securities by speculators. The central bank fixes minimum margin requirements on loans for purchasing or carrying securities. They are, in fact, the percentage of the value of the security that cannot be borrowed or lent. In other words, it is the maximum value of loan which a borrower can have from the banks on the basis of the security. If the central bank wants to curb speculative activities, it will rise the margin requirements. On the other hand if it wants to expand credit, it reduces the margin requirements.

This method of selective credit control has certain merits which make it unique.

1. It is non-discriminatory because it applies equally to borrowers and lenders. Thus it limits both the supply and demand for credit simultaneously.
2. It is equally applicable to commercial banks and non banking financial intermediaries.
3. It increases the supply of credit for more productive uses.
4. It is very effective anti-inflationary device because it controls the expansion of credit in those sectors of the economy which breed inflation.
5. It is simple and easy to administer since this device is meant to regulate the use of credit for specific purposes.

But the success of this technique requires that there are no leakages of bank credit for non-purpose loans to speculators.

B) Regulation of Consumer Credit : This is another method of selective credit control which aims at the regulation of consumer instalment credit or hire-purchase finance. The main objective of this instrument is to regulate the demand for durable consumer goods in the interest of economic stability. The central bank regulates the use of bank credit by consumers in order to buy durable consumer goods on instalments and hire-purchase. For this purpose, it employs two devises; minimum down payments, and maximum periods of repayment. If the central banks find slump in particular industries of the economy, it reduces the amount of down payments and increases the maximum periods of repayment. Reducing the down payments tends to increase the demand for credit for particular durable consumer durable goods on which the central bank regulation is applied. Increasing the maximum period of repayment, which reduces monthly payments, tends to increase the demand for loans, thereby encouraging consumer credit. On the other hand, the central bank raises the amount of down payments and reduces the maximum periods of repayment in boom.

The regulation of consumer credit is more effective in controlling credit in the case of durable consumer goods during both booms and slumps, whereas general credit controls fail in this area. The reason is that the latter operate with a time lag. Moreover, the demand for consumer credit in the case of durable consumer goods is interest inelastic. Consumers are motivated to buy such goods under the influence of the demonstration effect and the rate of interest has little consideration for them.

But this technique has its limitations. It is cumbersome, technically defective and difficult to administer because it has a narrow base. In other wards, it is applicable to a particular class of borrowers whose demand for credit forms an insignificant part of the total credit requirements. It is, therefore discriminates between different types of borrowers. This method effects only persons with limited incomes and leaves out higher income groups. Finally, it tends to malallocate resources by shifting them away from industries which are covered by credit regulations and lead to the expansion of other industries which do not have any credit restrictions.

C) **Rationing of Credit :** Rationing of credit is another selective method of controlling and regulating the purpose for which credit is granted by the commercial banks. It is generally of four types. The first is the variable port folio ceiling. According to this method, the central bank fixes a ceiling on the aggregate portfolios of the commercial banks and they cannot advance loans beyond this ceiling. The second method is known as the variable capital assets ratio. This is the ratio which the central bank fixes in relation to the capital of a commercial bank to its total assets. In keeping with the economic exigencies, the central bank may raise or lower the portfolio ceiling, and also vary the capital assets ratio.

Rationing of credit has been used very effectively in Russia and Mexico. This technique also involves discrimination against larger banks because it restricts their lending power more than the smaller banks. Lastly, by rationing of credit for selective purposes, the central bank ceases to be the lender of the last resort. Therefore, central banks in mixed economies do not use this technique except extreme inflationary situations and emergencies.

D) **Direct Action :** Central banks in all countries frequently resort to direct action against commercial banks. Direct action is in the form of 'directives' issued from time to time to the commercial banks to follow a particular policy which the central bank wants to enforce immediately. This policy may not be used against all banks but against erring banks. For example, the central bank refuses rediscounting facilities to certain banks which may be granting too much credit for speculative purposes, or in excess of their capital and reserves or restraint them from granting advances against the collateral of certain commodities, etc. It may also charge a penal rate of interest from those banks which want to borrow from it beyond the prescribed limit. The central bank may even threaten a commercial bank to be taken over by it in case it fails to follow its policies and instructions.

But this method of credit control suffers from several limitations which have been enumerated by De kock as "the difficulty for both central and commercial banks to make clear cut distinctions at all times and in all cases between essential and nonessential industries, productive and unproductive activities, investment and speculation, between legitimate and excessive consumption; the further difficulty of controlling the ultimate use of credit by second, third or forth parties; the dangers involved in the division of responsibility between the central banks and commercial banks for the soundness of the lending operations of the latter ; and the possibility of forfeiting the whole-hearted and active cooperation of the commercial banks as a result of undue control and intervention."

E) **Moral Suasion :** Moral suasion is the method of persuasion, of request, of informal suggestion, and of advice to the commercial banks usually adopted by the central bank. The executive head of the central bank calls a meeting of the heads of the commercial banks wherein he explains them the need for the adoption of a particular monetary policy in the context of the current economic situation, and then appeals to them to follow it. This method has been highly effective in India, New Zealand, Canada and Australia, though it failed in US. Moral Suasion is a method "without any teeth" and hence its effectiveness is limited. Its success depends upon the extent to which the commercial banks accept the central bank as their leader and need accommodation from it. If the banks possess excessive reserves they may not follow the advise of the central bank, as is the case with the commercial banks in US. Further, moral suasion may not be successful during booms and depressions when the economy is passing through waves of optimism and pessimism respectively. The banks may not head to the advice of the central bank in such situations. It may be a success where the central bank commands prestige on the strength of the wide statutory powers vested in it by the government of the country.

F) **Publicity :** The central bank also uses publicity as an instrument of credit control. It publishes weekly or monthly statements of the assets and liabilities of the commercial banks for the information of the public. It also publishes statistical data relating to money supply, prices, production and employment and of capital and money markets etc. It cannot be said with definiteness about the success of this method. It presupposes the existence of an educated and knowledgeable public about the monetary phenomena. But even in advanced countries, the percentage of such persons is negligible. It is, therefore, highly doubtful if they can exert any moral pressure on the banks to strictly follow the policies of the central bank. Hence, publicity as an instrument of selective credit control is only of academic interest.

Limitations of Selective Credit Controls : Though regarded superior to quantitative credit controls. Yet selective credit controls are not free from certain limitations.

1. Like general credit controls, selective credit controls have a limited coverage. They are only applicable to the commercial banks but not to non-banking financial banks but not to non-banking financial institutions. But in the case of the regulation of consumer credit which is applicable both to banking and non-banking institutions, it becomes cumbersome to administer this technique.
2. Selective credit controls fail to fulfil the specificity function. There is no guarantee that the bank loans would be used for the specific purpose for which they are sanctioned.
3. It may be difficult for the central bank to distinguish precisely between essential and non-essential sectors and between speculative and productive investment for the purpose of enforcing selective credit controls. The same reasoning applies to the commercial banks for the purpose of advancing loans unless they are specifically laid down by the central bank.
4. The commercial banks for the purpose of earning larger profits, may advance loans for purposes other than laid down by the central bank. This is particularly so if the central bank does not have a large staff to check minutely the accounts of the commercial banks. As a matter of fact, no central bank can afford to check their accounts. Hence selective credit controls are liable to be ineffective in the case of unscrupulous banks.
5. Selective credit controls unnecessarily restrict the freedom of borrowers and lenders. They also discriminate between different types of borrowers and banks. Often small borrowers and small banks are hit harder by selective controls than big borrowers and large banks.

6. Selective credit controls also lead to mal allocation of resources when they are applied to selected sectors, areas and industries while leaving others to operate freely. They place undue restrictions on the freedom of the former and effect their production.

1.8 Summary :

This introductory for unit attempted to provide an understanding to the student as to what is called Central Banking. The lesson provides a vivid picture of the origin of Central Banks in various countries and underlines the basic functions of a Central bank. Central bank has profound and influence on the development of a country. Monetary growth and stability depend on the effectiveness of the functioning of the central bank. Note issue, acting as banker to the government, banker to the other commercial banks, custodian of the Nations Reserves, lender of the last resort and controlling credit are the basic functions of a central bank. The efficiency of a Central Bank depends on how the stated functions are carried out and how it contributes to the well-being of the nation.

1.9 Self –Assessment Questions:

1. Discuss the essential functions of a central bank
2. Distinguish between Quantitative and Qualitative methods of credit control which are more effective in an inflationary situation?
3. Between Bank rate policy and open market operations which is more effective as an instrument of credit control? Give reasons.
4. Explain the significance of selective credit controls. How do they operate and with what success?
5. Discuss the role of a central bank in a developing economy.
6. Trace out the Historical development of Central Banking.
7. Highlight the significance of Central Bank in the Economic Development of a Country.

Lesson 2 **Central Banking in U.K. and U.S.A**

Objectives :

After studying this chapter you should be able to;

1) understand the origin and growth of central banking in U.K.
2) explain the gradual shift in the working of Bank of England as a Central bank;
3) analyse the working of bank of England as a controller of credit.
4) Know the origin and working of the Federal Reserve System.

Structure :

Central Banking in UK

2.1 History of Banking in U.K :

The origin of the first indigenous banking system dates back to the seventeenth century, when the London Goldsmiths used to issue paper money on the security of gold deposited with them. These notes were payable on demand and hence enjoyed considerable circulation. These notes were infact precursors of bank note. The business of the London Goldsmiths got a rude shock by the ill-treatment of the Government of Charles II, under the Cabal Ministry. The Goldsmiths used to deposit their reserves of treasure in the "Exchequer" under the care of the Government. But Charles II shut-up the exchequer and refused to return the reserves of treasure to the Goldsmiths.

This led to their ruin. However, the ruin of goldsmiths marked a turning point in the history of English banking which facilitated the growth of private banking and the establishment of the Bank of England in 1694.

The banking crisis of 1825 acted as an eye opener to the authorities to introduce some kind of banking reform. Accordingly, an Act was passed in 1826, permitting joint stock banks with note issuing powers to be setup outside a radius of 65 miles from London. This Act led to the growth of joint stock banking with branches throughout England, except in London. Another Act in 1833 permitted joint stock banks without note-issuing powers to be setup within a 65 miles radius. In pursuance of this Act, the first joint stock bank other than the Bank of England, was established in London in 1834. This was the London and Westminister Bank which exists even today. The rapid expansion of the joint-stock banks with their vast financial resources and ever-expanding branch system eclipsed the private banks which are not in a position to compete with the former. The establishment of the joint-stock banks also led to a process of consolidation and centralisation. Not only were the private banks in a number of cases taken over by the larger banks and converted into branch offices of same, but many well established joint stock banks with a good branch connection have been at one time or other were also absorbed. As a result of this process, there are now evolved huge combinations such as 'the Big Four' as they are commonly termed, Viz, the Midland Bank, Lloyds Bank, Barclay's Bank, and the National Westminister Bank.

Another important turning point in the history of English banking system was the enactment of the Peel's Act in 1844. Under the provisions of the Act of 1844, the right of note-issue was confined to Bank of England. The extension of the privilege of limited liability to banking concerns in 1862 removed the last important barrier to the formation of large joint-stock banks. Further, the Companies Act of 1879 provided that banks previously unlimited might register under the provisions of this Act as banks with limited liability.

In 1919 the British Bankers' Association was formed although as early as 1985 a Central Association of Bankers had been constituted inorder to embrace all Questions directly or indirectly affecting the banking community, whether arising from legislative proposals or practical working. With the formation of new Association, the objects were widened to provide facilities for the discussion of matters of interest to bankers and membership became open to British banks whose main business was in the United Kingdom; banks whose main business was outside UK were also eligible; provided they were members of the British Overseas Bank's, Association. At present, with one or two exceptions for technical reasons, the Association membership includes every British and foreign commercial bank in the United Kingdom.

2.2 Incorporation of the Bank of England :

The Bank of England was established in 1694, as a joint-stock company by an Act of Parliament under the official designation of the Governor. The idea of the establishment of the bank originated from an offer made in 1691 by Mr. William Patterson, a Scotchman supported by several Wealthy London merchants, to advance to the government of £10,00,000 in return for a right to receive £ 65,000 per annum as interest and the Costs of management and to issue bills which should be legal tender. The Government refused to give forced currency to the bills. However, the plan again came for the consideration of the Government, when Mr. Patterson submitted a new plan which contemplated a loan of £ 20,00,000 at 7 per cent interest per annum. It was finally put into shape by Mr. Montague. The Government had to accept it because of the necessity of finance to carry on war with France and the bill authorising the creation of the governor and Company of the Bank of England received royal assent in May 1691.

The Bank was originally organised with a capital of £ 12,00,000. It was required to lend the entire amount of capital to Government. In return, the Bank got the authority to carry on general banking business, including the rights to buy and sell coins and bullion, to deal in bills of exchange, to issue its own notes, and to make loans. The bank was in a very favourable position as compared to all of its competitors and especially to the goldsmiths. They received the government balances; they enjoyed alone the privilege of limited liability by which the share-holders were liable for the debts of the bank only to the amount of their investment and not for its entire liability; and they were able to loan money in excess of their deposits by reason of the circulating notes they were allowed to issue against the government debt.

The charter was granted in the first instance, for a period of ten years, however it was extended from time to time. During the early years of the Bank's existence, it had to face a lot of difficulties for the time was essentially a period of transition. The first attempt intended to strike at the very roots of the Bank was the scheme of Hugh Chamberlain to form a 'Land Bank', which received royal assent on 27 April 1696. But the attempt proved abortive. The next attempt made by the South Sea Company also proved futile.

Thus, the Bank of England proved its capacity to endure severe experience. It has seen two powerful rivals crushed and its own monopoly confirmed.

2.3 Bank of England and Note-Issue :

At the time of establishment, the bank enjoyed no monopoly of note-issue. In the legislation of 1697 the bank tried to safe guard its interests by including a provision preventing the formation of strong joint-stock banks. The Act of 1709 further made it unlawful for any body politic or corporate whatsoever, created (other than the said Governor and Company of the Bank of England) or for any other persons whatsoever, united or to be united in partnership exceeding the number of six persons in the part of great Britain called England, to borrow, owe or take up any sum or sums of money on their bills or notes, payable at demand, or at any less time than six months from the borrowing thereof. The provision was emphasised again in the renewal Charter of 1742.

The monopoly of the Bank to issue notes was subjected to severe criticism. Consequently, the Act of 1896, provided for the creation of joint-stock banks of issue at a distance of sixty-five miles from London. Nevertheless, the bank still retained its monopoly of banking in London. But the Act of 1883, allowed, in express terms, any body politic or corporate or partnership or carry on banking business in London or within sixty-five miles there of provided they did not issue notes payable on demand. The first bank to be established after the passing of the Act of 1833 was the London and Westminster Bank which exists even today.

2.4 Peel's Act 1844 :

The Peel's Act of 1844 marks an important turning point in the history of Bank of England. This Act absolutely prohibited the creation of banks of issue, except by the union of existing banks, and made coins or bullion deposited with the Bank of England the basis of note-issue with a few minor exceptions. The Act provided for the separation of the Issue Department from the Banking Department of the Bank of England. The former department related to the note-issue, and the latter to government and private banking. The Governor was directed to transfer to the Issue Department, securities worth £ 1,40,00,000 against which the Banking Department was to receive notes from the Issue Department for an equal amount. The issue Department could issue-notes in excess of this limit of £ 1,40,000 only against the deposit of coin and bullion. No department of the Bank was authorised to issue notes in excess of the limits thus fixed. Interms of this provision; the bank could increase its note-issue over this limit only through a suspension of the Act by the Parliament. In fact, it was found necessary to suspend the Act on three occasions, Viz, in 1847, 1857 and 1866, owing to the insufficiency of notes in the Banking Department. However people did not lose confidence. On the other hand, it was observed that the effect of letters of licence to break Peel's Act has confirmed the popular conviction that the Government is close behind the Bank and will help it when wanted. Neither the Bank nor the Banking Department have ever had an idea of being put into liquidation.

In terms of the Act of 1844, existing private and joint-stock banks of issue were allowed to continue their outstanding circulation. The Act provided that if any such Bank of issue relinquished this right, the Bank of England, could increase its fiduciary issue to an amount equal to two-thirds of the bank notes withdrawn. This provision enabled the Bank to increase its fiduciary issue from £ 1,40,00,000 to £1,84,50,000 in 1903 and to 1,97,50,000 in 1923. The Act further required the Bank to publish a weekly statement of its accounts, which it has since regularly done.

In 1914, the government was authorised to put in circulation Treasury or currency notes in addition to the Bank of England notes. These notes were for sums of £ 1 and 10s, and there was no statutory regulation as to the total amount to be issued, or as to the reserves to be kept against them.

In 1928, the Currency and Bank note Act was passed. According to this Act, the Bank was given the exclusive right to issue notes of £ 1 and 10s, besides those of £ 5 and upwards. The fiduciary issue was increased to £ 26,00,000. Further it was provided that this limit could be altered after consultation between the Bank and the Treasury. In 1939 the gold reserves in the issue department was revalued at the market price in terms of the currency and Bank Notes Act of 1939. The fiduciary issue was also increased. In August 1944, it remained at £ 120,00,00,000. It was again subjected to alteration from time to time since that date. During the Second world war, the bank transferred its gold holdings to the Government Exchange Equalisation Account. Thus since 1939, the gold reserves have played no part in the regulation of note-issue, although the bank is obliged cover by gold any note issued over and above the fiduciary limit under the Currency and Bank Notes Act of 1954. The note-issue, and therefore, also the general operations of the central bank remained nominally tied to gold; but the gold valuation become variable and the Fiduciary issue became so elastic that the ties with the gold supply could almost be forgotten.

2.5 Nationalisation of the Bank :

On 1 March 1946, the Bank of England was nationalised under the Bank of England Act 1946. In terms of this Act, private shareholders were given compensation in the form of 3 percent Government Securities which were redeemable on or after April 1966.

The Nationalisation of the Bank of England was one of the first acts of the Labour Government on assuming office in 1945. The main objective of the nationalisation has been to acquire a greater measure of direct control over the strategic and important position and power of the bank so as to make its policies in confirmity with the economic polices persued by the government. For all practical purposes, this change in the pattern of ownership was of little more than symbolic importance, because the Bank was conducting its operation, even before the nationalisation in the public interest in close operation with the treasury.

The management of the Bank is vested in a court consisting of the following members:

1. One Governor and one Deputy Governor appointed by the Crown, on the recommendation of the Government, for a period of five years. They are eligible for reappointment.
2. Sixteen Directors appointed by the crown on the recommendation of the government, for a period of four years, four of them retiring each year. They are also eligible for reappointment.

In terms of the Act of 1946, members of the Houses of Commons, Ministers of Crown, civil servants, and aliens should not be appointed to any of these offices. So also persons over sixty six years of age will not generally be appointed.

The Governor, the Deputy Governor and not more than four full time directors from the Chief Executive of the Bank. The day-to-day affairs of the Bank are administered by this body. Besides, there is another Committee known as 'Committee of Treasury', consisting of the Governor, the Deputy Governor and five directors elected from among the sixteen directors.

Certain important powers have been conferred upon the Bank on nationalisation. Before 1946, the bank could influence the commercial banks only through persuasion. No doubt, the Bank and the commercial banks were working in close cooperation and the commercial banks were always ready to recognise the unwritten traditional conventions by giving due respect to the requests of the Bank of England.

But according to the Act of 1946, the Bank is given specific statutory authority to issue directions to the commercial banks, with the approval of the Treasury. The provisions in this regard as laid down in sub-clause (3) of clause of 4 of the 1946 Act are given below.

"The Bank, if they think it necessary in the public interest, may request information and make recommendations to banks, and may, if so authorised by the Treasury issue directions to any banker for the purpose of securing that effect is given to any such request or recommendations." This clause was subjected to vehement criticism. It was feared that this would affect the traditional secrecy of the banker-customer relationship. However, the Qualification added to this sub-clause provide ample protection to the secrecy of the banker-customer relationship. According to these qualifications it is provided that, "a) no such request or recommendation shall be made with respect to the affairs of any particular customer of a banker, and

b) before authorising the issue of any such directions the Treasury shall give the banker concerned, or such person as appears to them to represent him, an opportunity of making representations with respect thereto."

A point may be made clear in this connection. Although the Bank of England is endowed with such wide powers, it seldom uses its official authority over the commercial banks. The Bank exercises its influence over the commercial banks mainly through the "art of persuasion". Ordinarily, the bank communicates with the commercial banks though the chairman's or general Manager's Committee of the clearing banks or through the Accepting houses Committee of the Discount Market Association.

Another important change effected by the Act of 1946, has been the power given to the Treasury to issue directions to the Bank. Under the Act, the Treasury may from time to time given such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest. This provision merely formalises the traditional relationship of the Treasury with the Bank of England.

2.6 Working of Bank of England as an Agent, Adviser and Banker to the Government:

Like the other central Banks the Bank of England acts as an agent, and adviser and a banker to the government. The Bank is responsible for the application of the governments' monetary policy to other banks and financial institutions. As banker to the government the bank maintains banking accounts for the exchequer and the government departments and handles the arrangements for borrowing the sums required to meet the governments' needs. It was in 1718 that the Bank first took over from the Exchequer the duty of receiving subscriptions for government loans. Since then the Bank under-took all responsibilities concerned with public debt.

The Bank also provides the government with advances from time to time. It will be recalled here that the charter was granted to the Bank of England in return for an advance of £ 12,00,000 made by the Bank.

It has become an integral part of the Bank's duty to grant temporary advances to the government. During the First and Second world war periods the Bank increased its holding of government securities enormously.

As an adviser to the government the Bank provides the government with advice and technical assistance on financial operations affecting the London Money Market and economic policy generally. It is the normal channel of communication between the government and the Banking world, and in fact, the city as a whole.

In addition to its domestic responsibilities, the Bank gives advice to the government on international financial problem; and because of the importance of starting as an international trading and reserve currency, and of London as a centre for international finance; the Bank itself has a close interest in financial and economic development overseas. Close contacts are maintained with other central banks throughout the world.

The Bank also provides the government with a variety of technical financial services. They include:

1) The Bank handles, for the government, various issues of government securities ranging from securities with a maturity many years ahead to Treasury bills, which are at present issued with a maximum currency of 91 days. These bills which first came into use by about 1877 meet the short-term loan requirements of the Treasury.
2) The Bank also acts as registrar of some 160 government, government guaranteed and commonwealth and corporation stocks.
3) The Bank acts as the agent of the Treasury in managing the Exchange Equalisation Account, a government fund set up in 1932 with the object of checking undue fluctuations in the exchange value of starting and conserving the camtry's exchange resources; and in the administration of exchange control, introduced at the outbreak of war in 1939 under defence regulations, and given more lasting lasting shape by the Exchange Control Act of 1947.

2.7 Bank of England as a Controller of Credit :

2.7.1 Bank rate policy :

Bank rate policy has a long history in England beginning with 1839. The position of the Bank of England as a lender of the last resort made it necessary for the Bank to meet all legitimate requirements of the money market. At the same time it was also necessary to curb any unwarranted credit expansion. In view of achieving these objectives the Bank rate was so designed as to make it a penal rate thus confining the accommodation given by the Bank to reorient its polices in view of the developing circumstances. This led the Bank to adopt a policy of fluctuating bank rate.

Prior to 1914 the bank rate policy of the Bank of England was especially effective. There was an intimate relationship existing between the bank rate and the market rate. The narrow margin on which the money market worked facilitated this relationship. Added to this were the traditional conventions laid down by the money market. The policies of the Bank of England always commanded the respect and confidence of the money market. Yet another contributing factor was the importance of London as a great financial centre of the world. London was the world's clearing house and the only real international market at that time, as a result of which the monetary as well as general economic tendencies in Great Britain were, through the medium of stable exchange rates under the international gold standard, transmitted in due courses and in varying degrees to practically all other parts of the world.

Since 1914, however the instrument of credit control has lost much of the former significance. The out break of First World War necessitated the maintenance of a cheap money policy by the Bank of England.

The suspension of the standard during the early thirties and the emergence of powerful money markets in other countries further tended up to reduce the importance of the Bank rate policy in England. During the 'thirties and fourties' they followed a cheap money policy by maintaining the bank rate at so low a level as 2 per cent. The suspension of the gold standard shifted the emphasis of monetary policy from external stability to that internal price stability and full employment.

2.7.2 Open Market Operations :

The comparative decline in the effectiveness of the bank rate since 1914 led the Bank of England to resort to alternative instruments of credit control. During the war period, operations were mainly devised to facilitate the war finance subsequently, the scope and volume of the open market operations were considerably enlarged and they came to be accepted as an independent weapon of credit control.

It can be summarised the various objectives of open market operations by the Bank of England as follows.

1) to prepare the ground for a change in the bank rate or to supplement the bank rate policy;
2) to avoid disturbances in the money market as a result of movements of government funds or seasonal movements generally;
3) to offset inflow of gold;
4) to support government credit in connection with the issue of new loans or the conversation of existing loans;
5) to create and maintain conditions of cheap money as an aid to business recovery.

2.7.3 Selective Control of Credit :

In England, selective controls of credit are mainly employed through Treasury requests, generally conveyed through the Bank of England. It will be recalled here that the Treasury is armoured with the necessary statutory powers for issuing directives on bank credit. However, the high sense of responsibility shown by the English bankers has made it unnecessary for the Treasury to make use of this statutory authority.

Through requests banks are directed from time to time, to give priority to production for exports or for the displacement of imports or for improving the national efficiency not to make advances for hire purchase or for speculative hoarding of commodities, etc.

2.8 Central Banking in USA :

The establishment of the Federal Reserve System in 1914 is one of the great landmarks in American banking history. The Federal Reserve System began with the primary objective of using its powers to create currency and bank reserves. In addition, the Federal Reserve Act sought to provide power to prevent or deal with banking crisis and panics; to replace the slow expensive system of cheque clearing and collection with one that would be faster and more efficient; to provide a more satisfactory fiscal agent for the federal government; to achieve a better coordination of state and national banks and especially to secure more effective supervision of state banks; to promote the development of an acceptance market in the United States; and to provide more liberal powers for national banks, such as those of establishing trust departments and lending on real estate, to enable them to compete more effectively with state banks and trust companies, many of which enjoyed more freedom of action.

2.9 Structure of the Federal Reserve System :

In general the functions of the Federal Reserve are similar to those of central banks in other countries. Despite the similarities, there are also important differences in the structure, control and functioning of the various central banks. For example, most countries have only one Central bank, with control clearly concentrated in the central authority. The United states has 12 separately incorporated Federal Reserve banks located in as many Federal Reserve districts, with controlling power divided among the 12 banks and the board of governors of the Federal Reserve System located in Washington , D.C.

2.9.1 The 12 Federal Reserve Banks and their branches :

The Federal Reserve Act provided that the continental United States should be divided into no fewer than 8 and not more than 12 Federal Reserve districts, each to have a Federal Reserve bank. The maximum number of districts and Reserve banks was established at the outset. Each Federal Reserve bank is named after the city in which it is located: Thus there are the Federal Reserve Bank of Boston, the Federal Reserve Bank of New York and so on. To facilitate their operations, some of the Federal Reserve banks have established branches in their districts.

The Federal Reserve banks differ greatly as to both size and influence on credit and monetary conditions. The Federal Reserve bank of New York, which is by far the largest, holds nearly a quarter of the total assets of all the Reserve banks. The predominance of the New York bank is even greater than these statistics imply, for it is the principle point of contact with foreign central banks. It has a direct influence on international financial transactions and it is located in the midst of the great New York money market which draws funds from and dispatches funds to every part of the country. Its member banks, especially the giant banks in New York city, greatly influence banks in all parts of the nation through their correspondent relationships. At the other extreme, the relatively small Federal Reserve Bank of Minnepolis holds only 2.4 per cent of all the assets of the Reserve banks, and its actions have much less influence on nationwide credit and monetary conditions.

Each Federal Reserve bank has many member banks, which are those commercial banks in the district that have met at least the minimum requirements and have been accepted for membership in the Federal Reserve System. As a member of the Federal Reserve, a commercial bank has both obligations and privileges. It must continue to meet various requirements for membership, submit to supervision and examination by Federal Reserve authorities subscribe to stock in its Federal Reserve bank, and hold all its legal reserves in the form of cash or deposits at its Federal Reserve bank and of using the other facilities of the system.

Before the establishment of the Federal Reserve System, there were wide differences of opinion as to which commercial banks should be required or permitted to become members. At one extreme, those who were opposed to further regimentation of banks would have made membership in the System optional with each bank. At the other extreme, some would have forced every commercial bank in the country to become a member or cease to perform commercial banking functions. This membership issue was settled by compromise. Every national bank must become and remain a member of its Federal Reserve bank or forfeit its federal charter. Each state bank may, at its option, become a member if it can meet the minimum requirements for membership.

2.9.2 ownership of the Federal Reserve banks :

Each member bank is required to subscribe to the stocks of its Federal Reserve bank in an amount equal to 6 percent of its own paid-up capital and surplus. If insufficient capital was obtained from this source it was provided that stock would be offered to the public and if subscriptions by the banks, and the public were insufficient, stock would be sold to the federal government. In reality, no stock of the Federal Reserve banks has been sold to either the public or the government, and even the member banks have been required to pay in only half of their subscriptions. Thus, the Federal Reserve banks are owned wholly by their member banks, each member bank having paid in to its Federal Reserve bank an amount equal to 3 percent of its own paid-up capital and surplus.

It is important to note that ownership does not carry with it control of the corporation and enjoyment of all its earnings. Annual dividends to stockholders of the Reserve banks are limited to 6 percent of the paid-in capital stock. The reminder of the Reserve bank earnings have been used to build up the surplus accounts of the Reserve banks and to provide revenue for the Treasury. Prior to 1933, each Reserve bank was required by the law to pay the Treasury a franchise tax equal to 90 per cent of its net earnings in excess of dividends after it had accumulated a surplus equal to its subscribed capital. By the end of 1932, the Reserve banks had accumulated surplus accounts amounting to $ 278 million and had paid $ 149 million in franchise taxes to the Treasury. The Banking Act of 1933 required the Reserve banks to pay half of their accumulated surplus or $ 139 million, as a subscription to the capital stock of the Federal Deposit Insurance Corporation) in return, the Act repealed the Franchise tax in order to enable the Reserve banks to use all their earnings in excess of dividend requirements to replenish their surplus accounts. By the end of 1946, the Reserve banks had built up their combined surplus accounts to nearly $ 440 million. Partly because of this, the Board of Governors in April 1947 voluntarily put into operation a plan to channel into the Treasury most of the Reserve bank earnings in excess of their dividend requirements. In recent years, all Federal Reserve earnings in excess of divided requirements have been transferred to the Treasury through an interest charge on outstanding Federal Reserve notes levied by the Board of Governors.

2.9.3 Control of the Federal Reserve System :

Closely related to the heated controversies over the structure of the Federal Reserve System were those concerning its control. The most widely debated questions were, 1) who should control the Federal Reserve ? 2) should control be centralised or decentralised. There principal groups wanted a voice in control – the federal government, member banks, and businessmen who were customers of member banks. Some, argue that banking is essentially a governmental function and that one of its principle objectives is the regulation of member banks, demanded full government control. On the other hand, many bankers who considered the new Reserve banks to be essentially cooperative institutions for member banks demanded that full control be placed in the hands of bankers, although some banks feared domination by their larger competitors. Others argued that businessmen as customers of banks should be given a choice. No less heated were the discussions concerning the degree of centralisation of control some wanted almost complete centralisation, whereas others demanded a large degree of regional authority.

Finally, all the competiting groups were given representation, and control was divided between a central authority in Washington D.C. and the regional Federal Reserve banks. It should be remembered that the original division of authority proved unsatisfactory in many respects and that it has been changed in several ways since 1914. In general the evolution has been toward greater centralisation of authority and a greater degree of control by the federal government.

2.9.4 The board of Governors of the Federal Reserve System :

The Central Controlling authority, which has its offices in Washington D.C., is the Board of Governors of the Federal Reserve System. This Board is composed of seven members appointed by the president of the United States with the advice and consent of the Senate. Each member is called a Governor and devotes his full time to the Board. He is appointed for a term of 14 years, and is ineligible for reappointment if he has served a full term. Not more than one member of the Board may be selected from any one Federal Reserve district, and in making appointments, the President is to have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and geographical divisions of the country. The president designates one of its members as chairman of the Board and another as vice chair man.

Although the actual location of control has in the past depended greatly on economic and political conditions and on the forcefulness of the various personalities involved, the Board of Governors is now clearly the most powerful controlling force in the entire Federal Reserve System. Among its most important powers are the following :

1. To exercise general supervision over the Federal Reserve banks to examine their accounts and affairs and to require reports by them.
2. To approve or disapprove appointments to the positions of president and first vice-President of each Federal Reserve bank and to suspend or remove any officer or director of any Federal Reserve bank.
3. To supervise the issue and retirement of Federal Reserve notes by each Federal Reserve bank.
4. To serve as a majority of the members of the Federal open Market Committee.
5. To permit one Reserve bank to lend to another and by a vote of at least five members of the Board, to require it to do so.
6. To determine within the Board limits prescribed by law, the types of loans that the Reserve banks may make.
7. To approve or disapprove discount rates established by the Reserve banks.
8. To fix, within the limits established by the law, member bank reserve requirements.
9. To regulate loans on securities.

2.9.5 Federal Open Market Committee :

One of the most powerful instruments of control in the hands of the Federal Reserve System is its power to buy and sell government securities, acceptances and other delegations in the open market. The Reserve banks can create additional member bank reserves by purchasing obligations in the open market and can contact member bank reserves by setting securities. The original Federal Reserve Act was vague as to who should control this function, with the result that the individual Reserve banks sometimes followed conflicting policies, and sharp controversies arose within the system. Attempts were made to solve the problem by creating an informal open market committee made up of representatives of the Federal Reserve banks, but these efforts were not adequately represented, others ignored the decisions of the informal committee, and the Board in Washington, D.C., felt that it should have more control of this function.

The Federal Market Committee was created by amendments to the Federal Reserve Act in order to clarify the location of authority and to centralize to control of Federal Reserve open market operations. It is composed of 12 members, 7 of these are members of the Board of Governors of the Federal Reserve System and 5 are representatives of the reserve Reserve banks. The latter are elected annually, must be either presidents or vice-presidents of Reserve banks, and are elected by the Board of Directors of the various Reserve banks, each board having one vote. The distribution of the five Reserve bank representative is as follows:

One from the Federal Reserve Bank of New York.

One from the Federal Reserve Banks of Boston , Philadelphia and Richmond.

One from the Federal Reserve Banks Atlanta, Dallas, and St. Louis.

One from the Federal Reserve Banks of Minneapolis, Kansas City, and San Francisco.

One from the Federal Reserve Banks of Cleveland and Chicago.

Because of its key position, the New York Bank is always represented on the Committee.

The Federal Open Market Committee has full control of all open-market purchases and sales by Reserve banks. No reserve bank may engage or decline to engage in open-market operations except in accordance with the regulations adopted by the Committee. The Committee was also given jurisdiction over Federal Reserve Purchases and sales of foreign exchange.

2.9.6 Federal Advisory Council :

The Federal advisory council is composed of 12 members, on being selected by the Board of Directors each Reserve bank. The sole function of this council is to act in an advisory capacity to the Board of Governors. The only sources of its power are its eloquence and the prestige of its members, most of who are prominent men.

2.9.7 Control of Individual Federal Reserve Banks :

Control of each of the 12 Federal Reserve banks in divided among the member banks in the district, businessmen in the district, and the Board of Governors of the Federal Reserve System. Each Reserve bank has a board of directors with nine members. Three of these are known as Class A directors, three as Class B directors, and three as Class C directors. The Class A directors represent the member banks of the district and are chosen by them. To prevent domination of the Reserve Bank by any one baking group, the member banks of the district are divided into three groups based on size and each group elects one Class A director. The Class B directors represent industry , commerce and agriculture in the district and must be actively engaged in one of these pursuits at the time of their election. They may not be officers, directors, or employees of any bank. They are elected by the member banks of the district in the same way as the Class A directors. All three of Class C directors are appointed by the Board of Governors. One of these must be the Chairman of the Board of Directors and Federal Reserve agent at the bank. As Federal Reserve Agent, he acts as official representative of the Board of Governors in carrying out its legal functions. Another Class C director at each Reserve bank acts as deputy chairman of the Board of Directors.

The Chief executive officer of each Reserve bank is its president, who is appointed by its Board of Directors with the approval of the Board of Governors. The First Vice-President of each Reserve bank is appointed in the same way. Other Reserve bank officers and employees are appointed by the bank's Board of Directors, although they may, of course, be removed by the Board of Governors.

After a long period of doubt as to the proper location of authority in the Federal Reserve System, it is later clear that the Board of Governors occupies the dominant position. Some power still rests with the representations chosen by member banks, but the Board of Governors has many sources of power.

1. Exclusive regulation of many Federal Reserve and Commercial bank functions is in the hands of the Board.
2. Its members make up a majority of the members of the powerful Federal Open Market Committee.
3. The Board appoints three members of the Board of Directors of each Reserve bank, one of its appointee at each bank being chairman of the Board of Directors and Federal Reserve Agent.
4. The Board may disapprove appointments of Presidents and first Vice-presidents of the Reserve banks and remove directors, officers and employees.

2.10 Summary :

This unit discusses the origin and growth of the two most important Central Banks of the world. One (Bank of England) has assumed significance by codifying the principles of Central Banking. The second (Federal Reserve System) turned out to be unique in its own way on terms of structure and organisation. The influence of these banks on the working of Central Banks is Unique. Though every Central bank is designated to function in their own right; both the Bank of England and the Federal Reserve System stand apart in the history of Central Banking.

2.11 Self-Assessment Questions :

1. Trace out the origin of Bank of England.
2. How do Bank of England and the Federal Reserve System differ in their organisation Structure?
3. Evaluate the effectiveness of the bank of England as the Controller of Credit.
4. Distinguish between Federal Open Market Committee and Federal Advisory Council.

Lesson - 3 RBI ORGANISATION & FUNCTIONS

Observations :

After studying this lesson, you should be able to:

- know about RBI and its nationalisation
- know about its organisation and management
- understand the functions of RBI
- know credit control of RBI

Structure :

3.1 Introduction
3.2 Nationalisation of the Reserve Bank
3.3 Organisation and Management
3.4 Functions of the RBI
3.4.1 Banking Functions
3.4.1.1 Issue of Bank Notes
3.4.1.2 Banker to the Government
3.4.1.3 Banker's Bank and Lender of Last Resort
3.4.1.4 Custodian of foreign exchange reserves
3.4.1.5 Control of currency and credit
3.4.2 Supervisory Functions
3.4.3 Promotional Functions
3.5 Credit Control
3.6 Summary
3.7 Self Assessment Questions

3.1 Introduction :

The Reserve Bank of India is the central bank of our country. It is the apex financial institution of the country's financial system entrusted with the task of control, supervision, promotion, development and planning. The RBI influences the management of commercial banks through its various policies, directions and regulations.

3.2 Nationalisation of the Reserve Bank :

Originally, the Reserve Bank was constituted as a share holders bank, in 1935 with a share capital of Rs. 5 crores divided into shares of Rs. 100 each. The entire share capital was owned by private individuals. In order to have a close integration between the policies of the Reserve Bank and the Government, it was decided to nationalise the Reserve Bank, immediately after the attainment of independence. The Reserve Bank (Transfer to Public Ownership) Act, 1948 was passed and the government took over the Reserve Bank of India from private shareholders by paying adequate compensation to them. On Jan 1, 1949 the RBI started functioning as a state - owned central banking institution.

3.3 Organisation and Management :

The affairs of the bank are controlled by a Central Board of Directors. The Central Board consists of

- One Governor and not more than four Deputy Governors appointed by the Central Government for a period not exceeding 5 years or as may be fixed by the Central Government at the time of their appointment.
- Four directors nominated by the Central Government, one from each of the four local boards.
- Ten other Directors, nominated by the Central Government
- One Government official.

The constitution of the central board is as follows:

Central Board Membership

Governor	1
Deputy Governor	4
Directors (nominated by each of the Local Boards)	4
Directors	10
Government Nominees	1
Total	20

The chairman of the central board of directors of the bank and its chief executive authority is the Governor. The Governor is assisted by four Deputy Governors and 3 Executive Directors. The Executive Directors attend the central board meetings on invitation. The Governor and the Deputy Governors are full - time officials of the RBI and other directors are part - time officials.

Besides the Central Board, there are four local boards at Delhi, Chennai, Kolkata and Bombay representing four regional areas i.e. northern, southern, eastern and western respectively. These local boards are advisory in nature. Government of India nominates one member each from these Boards to the Central Board.

Local Boards consist of five members, each appointed by Central Government for a term of 4 years. The members of the Local Board elect their chairman from among themselves. The functions of the Local Board is to advise the Central Board on such matters as may generally be referred to it and to perform such duties assigned to them by the Central Board.

The organisation of Reserve Bank is classified into central office and local office. The central office is divided into various departments which are as follows:

1. Department of Economic Analysis & Policy
2. Department of Statistical Analysis & Computer Services
3. Department of Information Technology
4. Industrial & Export Credit Department
5. Department of Currency Management
6. Secretary's Department
7. Exchange Control Department
8. Deposit Insurance & Credit Guarantee Department
9. Department of Administration & Personnel Management
10. Department of Banking Operations and Development
11. Rural Planning & Credit Department
12. Urban Bank Department
13. Human Resource Development Department
14. Reserve Bank of India Service Board

Reserve Bank of India : Organisation

Central Board of Directors
- Governor
  - Deputy Governors
    - Executive Directors
      - Principal Chief General Manager
        - Chief General Managers - in - charge
          - General Managers
            - Deputy General Managers
              - Asst. General Managers
                - Managers
                  - Asst. Managers
                    - Support. staff

Regional Offices :

Srinagar	Jaipur	Ahmedabad	Patna	Hyderabad
Jammu	Lucknow	Bhopal	Kolkata	Panaji
Chandigarh	Kanpur	Nagpur	Gowhati	Bangalore
New Delhi	Patna	Bhubaneswar	Belapur	Chennai
Mumbai				
Kochi				
ThiruvananthaPuram				

(For the latest Structure of Organisation please refer to Exhibit 3.1)

Exhibit 3.1 : Organisation Structure of RBI

CENTRAL BOARD / LOCAL BOARDS

GOVERNOR
Bimal Jalan

DEPUTY GOVERNORS
Vepa Kamesam
Rakesh Mohan
K. J. Udeshi

DIRECTORS NOMINATED UNDER SECTION 8(1)(b) OF THE RBI ACT, 1934
Y. H. Malegam
Mihir Rakshit
K. Madhava Rao

DIRECTORS NOMINATED UNDER SECTION 8(1)(c) OF THE RBI ACT, 1934
Ratan N. Tata
Amrita Patel
K. P. Singh
V. S. Vyas
D. S. Brar
C. N. R. Rao
H. P. Ranina
N. R. Narayana Murthy
Suresh Krishna
Ashok S. Ganguly

DIRECTOR NOMINATED UNDER SECTION 8(1)(d) OF THE RBI ACT, 1934
S. Narayan

MEMBERS OF LOCAL BOARDS

WESTERN AREA
Y. H. Malegam
K. Venkatesan
Dattaraj V. Salgaocar
Jayanti Lal Bavjibhai Patel
Mahendra Singh Sodha

EASTERN AREA
Mihir Rakshit
P. D. Chitlangia
A. K. Saikia
Sovan Kanungo
Kiran Ghai

NORTHERN AREA
Ram Nath
Mitha Lal Mehta
Pritam Singh

SOUTHERN AREA
K. Madhava Rao
C. P. Nair
S. Ramachander
M. Govinda Rao

As on June 30, 2003

PRINCIPAL OFFICERS

(As on June 30, 2003)

EXECUTIVE DIRECTORS	R.B. Barman
	Smt. S. Gopinath
	Y.S.P. Thorat
	P.K. Biswas
	Smt. Usha Thorat
	A.V. Sardesai
	N. Sadasivan (on deputation)
PRINCIPAL LEGAL ADVISER	N.V.Deshpande *
* With status equivalent to that of the Bank's ED	
PRINCIPAL MONETARY POLICY ADVISER	D. Anjaneyulu **
** With status equivalent to that of the Bank's ED	
CENTRAL OFFICE	
Department of Administration and Personnel Management	G. K. Sharma, Chief General Manager-in-Charge
Department of Banking Operations and Development	M.R. Srinivasan, Chief General Manager-in-Charge
Department of Banking Supervision	P.V. Subba Rao, Chief General Manager-in-Charge
Department of Currency Management	V.R. Gaikwad, Chief General Manager
Department of Economic Analysis and Policy	Narendra Jadhav, Officer-in-Charge
Department of Expenditure and Budgetary Control	Radhe Shyam, Chief General Manager
Department of External Investments and Operations	T.C. Nair, Chief General Manager
Department of Financial Companies	–
Department of Government and Bank Accounts	V.S. Das, Chief General Manager-in-Charge
Department of Information Technology	R. Gandhi, Chief General Manager-in-Charge
Department of Non-Banking Supervision	C. S. Murthy, Chief General Manager-in-Charge
Department of Statistical Analysis and Computer Services	D.V.S.S. Sastry, Principal Adviser
Exchange Control Department	Smt. G.E. Koshie, Chief General Manager-in-Charge
Financial Institutions Division	–
Human Resources Development Department	N.P. Sinha, Chief General Manager
Industrial and Export Credit Department	Smt. R.K. Makhija, Chief General Manager
Inspection Department	M.K. Bhattacharya, Chief General Manager
Internal Debt Management Department	H.R. Khan, Chief General Manager-in-Charge
Legal Department	*
Monetary Policy Department	**
Premises Department	E.U. Khan, Chief General Manager
Rural Planning and Credit Department	Varughese John, Chief General Manager
Secretary's Department	H.N. Prasad, Chief General Manager & Secretary
Urban Banks Department	S. Karuppasamy, Chief General Manager-in-Charge
COLLEGES	**PRINCIPALS**
Bankers Training College, Mumbai	C.R. Gopalasundaram
College of Agricultural Banking, Pune	Smt. Phulan Kumar
Reserve Bank Staff College, Chennai	Smt. C. Chandramouliswaran
OFFICES	**REGIONAL DIRECTORS**
Chennai	B. Ghosh
Kolkata	V.K. Sharma
Mumbai	M.P. Kothari
New Delhi	Ramesh Chander
BRANCHES	**REGIONAL DIRECTORS**
Ahmedabad	Smt. Vani J. Sharma
Bangalore	Smt. D. Muthukrishnan
Bhopal	Kum. Uma Subramaniam
Bhubaneswar	S. S. Satchidananda
Chandigarh	D.P.S. Rathore
Guwahati	Surindra Kumar
Hyderabad	S. S. Gangopadhyay
Jaipur	Karunasagar
Jammu	J. B. Bhoria
Kanpur	B. K. Vasdev
Nagpur	P. Aravind
Patna	Murari Swarup
Thiruvananthapuram	G. Gopalakrishna
	CHIEF GENERAL MANAGER
Lucknow	P. Saran
Navi Mumbai, Belapur	R.M. Deole
	GENERAL MANAGER (O-in-C)
Kochi	S. Mohanty

3.4 Functions of the RBI :

The functions performed by the Reserve Bank can be classified into three categories. They are:

1. Banking Functions
2. Supervisory Functions and
3. Promotional Functions

3.4.1 Banking Functions :

The Reserve Bank of India performs the following functions. They are:

1. Issue of Bank Notes
2. Banker to the Government
3. Banker's Banker and Lender of the last resort
4. Custodian of Foreign Exchange Reserves
5. Control of currency and credit

3.4.1.1 Issue of Bank Notes :

Under section 22, of the RBI Act, the Reserve Bank has the sole right to issue bank notes of all denominations (except one rupee notes which are issued only by the Government of India). The design, form and material of bank notes should be approved by the Central Government on the recommendations of the Central Board. The one rupee notes, coins and small coins are issued by the Ministry of finance but they are distributed by the Reserve Bank as agent of the Government. The Bank follows the "Minimum Reserve System" for issue of bank notes.

According to section 33 of the Reserve Bank of India Act, the assets of the Issue Department against which bank notes are issued should consists gold coins and bullion, foreign exchange, rupee coin, government of India securities and such bills of exchange and promissory notes payable in India and as are eligible for purchase by the Bank. The RBI is required to maintain gold and foreign exchange, reserves of Rs. 200 crore, of which at least Rs. 115 crore should be in gold.

The core central Banking functions of note issue and management of currency in circulation is performed by the Reserve Bank with the objectives of ensuring adequate availability of notes and coins in the economy and maintaining the quality of notes in circulation. This is done through its 18 regionals / issue offices / sub-officer and a wide network of currency chests, repositories and small win depats spread across the country.

In 1996, the Reserve Bank issued instructions to all banks to stop stapling of fresh note packets. In 1998, the instructions were reitereated in the case of re-issuables. Since the instructions were not being implemented by the banks, the Reserve Bank issued a directive in Nov 2001, under section 35A of the Banking Regulations Act, 1949 to all banks prohibiting stapling of bank notes, sending soiled notes to the Reserve Bank and to the public.

The Reserve Bank has been endeavouring to increase the number of chests in view of the need for expanding distribution channels for fresh notes and coins and mopping up soiled notes from circulation.

3.4.1.2 Banker to the Government :

The Reserve Bank Act as the Banker and Agent to the Government. Under sections 20, 21 and 21A of the Act of 1938, the RBI is obliged to act as a banker to the Government. RBI receives all taxes and incurs public expenditure on behalf of the government. It also acts as the financial agent of the Government. It grants loans for periods not exceeding three months to central and state governments. It provides overdraft facility to the State Governments. According to the Reserve Bank of India Act, the Bank is obliged to appoint the state bank of India as its sole agent at places where the Bank has no branch or office but where the state bank has a branch.

According to Decock " As the Governments banker, the Central Bank conducts the banking accounts of government departments, boards and enterprises, it makes temporary advances to the government in anticipation of the collection of taxes or raising of loans from public, and extraordinary advances during a depression, war or other emergency and it carries out the governments transactions involving purchases and sales of foreign countries. The central bank is also called upon to perform various services as the governments financial agent, and it acts generally as a financial adviser to the government.

The Act also requires the Reserve Bank to maintain currency chests at places prescribed by the government and to keep the chests supplied with sufficient notes and coins. The issue department of RBI maintains the currency chests at the places prescribed by the government. During 2002-03, by currency chests were established, total no of chests today are 4, 4 at present currency chests are predominantly held by the SBI and its associate banks. The RBI is encouraging other public sector banks, private sector and foreign banks to establish currency chests in order to enhance their storage capacity and reduce pressure on the Reserve Bank's Issue office.

The Reserve Bank also acts as the banker to the State Governments. The relationship of the bank with the State Governments is governed by agreements between the bank and the State Governments. The RBI acts as an advisor to the government on matters pertaining to the financial markets, market conditions, the terms of new loans, quantum of loans, terms of issue of loans, etc. It also advises the government on all monetary polices concerning allocation of funds, flotation of loans, banking legislations, etc.

3.4.1.3. Banker's Bank and Lender of the Last Resort :

The Reserve Bank acts as the banker's bank and has the right of controlling the activities of all commercial banker in the country. The RBI Act, 1934 and the Banking Regulation Act, 1949 have given powers to RBI to control and regulate the working of the commercial banks. As per section 42 of the RBI Act, every scheduled bank should maintain the minimum cash reserve with the RBI and also maintain the statutory liquidity ratio (SLR)

Provisions relate to the Reserve Bank's assistance to the Commercial Banks:

According to section 17 of the Reserve Bank of India Act, a scheduled bank can obtain financial assistance from the Reserve Bank in the form of rediscount of eligible bills and loans and advances against eligible securities. The provisions in this regard as laid down in section 17 of the RBI Act, are

1. Under section 17(2) (a), the Reserve Bank is empowered to purchase sell or rediscount bills of exchange and promissory notes drawn and payable in India and assign out of bonafide commercial or trade transactions bearing two or more good signatures, one of which shall be that of a scheduled bank or a state cooperative bank and maturing with in 90 days from the date of such purchase or rediscount, exclusive of days of grace.
2. Under section 17 (2)(b) the Reserve Bank in authorised to purchase sell or rediscount of exchange and promissory notes drawn and payable in India and bearing two or more good signatures one of which shall be that of a scheduled bank or a state cooperative bank drawn or issued for the purpose of financing seasonal agricultural operation or the marketing of crops and maturing within 15 days from the date of such purchase or rediscount, exclusive of days of grace.
3. Under section 17 (2)(c) the Reserve Bank in empowered to purchase, sell or rediscount bills of exchange and promissory notes drawn and payable in India and issued or drawn for the purpose of holding or trading in securities of the central government, or a state Govt., and maturing within 90 days from the date of such purchase or rediscount exclusive of days of grace.
4. Under section 17 (3)(b) the Reserve Bank is authorised to purchase sell or rediscount with of exchange drawn is any place or in any country outside India which is member of the international monetary fund maturing within 90 days from the date of such purchase or rediscount provided that no such purchase, sale or rediscount shall be made in India except with a scheduled bank.

Provisions relating to Reserve Bank's Assistance to Commercial Banks:

The provisions are:

1. Under section 17 (4) (a) the Reserve Bank is authorised to make loans and advances to scheduled banks, to state cooperative banks etc., repayable on demand or on the expiry of fixed period not exceeding 90 days against the security of stocks, funds and securities in which a trustee is authorised to invest trust money by any Act of parliament of the UK or by any law for the time being in force in India. The securities must be readily marketable and are selected by the Reserve Bank for advances on the merits of each security.
2. Under section 17 (4)(b) the Reserve Bank is authorised to make to scheduled banks, state corporative banks etc., loans repayable on demand or on the expiry of fixed periods not exceeding 90 days against the security of gold or documents of title to gold or silver.
3. Under section 17 (4)(c) the Reserve Bank is authorised to make to scheduled banks state cooperative banks etc., loans and advances repayable on demand or on the expiry of such periods not exceeding 90 days against the security of such bills of exchange and promissory notes as are eligible for purchase or rediscount by the bank or as are fully guaranteed as to the repayment of the principal and payment of interest by a State Government.
4. Under section 17 (4)(d) the Reserve Bank is authorised to make scheduled banks, state cooperative banker etc., loans and advances repayable on demand or on the expiry of fixed periods not exceeding 90 days against the security of promissory notes of any scheduled bank or state cooperative bank supported by documents of title to goods, such goods having

been transferred, assigned or pledged to any such bank as security for a loan or advance made for bona fide commercial or trade transactions or for the purpose financing seasonal agricultural operations on the marketing of crops.

In addition to the facilities provided by the bank against defined security section 18 (1) (3) of the Act provides for short-term loans against such other forms of securities as the bank may consider sufficient. As per the above section the eligibility rules of the bank are substantially relaxed and the bank is now empowered to make an advance to any bank in times of emergency, not withstanding the fact that the bank applying for financial accommodation is a nonscheduled bank. This helps the Reserve Bank to discharge its function as the banker's bank and as the lender of the last resort more efficiently.

3.4.1.4 Custodian of Foreign Exchange Reserves :

The RBI is responsible for maintaining the external stability of the rupee. It has the responsibility to maintain the official rate of exchange. It has to maintain exchange rates with the currencies of all the members of international monetary fund. It has to maintain foreign exchange reserves and protect them from depletion.

3.4.1.5 Control of currency and credit :

The RBI acts as the controller of currency and credit. The control of RBI's monetary system largely depends on the control of the constituents of the purchasing power. The important function of the RBI is to regulate the monetary system by controlling the credit prevailing in the entire financial system.

3.4.2 Supervisory functions :

In order to promote and develop a sound and efficient system of banking in India, the Reserve Bank has been given several supervisory powers over different banking institutions. The RBI Act and the Banking Regulation Act have empowered the RBI units adequate powers to supervise and control the constituents of the Indian financial system. These powers relate to licensing and establishment branch expansion, liquidity of assets management, advances to different sectors, management and methods of work reconstruction and liquidation of commercial and cooperative banks.

The Reserve Bank carries out periodical inspections of these banks and calls for such information which it considers necessary for effective performance of its functions. It has the powers to collect credit information from banking companies. It has been entrusted with management of the currency chests and public debt. The Bank may conduct adhoc investigation whenever there are complaints about major irregularities or frauds by certain banks.

3.4.3 Promotional Functions:

With the nationalisation of many commercial banks, the responsibility of the RBI has increased. Promotional functions of RBI covered three sectors i.e. agriculture industry and service sectors.

3.4.3.1 Agriculture Sector:

with the objective of promoting rural credit, the Reserve Bank has helped to evolve a suitable institutional infrastructure for providing credit in rural areas. Under the Reserve Bank of India Act, the Bank is charged with the responsibility of making its resources available to agricultural within certain limits. The RBI maintains an "Agriculture credit department. A number of Development banks and Regional Rural Banks also been setup for developing agriculture, trade, commerce and industry, and other productive activities in the rural areas.

Indian agriculture had experienced one of the worst droughts in 2002-03. The Government quickly initiated several policy measures to face the severity of the drought. A task force on drought was setup to over see the relief measures. Additional quantities of food grains were allocated to various states as part of the food for work programmes besides ensuring supplies of fodder for cattle. Measures were initiate to provide employment and purchasing power for the drought affected people. Further more, waiver of interest on kharif loans and rescheduling of crop loan into term loans werer announced. In addition specific fiscal measures were initiated in the form of a grant of input subsidy to small and marginal farmers. The Government announced a grant of an input subsidy to small and marginal farmers amounting to Rs. 1490 crore. The Union Budget for 2003-04 expanded the Antyodaya Anna Yojana from April 2003 to cover an additional 50 lakh families, raising the total coverage to more than a quarter of all BPL (Below Poverty Line) families during the current year.

Futures trading is expected to help farmers and traders to hedge their risk. Recently, all commodities were made eligible for futures trading. At present there are 91 commodities under the purview of section 15 of the forward contracts (Regulation) Act, 1952.

The Agricultural Insurance Company of India Limited (AIC) which was proposed in the Union Budget 2002-03 was constituted in Dec 2002 with the capital participation from General Insurance Corporation of India (GIC), National Insurance Company Limited, New India Assurance Company Limited, oriental Insurance Company Limited, United India Insurance Limited and the NABARD.

3.4.3.2 Industry ;

In recent years, the objective of industrial policy in India has been to improve competitive efficiency of Indian industry. The competition Act 2002 was enacted in December 2002 to promote competition through prohibition of anti-competitive practices and abuse of dominance. This act will replace the MRTP act, 1969.

In india, financing of infrastructure is still dominated by the public sector. The power sector was the first among the infrastructure sectors to be opend up to the private sector. Foreign equity up to 100 percent was allowed in green-field power projects in 1993-94. The Electricity Bill, 2003 may encourege private sector financing for electricity generation, and free permission of captive power generation plans. The Reserve Bank has also liberalised term loan financing by banks for infrastructure with recourse to finance through funds raised by way of subordinated debt, take out financing, direct financing, investment in infrastructure bonds and guarantee. Banks have been allowed to contribute to the equity capital infrastructure projects and lend to special purpose vehicles in the private sector for directly undertaking infrastructure projects.

3.4.3.3 Services Sector :

The Services sector is emerging and the mainstay of the Indias growth process in recent years. The improvement is the performance in financing insurance, social and personal services has more than the performance of trade hotels transport and communications in 2002 -03.

India maintained its internationally competitive edge in the production and exports of IT services during 2002-03. The BPO segment is estimated to have accounted for about a quarter of the total IT Enabled Services (ITES) and software exports from India.

3.5 Reserve Bank - Credit Control :

The RBI is entrusted with the responsibility of regulating the monetary system by controlling the credit prevailing in the country. There are two types of credit control. 1) Qualitative Credit Control and 2) Quantitative Credit Control. The Quantitative credit control refers to the measures taken by the RBI to control the volume and direction of credit. The quantitative credit control measures are Bank Rate Policy, Net Liquidity Ratio System, Open Market Operations, Statutory Liquidity Ratio and variable cash reserves etc. The Qualitative Credit control affects all sections of the economy. The RBI has the right to make the necessary instructions to the commercial banks in relation to the Quantum of credit the purpose of advances, margin to be maintained the rate of interest etc. The Qualitative credit control methods are rationing of credit, prescribing margin requirements, consumer credit regulations, control of Bank advances, publicity moral suasion and direct action.

3.6 Summary :

RBI, as the Central Bank of our country, was established under the Reserve Bank of India Act, 1934. There is a Central Board of Directors to manage the affairs of the bank. The Reserve Bank of India acts as a bank of issue and issues currency notes of various denominations. It acts as a Banker to Government, Bankers bank, and as a custodian of nations, foreign exchange reserves. It controls credit with the help of Quantitative and Qualitative credit control methods.

3.7 Self Assessment Questions:

1. What are the supervisory and promotional functions of Reserve Bank of India ?
2. Explain the various functions of Reserve Bank of India.
3. How does the RBI act as a banker to the government?
4. State the role of Reserve Bank of India in economic development.
5. Write short notes on :
   a) Quantitative credit control measures
   b) Qualitative credit control measures

Lesson : 4

RBI - CONTROL OF CREDIT

Objectives :

After studying this lesson, you should be able to

- Understand about Quantitative credit conrol
- Understand about Qualitative credit conrol

Structure :

4.1 Introduction :

The financial and economic stability of a country is achieved through proper conrol of the power of credit creation of commercial banks by the central bank. Two broad Techniques are available to control credit by Reserve Bank. The instruments of these two methods are as follows:

Techniques of Quantitative credit conrol	Techniques of Qualitative credit control
Bank Rate Policy	Regulation of margin requirements
Open market operations	Rationing of credit
Cash Reserve Ratio (CRR)	Regulation of consumer credit
Statutory Liquidity Ratio (SLR)	Publicity
	Moral Suasion
	Direct Action

The RBI is entrusted with the responsibility of regulating the monetary system by controlling the credit prevailing in the entire financial system in the country.

4.2 Quantitative Credit Control :

The stability of the money market depends largely on the careful manipulation of credit. There are two types of credit control. 1) Quantitative Credit Conrol and 2) Qualitative Credit Control.

The quantitative Credit Control may refer to the measures taken by the Reserve Bank to control the volume and direction of credit. The Quantitative techniques are : i) The Bank Rate Policy, ii) Open Market Operations, iii) Cash Reserve Ratio, iv) Statutory Liquidity Ratio.

4.2.1 Bank Rate :

Bank rate is the official rate at which Reserve Bank is prepared to buy or rediscount bills of exchange or to lend on approved securities under the Act. The Reserve Bank makes use of Bank Rate either to expand or to contract the credit by the commercial banks and thus indirectly controls the currency flow in the country. If the commercial banks indulge in expansion of credit, the Reserve Bank will raise the Bank Rate. Increase in Bank Rate leads to lesser demand for credit and reduced volume of credit which reduces the Quantum of credit money leading to fall in prices. Thus, the bank rate can be used to control inflationary conditions. Similarly, decrease in bank rate leads to easy credit and increase in the price level.

The bank rate changes from time to time. In our country, the bank rate has generally influenced other market rates including the lending rates of the commercial banks. Due to governments liberations policies, the interest rates are deregulated and lowered.

Since 1997, the bank rate has been reactivated as the principal signalling device of the monetary policy. Bank rate, which was 8% in July, 2000, was reduced to 7.5% on Feb 2001. It was again reduced to 7% on March 2001. It was 6.5 on Oct 22, 2001. It was reduced to 6.25% on Oct 20, 2002, the lowest rate since May 1973, and by a further 25 basis points in April 2003. The bank rate has been reduced by 500 basis points in the last five years. This is the sharpest reduction its the bank rate since independence (Table 4.1)

Table 4.1 Adjustments in Bank Rate

Effective Date	Rate
Jan 17, 1998	11.0
March 19, 1998	10.5
April 3, 1998	10.0
April 29, 1998	9.0
March 2, 1999	8.0
April 2, 2000	7.0
July 22, 2000	8.0
Feb 17, 2001	7.5
March 2, 2001	7.0
Oct 23, 2001	6.5
Oct 29, 2002	6.25
April 29, 2003	6.0

Limitations : The utility of the Bank rate policy in India was limited by the following :

1. Absence of bill market 2. unorganised nature of money market
3. Absence of close relationship between bank rate and other rates in the money market
4. Existence of wide dispasity in interest rates.

4.2.2 Open Market Operations :

This is another important technique of Quantitative control available to the Reserve Bank of India. Open market operations refer to the deliberate and direct buying and selling of securities and bills in the money market by the Reserve Bank. The purchase or sale of securities tends to increase or decrease the quantity of money in circulation as well as the cash reserves of the commercial banks directly and immediately.

Section 17 (8) of the RBI Act empowers the RBI to buy and sell government securities. Immediately after the second world war, the commercial banks experienced heavy withdrawls of deposits by the depositors due to political and other uncertainities, and commercial banks were faced to sell securities to meet their customer's demands. At this stage, the RBI was compelled to enter into money market and bought the securities on a large scale to maintain stability in the security prices. In order to maintain security prices and to stabilise increased the financial structure of the country, the Reserve Bank increased its open market operations.

When there is inflation due to an increase in money circulation, the Reserve Bank sells securities. The buyers of these securities either pay actual cash or hand over cheques on their deposits with commercial bank. So immediately, the cash reserve of the commercial decreases, leading to credit contraction.

In the recent years, there has been large scale government borrowings for development purposes which are responsible for increase in the volume and variety of securities.

4.2.3 Cash Reserve Ratio :

As per section 42 of the RBI act, 1935 all scheduled commercial banks should maintain certain minimum cash reserves with the RBI. According to an amendment in the RBI Act (in 1962) the RBI was empowered to vary the cash reserve ratio between 3-15% of the total time and demand liabilities in India. In addition to this, it can direct scheduled banks to deposit with it a certain percentage of any increase in deposits that takes from specified data.

The RBI used this weapon for the first time in 1960. In April 1996 the ratio was 13% in 1999-2000, it was 9%, and in 2000 - 2001 it was 8% and in 2001 - 2002 it is 5.5.

The Narasimham commitee recommended strongly the phased reduction of CRR. It is also recommanded paying of interest on cash reserves by RBI at the rate charged by banks on one year deposits.

The Cash Reserve Ratio (CRR) remains an important instrument for modulating liquidity conditions. The medium-term objective, is however, to reduce CRR to the statutory minimum level of 3.0 percent. Accordingly, on a review of developments is the international and domestic financial markets, a 75 basis point reduction in the CRR during June to November, 2002 was followed by a further 25 basis points cut from june 14, 2003 taking the level of the CRR down to 4.5 percent. The payment of interest on eligible CRR balances maintained by banks was changed from quarterly basis to monthly basis from April 2003. Table

Table - 4.2

Adjustments in Cash Reserve Ratio

	2003 - 04	2002 - 03	2001 - 02	2000 - 01
April	4.75	5.5	8.0	8.0
May	4.75	5.5	7.5	8.0
June	4.5	5.0	7.5	8.0
July		5.0	7.5	8.25
August		5.0	7.5	8.5
September		5.0	7.5	8.5
October		5.0	7.5	8.5
November		4.75	5.75	8.5
December		4.75	5.5	8.5
January		4.75	5.5	8.5
February		4.75	5.5	8.25
March		4.75	5.5	8.0

4.2.4 Statutory Liquidity Ratio (SLR) :

As per the RBI Act, 1934 and the Banking Regulation Act, 1949, every commercial bank should maintain certain minimum liquid reserves corresponding to its total time and demand liabilities. The liquid asset means cash, or cash with RBI, cash with other banks, gold with other approved securities. Prior to 1972, the liquidity ratio was fixed at 25% of their total time and demand liabilities, later it was raised to 30% in 1972, 33% in 1972 and 38% in 1981.

Reserve requirements have been a major instruments of control of liquidity in India. The Narasimham committee on the fiscal system has recommended that the SLR be brought down in a phased manner.

On the recommendation of the committee on financial sector (1991), the RBI reduced the SLR to 27 percent by December 1999, later, it was reduced to 25 percent, as desired by the Narasimham Committee.

The Statutory Liquidity Ratio (SLR) to be maintained by all scheduled commercial banks remains unchanged at a minimum of 25 percent of net demand and time liabilities since October, 1991. From April, 2003 all scheduled Urban Co-operative Banks (UCBs) have to maintain the entire SLR holidays of 25 percent of net demand and time liabilities in government and other approved securities only. Similarly regional rural banks (RRBs) were required to maintain their entire SLR holdings in government and other approved securities by March 31, 2003 with SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 being reckoned for the SLR till maturity.

4.3 Qualitative Credit Control or Selective Credit Control :

The Banking Regulation Act 1949, gave wide powers to the RBI to use selective credit controls. Tne Reserve Bank can issue directives to banks in respect of (1) their lending policies, the purposes for which advances may or may not be granted, (2) the margins to be maintained on secured advances and, (3) the rate of interest charged.

Selective credit controls regulate the use of credit by discriminating between essential and non-essential purposes. Quantitative credit controls are used to check the credit extending to non-essential purposes or uses with a view to control inflation in the country. The following are the different methods of selective credit control.

1. Rationing of credit
2. Prescribing margin requirements
3. Consumer credit regulations
4. Publicity
5. Moral suasion and
6. Direct Action

4.3.1 Rationing of Credit :

The rationing of credit refers to the control exercised by the RBI in regulating the purposes for which the credit is granted among the various applicants. If the control aims at controlling the total credit, it may be considered as quantitative credit. But it becomes selective when it aims to limit only certain types of loans and advances.

4.3.2 Prescribing Margin Requirements :

The term "margin requirements" refers to the proportion of the prices of securities which banks and other security dealers are not permitted to lend i.e. the difference between the loan value and the market value is called margin. The object of prescribing margin requirements is to restrict speculative dealings in stick exchanges, If higher the margin prescribed by RBI, the lesser the speculation can borrowors and it also reduces the volume of credit. This method also enables the commercial banks to direct their funds to productive investments rather than speculative activities.

4.3.3 Consumer Credit regulations :

The RBI may restrict consumer expenses on non-essential items by directing the commercial banks to fix the minimum percentage of down payment, length of period over which instalment payments may be spread etc. By lowering the exemption list, the instalment buying is couraged and vice versa.

4.3.4 Publicity :

The objective of publicity is to educate the public about the monetary situation in the country. Regular weekly reports, monthly reviews, annual reports monthly bulleton and annual reports are, published by RBI about the working of commercial banks and financial institutions.

4.3.5 Moral Suasion :

The Reserve Bank also excercises control over credit by moral persuasion. It is not a statutory obligation. Periodically, letters are issued to banks urging them to excercise control over credit in general or advances against specified commodities or unsecured advances in particular. Discussions are also held from time to time with banks with the same objective. It is merely a persuasion or request to commercial banks not to apply for further accommodation from RBI and also not to use the accommodation already obtained for financing speculative activites.

4.3.6 Direct Action :

Direct action may refer to all forms of restrictions imposed upon the commercial banks in general or in particular concerning lending and investment. The RBI may bring direct action against any commercial bank by enforceing the restriction on credit for speculative purposes.

4.4 Summary :

The financial and economic stability of a country is achieved through proper control of the power of credit creation of commercial banks by the central bank. There are two types of credit control viz., quantitative and qualititaive.

Techniques of Quantitative credit control are : 1) Bank rate 2) Open market operations 3) Cash reserve ratio and 4) Statutory Liquidity ratio.

Techinques of qualitative credit control are : 1) Regulation of margin requirments 2) Rationing of credit 3) Regulation of consumer credit 4) Publicity 5) Moral suasion and 6) Direct action.

4.5 Self Assessment Questions :

1. What do you mean by selective credit control of explain ?
2. What are the monetary and credit control measures recently adopted by the Reserve Bank of India ?
3. Write a note on Statutory Liquidity Ratio.
4. What do you mean by Cash Reserve Ratio?
5. What are the various weapons of credit control available to Reserve Bank of India?

   How are they used?
6. What are open market operations? How are they used by the RBI?

Lesson - 5 MONETARY AND FISCAL POLICIES

Objectives :

After reading this lesson, you should be able to:

- define monetary policy, its objectives and nature
- explain the instruments used by RBI for implementing monetary policy
- define the fiscal policy and its objectives in controlling the economy
- analyse the Indian fiscal policy
- evaluate the monetary and fiscal policies of the RBI and Government of India

Structure :

5.1 Introduction

The monetary and fiscal policies effect the financial sector and the economy in general. They can be used to influence specific sectors of industries or segments. These policies have important influence on the Gross National Product.

The Government and the Central Bank make use of various fiscal and monetary weapons respectively to achieve stability and growth by influencing and regulating the behaviour of the various classes of spenders as savers, consumers and investors. In other words, the fiscal and monetary policies are also important determinants of business prospects and investment decisions. They can help the overall economic situation and business prospects bright or check an unwarranted boom or unhealthy demand explosion. They can encourage investment and production in certain priority sectors and discourage them in the non-priority sectors. They are also capable of influencing technological choice and investment and production trends. In short, the fiscal and monetary policies influence the aggregate supply and demand and the associated level of employment, wages, interest rates, rent, prices and profits.

5.2 Objectives of Monetary Policy :

Monetary policy is assuming greater relevance in the transition era of the economy from closed system to open system. The primary objectives of monetary policy are 1) to provide necessary finance to various investors through commercial banks and co-operative banks for economic development 2) to control the inflationary pressures generated in the economy, 3) to maintain full or nearfull employment. The ultimate objective of monetary policy is expansion and development of economy. This does not mean that it is solely responsible for it. The government is the major responsible authority for stimulating the economy. Monetary policy and fiscal policy work together for the same set of objectives.

Monetary policy is the policy statement through which the Reserve Bank of India targets a key set of indicators to ensure price stability in the economy. Historically, the monetary policy has been announced twice a year one for the slack season, i.e. April to September and one for the busy season, i.e. October to March from the financial year 1998-99, the RBI has decided that the policy would be released once in a year, since the share of the agricultural credit has come own.

The government can build-up excess demand in the economy by development expenditure and then regulate the supply through physical controls on price and distribution. On the other hand, it can act through monetary policy, which is designed to regulate demand through the use of monetary and fiscal instruments and then let the market forces determine commodity prices and their distribution and consumption pattern.

5.3 Monetary Policy and Money Supply :

Money supply comprises currency with the public and demand deposits. The budgetary operations of the government considerably affect the money supply. If the government meets its budgetary deficits by borrowing from the Reserve Bank, there will be an increase in money supply, both in currency and bank deposits. The RBI has no control over budgetary operations, though it has opportunities of tendering advice to government on this matter.

Another source of variation in money supply, over which the RBI's influence is restricted, is the country's international payments position. Demand deposits are a very important determinant of money supply. In many developing countries, the proportion of demand deposits in money supply has been increasing. This trend is association with economic development and banking habits of people.

Deposits with banks may originate in two ways – through passive creation or active creation. The former occurs when banks open deposit accounts for customers against the receipt of value either in cash or cheques drawn on other banks. The latter takes place when banks create deposits by extending credits. In the first case, the immediate effect is that there is no addition to the Quantum of money, though its distribution may undergo a change; but ultimately it enables the banks to extend credit and thus results in an increase in money. In the second instance, the supply of money is augmented immediately. When a bank extends credit, it would result partly in a rise in deposits either with itself or with other banking institutions. Under the fractional reserve system, the banks can create deposits by a multiple of the reserves, since the payments made with the proceeds of bank loans are eventually redeposited with banks, leading to additional reserve funds.

By varying the cost and availability of credit Central Bank produce desired changes in the assets pattern of credit institutions, mainly commercial banks. The item among bank's assets having special significance in this connection is the credit extended by banks to their constituents, which is the sum of what are usually called loans and discounts. The capacity of banks to provide credit depends on their cash reserves, comprising cash in hand and balances with the Reserve Bank. These increase through a rise in the deposit resources of banks, or by their borrowing from the reserve bank, or by sale of their investments. The regulation of credit by the Reserve Bank in essence means regulation of the quantum of the reserves of banks. If the bank desires to bring about an expansion in credit, it adopts measures to augment the bank's reserves of credit is to be restricted, it attempts to curtail the reserves.

5.3.2 Extent of Money :

Before initiating measures for the expansion or contraction of money supply the RBI generally measures the extent of money and credit available in the economy at a given time. The following indices are generally used for the purpose. M_1 represents money supply with public. M_1 has two components; a) currency with the public and b) deposits of the public with banks. Currency with the public is sum total of notes in circulation and circulation of coins minus the cash on hand with the banks. Deposits of the public with banks is the sum total of demand deposits with banks and other deposits of the public with RBI.

M_2 represents the total M_1 plus post office savings and bank deposits.

M_3 is the sum total of M_2 and time deposits with banks.

M_4 represents M_1 plus total post office deposits.

M_1 is called "narrow money" and M_3 is called "broad Money". M_3 represents the aggregate monetary resources or the money stock of the entire banking sector. The sources of M_3 are a) the net bank credit to the government, b) bank credit to the commercial sector, c) net foreign exchange assets of the banking sector and d) the government's currency liabilities to the public.

5.3.3 Expansion of Money :

Money is pumped into the economy through the issue of currency by the RBI, budgetary operations of the government and borrowings by the government from foreign countries. Expansion of money has always been on the increase. Expansion of money supply is not wrong, it is desirable, in a developing economy as money is needed to match the growth in the real national income. Actually, the growth in money supply must be higher than the growth in the real national income. This happens because of two reasons; a) as incomes grow, the demand for money as one of the components of savings tends to increase. b) an increase in money supply is also necessitated by the general reduction of the non-monetised sector of the economy. In our country, the rate of increase in money supply has been far in excess of the rate of growth in real national income. Hence the inflationary pressure is there on the economy.

5.3.4 Contraction of Money :

Unlimited expansion of money and credit results in hyper-inflation, which hits all sections of society, particularly the poor. The Reserve bank has responsibility to ensure that money supply is within manageable limits and inflation is not too harsh. For this purpose, the Reserve Bank has been using different general credit control measures.

5.3.5 Structural Adjustments and Monetary Policy :

In tune with the ongoing structural adjustment programme, objectives and instruments of the monetary policy have been redefined. The major considerations which underlie the monetary policy in recent years have been; a) bringing about a declaration in monetary expansion with a view to containing inflation without hampering the revival of the economy; b) reducing the monetised deficit, i.e., printing of new currency consistent with the government's objective of bringing down gross fiscal deficit and c) boosting exports in order to alleviate the problem of external payments deficit. To achieve these objectives, the following instruments of monetary policy have been employed.

1. The stipulation of minimum lending rate for advances of over Rs. 2 lakhs has been discontinued and banks would be free to fix their own prime rates.
2. Statutory Liquidity Ratio (SLR) has been reduced to 25 per cent, sharply shrinking the captive market for government securities.
3. State governments too would have to go to market for loans.
4. Automatic monetisation of the budget deficit would cease and has been replaced by a system of 'ways and means advances' under which temporary accommodation provided to the central government would have to be liquidated by the end of the financial year.
5. The RBI would endeavour to develop an active market in securities for which it would undertake to develop institutions and instruments as well as an appropriate structure of market – determined rates of interest on securities.
6. A close linkage would be established between monetary policy and exchange rate policy.
7. The RBI is prepared to accept that banks choice of asset holdings would be determined not by statutory prescriptions but by risk – reward perceptions.

8. Guidelines have been issued for the promotion of market – makers in major stock exchanges and for the grant of bank advances for the purpose, without any ceiling and without applying the 50 percent margin applicable to advances against shares.

5.4 Instruments of Monetary Policy :

The central bank acts as leader of the money market supervising, controlling and regulating the activities of the commercial banks and other financial institutions. It also controls the credit operations of the commercial banks and other financial institutions. It attempts to stabilize business conditions in a country. Various methods and instruments are available to the central bank for this purpose. Some are general and quantitative which control and adjust total quantity of size or the volume of the deposits created by the commercial banks. Other measures are selective or qualitative controls as they control only certain types of credits and not all. The former measures control the volume or stock of the money and credit while the later measures control the availability or flow of money and credit.

5.4.1 General or Quantitative Controls :

Quantitative or general controls relate to the volume and cost of bank credit in general without regard to the particular field of enterprise or economic activity in which the credit is used. Consists of a) bank rate or discount rate policy, b) open market cooperation's, and c) reserve ratio. The general or quantitative control.

a **Bank rate or discount rate :-** Bank rate is the rate which the central bank charges for giving loans to commercial banks. When a commercial bank has low or no cash reserves above the legal requirements, it may obtain the additional cash reserves from the central bank at an 'interest rate' i.e., bank rate.

Suppose, the central bank believes that inflationary conditions are prevailing, it will raise the bank rate. In their turn commercials will increase their interest rates. The cost of credit to the public will increase. Contraction in business activity takes place leading to contraction of income and expenditure, reduction in the demand for goods, resulting in fall in the price level. The success of bank rate policy to control credit will depend upon the relationship bank rate, interest rate, cash reserves, security and effect of interest rate on borrower and investor.

b **Open market operations :-** Direct buying and selling of Government securities and bills in the money market by the central bank of the country, with the objective of expansion and contraction of credit and economic activity in the economy is known as open market operations. If the securities are purchased then there will be an outflow of money from the capital market. This results in expansionary effect on income, employment, output and prices. Similarly the sale of securities will yield contractionary effect on the level of economic activity.

c **Reserve ratio :** In view of safety and liquidity, the commercial banks are legally required to keep a part of their total demand and time deposits with the central bank. This is known as

Statutory Liquidity Ratio. Changes in reserve requirements affect the amount of reserves that commercial banks must keep as deposits with the central bank and consequently the amount available for lending or investing. By raising the reserve ratio to be maintained by every bank, the central bank can reduce the volume of credit and by lowering the reserve ratio, it can expand the volume of bank credit. Hence, changes in reserve requirements are a powerful weapon for influencing the volume of bank deposits and money.

5.4.2. Selective or Qualitative Controls :-

In selective controls, the essential and non-essential uses of bank credit are distinguished and only the non-essential uses are brought under the scope of central bank control. It allows the expansion of bank credits to essential industries. This helps to raise the level of production and real income in the essential industries and curbs inflationary pressures that would have been created.

Several methods can be exercised to affect particular sectors of the economy and include such as:

a) insisting on minimum margins for lending against specific securities,

b) fixing a ceiling on the amount of credit for certain purposes,

c) changing discriminatory rates of interest on certain types of advances,

d) moral suasion and

e) direct action

Among the above five measures, the first three are self-explanatory, the latter two need clarification.

Under moral suasion, the RBI addresses periodical letters to banks urging them to exercise control over credit in general, or advances against particular commodities or unsecured advances. Periodic discussions are also held by the Governor of the Reserve Bank with the authorities of commercial banks urging them to restrain from lending liberally.

Direct action may involve by the Reserve Bank to rediscount bills of a particular commercial bank which has failed to comply with the directives of the former. At the extreme, it may involve cancellation of license of an erring bank. Direct action is too severe and is there fore, rarely followed. Despite the priority of selective controls in underdeveloped economies characterised of sectoral shortages and surpluses, the qualitative techniques suffer from some limitations:

1) They have no control over non-banking institutions,

2) It may not always be possible for banks ensure that loans granted by them are spent for the purpose for which they were originally sanctioned,

3) The banks may sanction loan for forbidden uses

5.5 Evaluation of Monetary Policy :-

Monetary policy has become a target of severe criticism. The primary objective of monetary policy will be controlled expansion. It is said that the RBI has failed both in expansion and control of money and credit in our economy. With regard to the expansion of credit, major component of the increase in money supply was the reserve bank credit to the central government. The inability of the RBI to deny or regulate credit to the central government due to both legal and practical considerations has been interpreted by the committee as an important factor. Thus money supply has expanded.

It is further said that the monetary policy operated by the RBI did not play any effective role in curtailing inflation in the economy. The reasons for failure to formulate an effective monetary policy should be found elsewhere and not with the RBI. It was criticised that the central government has lived beyond its means and making central bank impotent in discharging its responsibility in maintaining the value of the currency. Another argument to prove the Reserve Bank's helplessness is that the powers and weapons of the bank cover only the commercial banks. If the inflationary pressure is really brought about by deficit financing and shortage of goods, the RBI's control may not have any effect at all.

5.6 Fiscal Policy :

Fiscal policy refers to the policy of the government regarding taxation, public expenditure and public debt. Fiscal policy generally believed to be the government's weapon to regulate their economic and business activities.

5.7 Meaning of Fiscal Policy :-

Fiscal policy is commonly looked upon as comprising variations in government tax and expenditure programmes. Since changes in tax and expenditure policies often imply a change in the size of the national debt, variations in debt policy are often included under the general heading of fiscal policy. Many economists consider debt management policy to be an entirely separate and distinct policy question. Government tax and expenditure policies can influence the volume of money in circulation.

5.8 Objectives of Fiscal Policy :-

Conventionally, macro-economic policy goals are concerned with full-employment of the labour force, enhanced economic growth avoidance of inflation, maintenance of bålance of payments equilibrium and international competitiveness and promotion of regional balance another important objective is the promotion of social justice. Governments all over the world have been using fiscal measures to regulate their economic and business activities in order to achieve such objectives as: 1) accelerating the rate of investment; 2) promoting socially desirable investment; 3) achieving rapid economic development; 4) achieving full employment, 5) promoting foreign trade; 6) reducing inequalities of income and 7) establishing a welfare state.

5.9 Importance of the Budget :-

There is no other government measure that affects the whole economy as the Budget. It in not exasirating saying that all sections of the people await the annual budget with mixed feelings of anxiety, fear and hope. The big task of a finance minister is to present the annual budget which gives maximum support to forces that can move the country forward on the path of growth with stability and social justice. The budget should set the stage for the achievement of economic and social goals.

In India, about a half of the GDP is channelled into the government sector by the Union, State and UT budgets and disbursed by the Union, State and UT governments under various development and non-development heads. This indicates the development and distributive importance and implications of the budgetary operations.

There has been a steep increase in the government expenditures, both in absolute and relative terms. The total budgetary expenditures are about 50 percent of the Gross Domestic Product today. The central government expenditure alone account for one forth of the GDP. In a developing country like India, the budget policy has to serve the following purposes;

1) accelerate the pace of economic development by mobilizing resources for the public sector and their optimal allocation;

2) effect improvement in production in the private sector in accordance with the national priorities;

3) effect improvements in income distribution,

4) promote exports and encourage import substitution; and

5) achieve economic stabilisation.

To achieve the above purposes various fiscal incentives and disincentives are also employed by the budget. Certain sectors or industries may be significantly influenced by the budget proposals like tax proposals or budgetary allocations.

5.9.1 The Union Budget

An estimate of all anticipated revenue and expenditure of the Union Government of India for the ensuring financial year is laid before Parliament on the last working day of February every year. All receipts and disbursements of the Union Government are kept under two separate headings, namely, the Consolidated Fund of India and the Public Account of India. All revenues received, loans raised and money received in repayment of loans by the Union government from the consolidated Fund. No money can be withdrawn from this Fund except under the authority of an Act of Parliament. All other receipts and disbursements, such as deposits, service funds and remittances go into the Public Account, which is not subject to the vote of parliament. To meet unforeseen needs not provided in the Annual Appropriation Act, a Contingency Fund of India has also been established under Article 267 (1) of the Constitution.

After the presentation of the Annual Financial Statement, a general discussion will be held on the Budget in both the house of Parliament. The estimates of expenditure from the consolidated

Fund of India are then placed before the Lok Sabha in the form of Demands of Grants. Generally, a separate demand is made for each Ministry. All withdrawals of money from the consolidated Fund are authorised by an Appropriation Act passed embodied in another Bill, which is passed as the Finance Act of the Year. The receipts and expenditure of the Central and State Governments are audited by the Comptroller and Auditor General who is independent of the executive, and his reports on the accounts are submitted to the president governor for having them laid before parliament/ State legislature.

The Budget is divided vertically into revenue and expenditure. Horizontally, it is divided into revenue account and capital account. Thus, the receipts are divided into revenue receipts and capital Receipts. And the expenditure is broken up into Revenue Expenditure and capital expenditure. The revenue expenditure includes all current expenditure of the government on administration, and the capital expenditure includes all the capital transactions of the government. The revenue receipts include revenue from taxes, white capital receipts include market loans, external aid, income from repayments and other receipts, such as income from public undertakings.

5.9.2 State Budgets :

Like the Union Government, State governments have their own budgets. Estimates of receipts and expenditure are presented by the State Governments to their legislatures before the beginning of the financial year and legislative sanction of expenditure is secured through similar procedure. The constitution has provided for the establishment of a Consolidate Fund, a Public Account and a Contingency Fund for each state as in the case of Union Government.

5.9.3 Sources of Finances of the Union and States :

The constitution of India has provided for the sources of revenue for the Union and the States separately.

Sources of Revenue for the Union :

The Union list in the Constitution includes the following revenue subjects.

1. Taxes on income other than agricultural income;
2. Duties and customs, including export duties;
3. Duties of excise on tobacco and other goods manufactured or produced in India, except alcoholic liquors for human consumption and opium, Indian hemp and other narcotic drugs and narcotics;
4. Corporation tax
5. Taxes on the capital Value of assets, exclusive of agricultural land, of individual companies; taxes on the capital of companies.
6. Estate duty in respect of property other than agricultural lands;
7. Duties in respect of succession to property other than agricultural land;
8. Terminal taxes on goods of Passengers carried by the railways, by sea, or air; taxes on railway fares and freight;

9. Taxes other than stamp duties on transactions on stock exchanges.
10. Rate of stamp duty on bills of exchange;
11. Taxes on the sale or purchase of newspapers and on advertisements published therein;
12. Fees in respect of any of the matters in Union list, but not including fees taken in any court;
13. Any tax not mentioned in the state list or concurrent list.

Sources of Revenue for the State :

The State List in the Constitution of India includes the following revenue subjects :

1. Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights and alienation of revenue.
2. Taxes on agricultural income.
3. Duties in respect of succession to agricultural lands.
4. Estate duty in respect of agricultural land.
5. Taxes on lands and buildings.
6. Taxes on mineral rights, subject to any limitations imposed by parliament of law relating to mineral development.
7. Duties of excise on the following goods manufactured or produced elsewhere in India: a) alcoholic liquors for human consumption; b) opium, Indian hemp and other narcotic drugs and narcotics.
8. Taxes on the entry of goods into a local area for consumption, use and sale therein.
9. Taxes on the consumption and sale of electricity.
10. Taxes on the purchase and sale of goods (other than news papers)
11. Taxes on advertisements (other than those on newspapers)
12. Taxes on goods and passengers carried by road or inland water ways.
13. Taxes on animals and boats.
14. Taxes on vehicles, whether mechanically propelled or not, used on roads.
15. Tolls.
16. Taxes on profession, trades, callings and employment.
17. Capitation taxes.
18. Taxes on luxuries, including taxes on entertainment amusements, betting and gambling.
19. Rates of stamp duty in respect of documents other than those specified.
20. Fees in respect of any of the matters in this list but not including fees taken in any court.

21. Fisheries
22. Forests
23. Irrigation, water storage and water power.

5.9.4 Concurrent list :

Following are the revenue items in the concurrent list under the constitution.

1. Stamp duties other than duties or collected by means of judicial stamps but including rates of stamp duty.
2. Fee in respect of any of the matters in this list but not including fees taken in any court.

   Under the constitution of India, a Finance Commission is to be constituted every fifth year or at such earlier times as the president considers necessary to make recommendations to the president regarding(a)the distribution between the Union and States of the net proceeds of taxes which are to be or may be divided between the states of respective shares of proceeds,(b)the principles which should govern the grants-in-aid of the revenues of the state in need of such assistance out of the Consolidated Fund of India; and(c)any other matters referred to the commission by the President in the interest of sound finance. The recommendations of the Commission, together with an explanatory memorandum as to the action taken thereon, are laid before each House of Parliament.

5.10. The evaluation of Fiscal Policy :-

The effectiveness of fiscal policy can be assessed form three angles,

a) fiscal policy and savings and capital formation,
b) fiscal policy and economic inequalities and
c) fiscal policy and inflation control.

With reference to the effectiveness of fiscal policy and savings and capital formation, the policy failed to produce enough savings for public investment. Financial has become a standard excuse to avoid or postpone project implementation. With regard to the impact of public revenue and public expenditure on minimising income inequalities, the gap between the rich and the poor has widened. The tax system has failed to rob the rich and public expenditure has failed to pay labour. Our fiscal policy has totally failed to check the inflation.

5.11 Review of the working of Monetary System :

Recommendations of Chakravarthy Committee :

The Hiltin-young commission reviewed the working of the Indian monetary system as far back as 1925 and since then so many changes have taken place in the Indian Economy. Since independence, the monetary system has been made to help in mobilisation of resources for planned economic development. But in the process, the economy had to undergo considerable, inflationary pressure. The Reserve Bank of India took the initiative of appointing a committee in 1982 to review the working of the monetary system in India with Professor Sukhamoy Chakravarthy as Chairman. The Chakravarthy Committee was asked;

a) to review critically the structure and operation of the monetary system in the context of the basic objectives of planned development;

b) to evaluate the various instruments of monetary and credit policies;

c) to assess the interaction of monetary polices and public debt management; and

d) to recommend suitable measures for the formulation and operation of monetary and credit policies and for strengthening the instruments of monetary and credit policies

The Chakravarthy Committee submitted it s report in May 1985.

Operation of the Monetary System in India :

According to Chakravarthy Committee, the operation of the monetary system should be consistent with plan priorities, so that the process of mobilisation of savings and utilisation of the mobilised savings become socially purposive. The Committee appreciated the increase in the savings rate from 10.2 per cent in 1950-51 to 22.6 per cent in 1983-84 but it found that the increase was not adequate to fiancé public sector investment. Accordingly, the government had to resort to deficit financing creating, in turn, inflationary pressure. The Committee has therefore emphasised the need for financing the Plans in a non-inflationary manner by; a) tapping the savings of the public in a great measure than in the past, b) raising higher savings from the public sector enterprises; and c) improving efficiency in revenue gathering and expenditure functions.

Objectives of Monetary Authorities :

In the context of planned economic development, monetary authorities should aim at "price stability in the broadest sense" Price stability, according to the Committee, does not mean constant price level but is consistent with an annual increase of four per cent in the whole sale price index. The Committee recognises the existence of violent fluctuations in agricultural productions in India caused by weather conditions and the consequent difficulty in controlling inflationary pressures. Accordingly, the Committee recommends strong supply management measure. At the same time, demand management is equally important. Thus, to achieve the objective of price stability, the committee has suggested a two-pronged strategy, the government should aim at raising output levels and RBI should control the expansion in reserve money and money supply.

Monetary Targeting :

There is a close interrelationship among money supply, output and prices. The increase in reserve money and in money supply has been largely due to a rise in the level of RBI credit of government which reflects significant monestation of debt. In this connection, the Committee makes two related recommendations. First, the target for increase in money supply (Ms) during a year should be announced in advance. The target should be in terms of a range based on anticipated growth in output and in the light of the price situation. The target can be modified but the circumstances under which the modification is being made should also be announced in advance. This policy of monetary targeting will help the RBI in the use of its monetary policy instruments.

Secondly, the government should restrict its resource to RBI, at predetermined levels so as to restrict monetisation of debts. Towards this end, the yield rate of dated government securities and Treasury Bills should be two per cent per annum in real terms so that the government could attract lenders from outside the captive market of banks and insurance companies. In other words, the government should raise the needed financial resources by tapping the savings of the people of by increasing tax revenues or by incurring budget deficit financed by borrowing from sources other than RBI. As a corollary to the above point, the Committee has recommended a redefinition of the budgetary deficit of the government of India. The present definition does not provide a clear picture of the monetary impact of the fiscal operations as the deficit is related only to the changes in the level to Treasury Bills outstanding. The present concept of budget deficit does not cover the rise in the RBI's holdings of dated securities which have a monetary impact and distinguish between an increase in the RBI's holdings of Treasury Bills in the portfolio of non-RBI investors which do not have a direct monetary impact.

The Committee, therefore, believes that changes in the level of RBI credit to government provide an unambiguous and economically meaningful measure of the monetary impact of fiscal operations and hence a suitable modification in the definition of the budgetary deficit is warranted.

The Committee rightly feels that closer coordination of fiscal and monetary policies would be facilitated when the government and the RBI are able to determine in advance the desired monetary impact of the government's borrowing programme as a part of the annual budget exercise.

Interest Rate Policy :

The Committee has advocated a strong supportive role for interest rate policy. In the first place, the yield rate of dated securities and of Treasury Bills should be high enough to attract lenders from outside the captive market and also helps to improve the profitability of banks. The recommended revision in the yields on government securities and Treasury Bills is expected to promote greater efficiency in government expenditure and greater accountability.

Secondly, the interest rate policy has an important role in promoting the effective use of credit and in short term monetary management. The Committee has recommended an administered spread of three percentage points between the maximum interest rate on bank deposits to be fixed by the RBI for a period of 60 days or more and the minimum lending rate of banks. The Committee has not recommended any ceiling on lending rates of banks which are, in fact, expected to vary their lending rates according to fluctuations in business activity and their own cost of funds.

Thirdly, savers should be able to earn a reasonable return on their long-term savings. The committee, therefore, recommended that the deposit rate offered by banks for deposits of five years or more should offer the saver a minimum positive real return of two per cent annum. The RBI should fix the nominal deposit rates accordingly. The Committee has also suggested that banks should devise innovative schemes to provide small savers a better return than they have been so far getting on their deposits.

Fourthly, the Committee has recommended only two confessional interest rates for bank credit to priority sector borrowers. One should be equivalent to the basic lending rate. The Regional Rural banks are exclusively involved in lending to the priority sector and has suggested a detailed review of over dues by areas and by activity so as to facilitate remedial action by the concerned developmental agencies and banks. The revision of deposit and lending rates aims at promoting the effective use of bank credit and introducing an element of price competition among banks. The restructuring of interest rates will also promote the development of the money market.

Functioning of Commercial Banks :

The Committee analysed in depth the working of the commercial banks in India and noted their low profitability and the causes responsible for it. The Committee has stressed the need to improve productivity in all aspects of banking operations. Among the many important findings and recommendations of the committee, regarding the working of commercial banks in India are :

a) **Discipline in the use of credit :-** The Committee has called for stricter discipline in the use of credit needs; for example, as a more careful appraisal of loan requests and ensuring that creation of additional capacity is not induced by availability of funds at confessional interest rates. As regards the growing incidence of industrial sickness over the years, the committee has called for preventive measures rather than remedial measures.

b) **Cash – Credit System :-** The Committee is of the view that the wide spread use of cash credit mode of lending by banks has rendered the supervision of the end use of bank credit more difficult. Besides the extensive use of the cash – credit systems has not allowed the rapid development of the bill marked in India. Accordingly, the Committee has recommended a steady reduction in the use of cash – credit and greater resort to financing of working capital through loans and bills.

c) **Encouragement to Bill Financing :-** In order to encourage bill financing, the committee has suggested that financing through bills should attract an interest cost which is two percent per annum lower than the basic lending rate of interest. Besides, the many procedural obstacles coming in the way of developing the bill market should be removed.

Development of Money Market :

A well organised money market provides an efficient mechanism for the transmission of the impact of monetary regulation measures to the rest of the economy. The Committee has, accordingly, asked the RBI to take measures to develop an efficient money market. The Committee envisages a restructured monetary system in which the treasury bills market and the inter corporate funds market would be expected to play an important role in the allocation of short-term resources with minimum transation cost and minimum of delays.

Non – Banking Financial Institutions :

The traditional non-banking financial intermediaries like investment trusts, chit funds, etc; have been meeting some of the credit needs of the informal sector and their operations are governed by long-standing conventions and practices. The Committee has suggested a system of licensing to protect the interest of depositors of these institutions.

Role of Reserve Bank in India :

The RBI is major responsibility should be in the area of monetary regulation. The RBI should not depend excessively on any single instrument of monetary policy. Besides, it should use the regulatory measures early and gradually so that the effects of such regulation may not be too drastic and caused unintended hardships to the specific sectors of the economy.

The RBI role in money creation has been prominent since 1951 because of the government's resort to deficit financing. The Committee wants the creation of reserve money to be kept within bounds.

Finally, as lender of the resort, the RBI has been the source of funds to other financial institutions, particularly to the developmental institutions should obtain their working funds ordinarily from sources other then the RBI.

5.12 Summary :-

The effectiveness of the economic policy depends on the formulation and implementation of the policy instruments. And also on the degree of coordination in the use of policy instruments. Likewise the effectiveness of any given policy depends upon the choice of objectives and the relative weight assigned to each one. Fiscal and monetary policies constitute indirect and direct controls and they effect the overall working of the economy. Monetary and fiscal policies may be combined to achieve simultaneously internal and external equilibrium. There is no absolute choice between monetary and fiscal policy, particularly when both work for more or less the same set of objectives.

5.13 Self-Assessment :

1. Define monetary policy? What are its objectives?
2. Critically examine the operation of control measures adopted by RBI.
3. What is fiscal policy? What are its objectives?
4. What is a budget? Why is it so important?

5.14 Further Readings :

1. Adhikary. M., Economic Environment of Business, Sultan Chand & sons, New Delhi, 1991.
2. Francis Cherunilan Business Environment Text and cases, Himalaya Publishing House, Delhi, 2003.

Lesson 6 MONEY MARKET IN INDIA

Objective :

After studying this lesson, you should be able to

- know about money market
- know about organized vs unorganized money markets
- understand the constituents of money market
- understand the significance of money market
- understand different instruments of money market and recommendations of working group on money market

Structure:

6.1 Introduction :

The financial system in India is broadly classified into organized and unorganized sectors. Money market is a major segment of the organized sector regulated by the RBI. It plays a significant role in the organized market. It is a market for short-term monetary instruments and financial assets, such as short-term government securities, treasury bills, bills of exchange etc. The leading players in the money market are the commercial banks, RBI and other financial institutions (Exhibit - I)

6.2 Organized vs unorganized money market :

The distinctive feature of Indian Money Market is the existence of both organized and unorganized sectors side by side. The organized money market consists of the RBI, the State Bank of India with its seven subsidiaries, twenty seven nationalized commercial banks, foreign banks, and regional rural banks. It is called organized because it is systematically coordinated by the RBI. Nonbank financial institutions such as LIC, GIC and subsidiaries operate indirectly through banks. Cooperative credit Institutions are in between organized and unorganized parts of the Indian money market. These institutions have a three tier structure. At the top, state cooperative banks, the local, primary credit societies and urban cooperative banks.

The RBI has wide powers of control over these institutions in the money market. The unorganized market is remained out side the preview of RBI's control. The unorganized money market consists of money lenders, indigenous banks, Nidhis and chit funds. The rates of interest in the unorganized sector are normally higher than those in the organized sector.

The Central Banking Enquiry Committee has classified money lenders into professional and nonprofessional money lenders. Money lenders do not accept deposits. They lend their own funds on the basis of trust and confidence. The Indigenous banks are the earliest bankers in India and are still occupying an important role in the Indian money market. The indigenous bankers are the earliest bankers in India and are still occupying an important role in the Indian money market. The indigenous bankers are more popular is urban and semi-urban areas. The chit fund is one of the financing agencies in India. In recent years, the banking commission has recommended for passing of an uniform chit fund regulation for the whole country.

6.3 Constituents of Money Market:

The main constituents of money market are the lenders who supply and the borrowers who demand short-term credit.

1. **Supply of Funds :** There are two main sources of supply of short-term funds in the Indian money market (i) unorganized and (ii) organized sector.

   i. **unorganised sector :** The unorganised sector in the Indian financial system consists of money lenders, indigenous bankers, nidhis and chit funds. The indigenous bankers accept deposits from the public and advance loans to their customers against all types of securities such as land crops and gold etc. The RBI has no control over these indigenous bankers and money lenders.

ii. **organised sector :** The organised sector in the Indian financial system consists of (a) the Reserve Bank of India; (b) the SBI and its associate banks; (c) the scheduled commercial banks; (d) co-operative banks; (e) other financial institutions such as IDBI, SFC, NABARD, EXIM BANK, Which operate in the money market indirectly through banks and (f) quasi-government bodies and large companies also operate through banks.

The most important source cf supply of funds in the money-market is from the financial institutions such as LIC, GIC and its subsidiaries. These institutions are normally required to employ their funds in the long-term investments. These institutions have regular flow of funds under various schemes. Another important source of funds is the cooperative banks.

2. **Demand for Funds :** The main borrowers of short-term funds are in the Indian money market are :

i) Central government **ii)** State government **iii)** Local bodies, municipalities, panchayats etc, **iv)** Traders, business people, farmers, exporters and importers and **v)** general public.

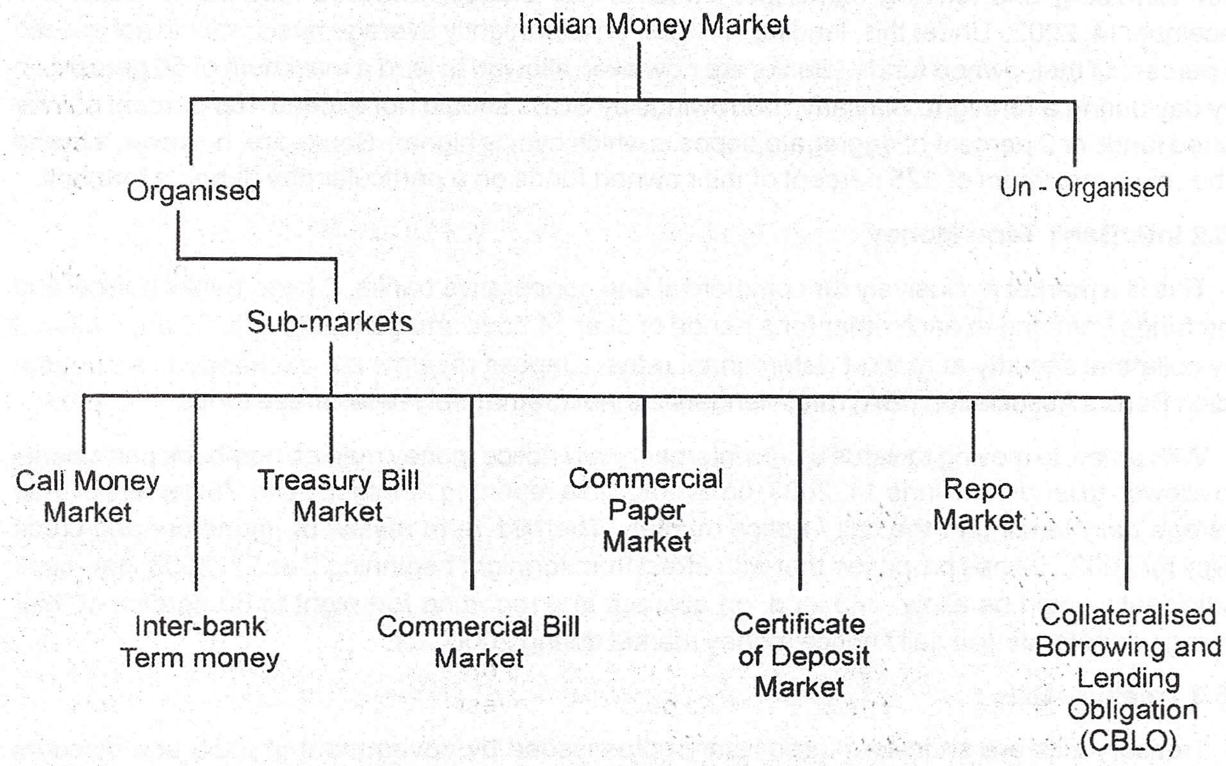
6.4 Significance of Money Market :

1. A well organised money market facilitates the working of the capital market. Indirectly, money market influences the development of the capital market.
2. A developed money market helps the commercial banks to employ their cash reserves more economically. The commercial banks can invest their excess short-term funds in a profitable manner without impairing the liquidity of these funds.
3. Money market facilitates the development of the economy as a whole through discounting operations by its various sub-market finances the short-term working capital requirements of the public sector and private organisations, banking and financial institutions.
4. A well organised money market structure enables the Reserve Bank to deal with most sensitive of sub-markets through its operations, there by exercising control over the banking system.
5. It provides an investment outlet to the commercial banks.
6. A well developed money market makes the monetary policy effective.

6.5 Instruments of Money Market:

The Indian money market comprites two sectors : 1) organised sector and 2) unorganised sector. The organised sector can be further classified into the following sub-markets.

Exhibit - 6.2
Constituents of Indian Money Market



Instruments of Money market are 1) Call money market 2) Inter-bank term money 3) Treasury bills 4) Commercial bills 5) Commercial Paper 6) Certificate of deposit 7) Repo and Reverse Repo 8) Collateralised Borrowing and Lending Obligation CBLO.

6.5.1 Call and Notice Money :

In the call money market, funds are borrowed and lent for one day (call) and for a period up to 14 days (Notice) without any collateral security. Call money represents the amount borrowed by commercial banks from each other for short periods to meet their cash reserve requirements. The bank whose cash reserves decline below the statutory requirement borrow from the banks who have surplus cash reserves. The borrowing bank will repay principal with interest.

Scheduled commercial banks, cooperative banks, LIC, DFHI are the participants in the market. Commercial and cooperative banks and DFHI are permitted to act as both borrowers and lenders, LIC and GIC are permitted to act as only lenders with effect from May, 2 1990 GIC, IDBI and NABARD are permitted to participate as lenders. In Jan 1991, the RBI allowed Indian Bank Mutual Fund and PNB Mutual Fund to enter into their market as lenders. From May 1, 1989 the interest rates in this market are deregulated and market determined. Interest rates in this market are highly sensitive to the demand supply factors.

The monetary and credit policy for 2002-03 stipulated prudential limits in a symmetric way on both borrowing and lending of banks in the call / notice money market. This was done to preserve the integrity of the financial system and to facilitate the development of the term money market as well as the repo market. Accordingly, after consultation with banks, prudential limits in respect of both borrowing and lending came into effect in two stages; effective October 5, 2002 and December14, 2002. Under this, lending of SCBs, on a fortnightly average basis, should not exceed 25 percent of their owned funds. Banks are how ever, allowed to lend a maximum of 50 percent on any day during a fortnight. Similarly, borrowings by SCBs should not exceed 100 percent of their owned funds or 2 percent of aggregate deposits which ever is higher. Banks are, however, allowed to borrow a maximum of 125 percent of their owned funds on a particular day during a fortnight.

6.5.2 InterBank Term Money :

This is a market exclusively for commercial and cooperative banks. These banks borrow and lend funds from and to each other for a period of over 14 days and generally upto 90 days without any collateral security at market determinant rates. Deposit receipts are exchanged. As per the Indian Bank's Association (IBA) rules, lenders cannot prematurely recall these funds

With a view to moving towards a pure interbank call / notice money market, non-bank participants are allowed to lend from June 14, 2003; on average in a reporting fortnight, up to 75 percent of their average daily lending in the call / notice market. The Mid-Term review of ,monetary and credit policy for 2003 - 04 has proposed that with effect from fortnight beginning Dec 27, 2003, non-bank participants would be allowed to lend, on average in a reporting fort night to 60 percent of their average daily lending in call / notice money market during 2000 - 01.

6.5.3 Treasury Bills :

Treasury bills are short-term promissory notes issued by government of India at a discount generally for a period between 91 days and 364 days. The sale of treasury bill is by auction and not by application and allotment. The maturity of these bills for each auction, the amount accepted at each auction and the cut-off prices are determined by the RBI as a part of debt management policy and the conditions in the money market.

Treasury bills can be purchased by any person residing in India i.e., banks, institutions, corporations, individuals etc except State Governments and provident funds for a minimum subscription of Rs 1 lakhs. Every fortnight, the RBI invites bid for sale of Treasury bills of varying maturities upto 364 days. The bids are scrutinised by a committee headed by a Deputy Governor of the RBI. The committee decides on a cut-off price and all bids quoting a price equal to or higher than the cut-off price are accepted for allotment. The successful bidders are required to deposit the amount with in 24 hours with the RBI from the time of announcement of results and collect the letters of acceptance.

6.5.4 Commercial Bills :

Bills of exchange are drawn by the seller (drawer) on the buyer (drawee and acceptor) for the value of goods sold. When the bill is accepted by the buyer of goods (drawee), it becomes a legal document. These bills are drawn generally for 90 days. During tenure of the bill, if the holder is in need of cash, he can discount it with a commercial bank. When trade bills are accepted by commercial banks, they are called commercial bills. One of the method of providing credit to customers by bank is by discounting commercial bills at a negotiated discount rate. The bank will receive the face value on the due date, from the drawee. Mean while, if the bank is in need of funds, it can rediscount it is the commercial bill rediscount market at the market related discount rate.

Scheduled commercial banks, All India financial institutions, mutual funds and selected scheduled cooperative banks, urban cooperative banks and DFHI are approved participants in the market.

In December 1999, the reserve bank had constituted a working group on discounting of bills by banks under the chairmanship of shri K.R. Rama Murthy. The working group had examined the suggestions of various banks, financial institutions and NBFC's in respect of granting freedom to banks in discounting of bills. After considering the recommendations of the working group, revised guidelines were issued to banks on Jan 24, 2003 in supersession of the earlier instructions and banks were advised to adhere to the new guidelines while purchasing / discounting / negotiating / rediscounting of genuine commercial / trade bills.

The important features of the revised guide lines are:

- Banks are presently required to open letters of credit (LCs) and purchase / discount / negotiate bills under LCs only is respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by them.
- The practice of drawing bills of exchange claused "without recourse" and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act.
- Bills rediscounting should be restricted to usance bills held by other banks. Banks should not rediscount bills earlier discounted by non-banking financial companies (NB FCs) except irrespect of bills arising from sale of light commercial vehicles and two / three wheelers.
- While discounting bills of services sector, banks should ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting and
- Banks should not enter into repo transactions using bills discounted / rediscounted as collateral.

6.5.5 Commercial Paper Market :

On the recommendations of Vaghul Committee Commercial Paper is introduced is the Indian Money Market in Jan, 1990. Commercial papers are unsecured promissory notes issued by well rated corporate entities to raise short-term working capital requirements directly from the market instead of borrowing from banks. It is issued on a discount to face value basis but it can be also issued in interest bearing form. Commercial paper can be issued by a company directly to the investors or through banks. When the companies directly deal with the investors, the commercial paper is called a direct paper and when they issued by security dealers / dealers on behalf of their corporate customers, they are called dealer papers.

The RBI issued guidelines for the issue of CPs through the non-banking companies directions, in Jan 1990. These guidelines provide the broad framework of the CPs market in India. They are:

1. A company could issue CP only if it had a tangible networth of not lessthan Rs 10 crores per the latest audited balance sheet.
2. A fund based working capital limit of Rs 25 crore or more
3. At least P_1 + credit rating from CRISIL or A_1 + credit rating from ICRA which is not more than two months old.
4. A minimum current ratio of 1: 33 : 1

The requirement of minimum tangible networth was reduced to 5 crore in 1990 and Rs 4 crore in 1993. Similarly, the working capital limit was reduced to Rs 15 crore in April 1990, to Rs 10 crore in April 1991 and to 4 crore in October 1995. The maturity period of CP was originally 3 to 6 months from the date of issue, from April 15, 1997 onwards, the minimum maturity period was reduced to 30 days. It was further reduced to 15 days in Oct 1998.

A CP is issued to any person or corporate body registered or incorporated in India. The participants in the market are the corporate bodies, banks, mutual funds, UTI, LIC and GIC.

6.5.6 Certificate of Deposit :

Based on the recommendations of the Vaghul committee, the RBI introduced the certificate of deposits scheme in June 1989. The object is to widen the range of money market instruments and to give the investors further opportunity to deploy their short-term funds. Certificates of Deposit (CDs) are negotiable term deposit accepted by commercial banks from depositors at market-related rates. They are bearer certificates and are negotiable in the market.

CDs can be issued by scheduled commercial banks (excluding regional rural banks) at discount to face value for a period from 3 months upto one year. On maturity, face value of the CDs are paid to the last holder by the issuing bank. CDs can be issued for a minimum amount of Rs - 25 lakhs to a single investor in the minimum denomination of Rs 5 Lakhs. The minimum size was further reduced to Rs 5 lakhs and is multiples of Rs 1 lakh with effect from Oct 22, 1997.

In order to increase the investor base the minimum size of issues of CDs by banks and RIs was reduced to Rs 1 lakh in June 2002. To provide more flexibility in pricing of CDs and giving additional choice to both investors and issuers CDs were permitted to be issued as coupon-bearing instruments. Banks were allowed to issue CDs on a floating rate basis provided the methodology of computing the floating rate was objective, transparent and market-based.

6.5.7 Repos and Reverse Repo Market:

Repo / ready forward / repurchase transaction is an agreement between a seller and a buyer and the buyer stipulating the sale and later repurchase of securities at a particular price and a date. In a ready forward (repo) transaction, a bank can sell securities and enter into a contact with the later to repurchase them at a predetermined date and price in future. Both purchase and repurchase prices are determined prior to entering into the deal. Any security can be sold as collateral under a repo transaction, only Government of India dated securities. Treasury bills and state government bonds are the eligible underlying instruments for undertaking repo transactions in India.

To develop the money market in the light of the recommendations of Narasimham committee II, RBI initiated measures to develop repos market with appropriate regulatory safeguards such as delivery versus payment, uniform accounting, valuation and dirclosures norms and restricting repos to instruments held in demat form with a depository. All banks / cooperative banks / PDs / SDs are permitted to undertake repos in all Central Government securities. Non-bank entities are also permitted to lend money through reverse repos to other eligible participants. They are also permitted to borrow money through repos on par with banks / PDs.

The eligibility to participate in the repo market was expanded with effect from March 3, 2003 to include non-SGL account holders like non-banking financial companies, mutual funds, housing finance companies and insurance companies. These entities were permitted to access the repo market through their "gilt accounts" maintained with the custodian.

The one day and 14 days repo rates were reduced from 6.0 percent to 5.75 percent in June, 2002 and further to 5.5 percent and 5.0 in Oct, 2002 and in March 2003 respectively. In view of the macro economic and over all monetary conditions, one-day repo rate was reduced further on Aug 25, 2003 to 4.5 percent.

6.5.8 Collateralised Borrowing and Lending Obligations :

Collateralised Borrowing and lending obligation (CBLO) was operationalised as a money market instrument through the clearing corporation of India Ltd (CCIL) on Jan 20, 2003. The CBLO has original maturing between one day and upto one year. The regulatory provisions and accounting treatment for CBLO are the same as those applicable to other money market instruments; in order to develop CBLO as a money market instrument, it has been exempted from CRR subject to banks maintaining minimum CRR of three percent. As on July 31, 2003, 52 members were admitted in CCIL's CBLO segment. The total turn over in CBLO during Jan 20, 2003 - July 31, 2003 stood at Rs 7,925 crore amounting to a daily average turnover of Rs. 74 Crore. The active participants include select cooperative banks and an insurance company. In the recent period, select public, sector banks and a mutual fund have also become active in their segment.

6.6 Recommendations of Working Group on Money Market :

In September 1986, the Reserve Bank of India appointed a working group on the money market under the chairmanship of Mr. N. Vaghul to review the money market and make recommendations for the development of the money market. The working group submitted its report in January, 1987.

Some of the important recommendations were:

1. Measures should be taken to improve the operation of the call market.
2. Activation of existing instruments like commercial bill and introduction of commercial paper and certificates of deposit.
3. Limited freeing of interest rates in the money marked.

4. Setting up of a Discount & Finance House of India to deal short-term money market instruments.
5. Banks and private non-bank financial institutions should be encouraged to provide factoring services.
6. Introduction of the 182 day T bill to the development of the short - term money market.

6.7 Summary :

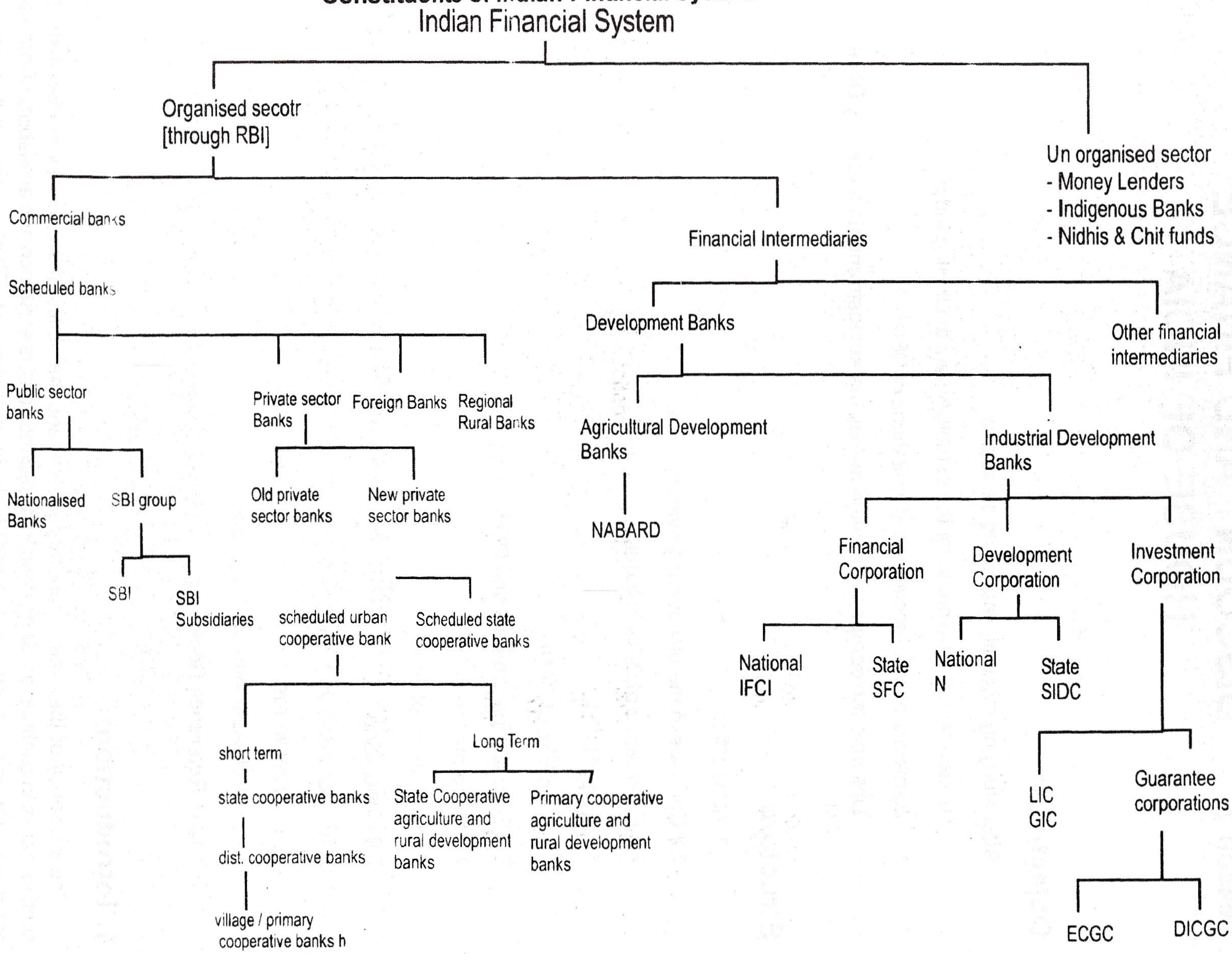
Money market is a major segment of the organised sector regulated by the Reserve Bank of India. It is a market for short - term monetary instruments and financial assets. The main constituents of money market are the lenders who supply and the borrowers who demand short-term demand. The organised sector of Indian money market classified into 1) call and notice money market 2) Inter-bank term money market 3) Treasury bills market 4) Commercial bills market and 5) Collateral loan market 6) Certificate of deposit and commercial paper market.

The major instruments used in money market are call money Treasury bills Certificate of Deposit, Commercial paper and Commercial bills.

6.8 Self - Assessment Questions :

1. What is the money market? Explain the characteristics of the money market?
2. Write short notes on in certificate of deposits and commercial paper?
3. What is Repo Market? Explain ?
4. What are the instruments of the money market? Briefly explain ?

Exhibit - 6.1
Constituents of Indian Financial System



Lesson 7

DISCOUNT AND FINANCE HOUSE OF INDIA

Objectives:

After studying this unit, you would be able to :

* Understand the rationale for the establishment of DFHI in India.
* Explain the role, functions and limitations of DFHI.
* Describe the components in the money market instruments traded by DFHI.

Structure:

1. Introduction:

The efficiency of the entire monetary system and the ability of the money market institutions such as banks to continue as going concerns, depends on the existence and availability of institutions, arrangements and services for the best liquidity management. That is, the participants in the money market must be in a position to command liquidity in times of need or crisis, and they must be in a position to even out the excesses or deficits in liquidity in different segments of the money market, if the latter are to function smoothly. Through efficient liquidity management, the monetary system works smoothly without experiencing revolutions of the money market rates or without being forced to suffer from monetary losses or liquidation.

Traditionally in all countries, the central banks help banks in their liquidity management by providing them discounting and refinancing facilities. One of the important or primary functions of the central bank in any country has been to supply promptly and in abundance liquidity to banks on occasions when liquidity shortages threaten economic stability. The central bank performs this function through its discount window or discounting mechanism. Banks borrow funds temporarily at the discount window of the central bank. They are permitted to borrow or are given the privilege of doing so from the central bank against certain types of eligible paper(collateral) such as the commercial bill or treasury bill which the cultural bank stands ready to discount for the purpose of financial accommodation to banks.

7.2 Changes in the discounting system :

Over the years, certain important changes have taken place in the basic discounting mechanisim. The term discounting has tended to acquire much more broader meaning, scope and purpose than originally intended. The Central Bank has come to lend to banks on the basis of any collateral security. The borrowings of most banks from the central bank are now accomplished straight away i.e., in the form of advances without involving any customer 'IOUs' (I owe you) or without discounting notes of business firm already held by banks. This borrowing takes place on the basis of banks' own promissory notes or some government securities as the collateral security. However, in popular terminology, the term discounting has come to describe all borrowings by banks from the central bank, regard less of the technical details of how it is accomplished.

Similarly it is not only in emergencies or for meeting liquidity or financial crisis that the central bank supplies financial accommodation to banks, and this has become a routine means of supplying funds to banks for temporary needs or short term adjustments in the day to day course of events also. The central bank however, is only the ultimate and in a sense an exogenous source of funds to the money markets. In different countries, various institutional arrangements, facilities and practices have evolved, which, in addition to the central bank help to provide and smoothen liquidity flows in the money markets. In many countries, banks of various sizes, specialised dealers in bonds, bills and papers and financial institutions discount, rediscount and refinance money market instruments and smoothen the liquidity flows in the primary and secondary markets.

7.3 Emergence of DFHI in India :

In India, institutions such as IDBI, NABARD, SIDBI, EXIM bank and NHB play an important role in the discount market. In a country like UK, a unique, specialised institutional set up, namely, the discount houses exist to perform this task. A similar setup is sought to be imitated in India also. The attempts resulted in the setting up of DFHI [Discount and Finance House of India Limited]. The question of setting up of discount houses in India was considered by the Banking Commission in the early 1970's. It was thought that the need for a discount house in India can arise when the bill market develops sufficiently. Till then, the merchant banking institutions could be set up to take up acceptance and discount business among other activities. The working group to Review the system of cash credit (Chore group) in 1979 also considered the question of setting up of a discount house in India and opined that the manner in which the discount houses in the UK operate could be profitably adopted to Indian conditions. The chore committee recommended that the proposed discount house should have specific functions, constitution and resources, etc., The Sukhamoy Chakravarthy Committee on monetary reforms suggested in its report submitted in 1985, that the development of money market should be studied in depth. The Reserve Bank subsequently set up a working group on the money market with Sri N. Vaghul as its chairman. It is this working group that suggested in 1987, the setting up of discount and finance House of India (DFHI)

The Vaghul committee has said that "such an institutions could facilitate the smoothening of short term liquidity in balances and also lead to the integration of the short term money market, such an institution could activate the short term money market and also impart greater flexibility to this market. By functioning as a major money market intermediary, it could also promote a secondary market in short term money market instruments. The decision of the Reserve Bank of India in March 1987 to set up DFHI was based on the recommendations of the working group on money market to activate secondary money market for money market instruments with a view to widening, deepening and stabilising the money markets. Its main goal was to "smoothen short term liquidity imbalances by activating secondary money market".

DFHI commenced its business operations on April 25, 1988. It was founded with the help of the Reserve Bank of India, Public sector banks and other financial institutions. RBI holds 51% of its shares while public sector banks and All India financial institutions hold 33% and 16% of the shares respectively. Its authorised share capital is Rs. 250 crore and paid up capital is Rs. 150 crore as on March 1991. Recently , the share capital of DFHI was further raised by Rs. 100 crore, besides its own share capital and reserves aggregating Rs. 162 crore. Apart from its own share capital DFHI was setup with having a line of credit from the public sector banks and the refinance lines from RBI to augment, its working funds. The amount and the rate of interest on refinance from the latter will be flexible so that the latter can send appropriate signals to the money market.

In the initial stages, DFHI's operations were to deal with RBI in the 182 day treasury bills and also rediscount short term commercial bills. In respect of treasury bills, it will offer two-way prices with fine margins so that the banks will find it attractive to deal with the house.

7.4 Role of DFHI :

The role of the DFHI is both developmental and stabilising. If facilitates the smoothening of short term liquidity imbalances by developing active primary and secondary money markets. In other words, it works as a specialised money market intermediary for stimulating activity in the money market instruments and developing secondary markets in those instruments. It discounts or deals in not only commercial bills but also treasury bills and other money market instruments. It undertakes short term, buy back operations in the Government and approved dated securities also. Ever since 1988, its focus was on the short end of the market i.e., on call money, treasury bills and commercial bills. It commenced dealing in Government, dated securities in April 1992. It was accredited as a Primary Dealer in Feb 1996. Thereafter, its participation in the primary and secondary markets for Government securities including dated securities has increased. It may be noted that the DFHI has undergone a role transformation over the years.

The DFHI has actually been endeavouring to bring into fold of the active monetary system all types of banks, financial institutions and non-bank, public and private sectors so that their short term surpluses and deficits are equilibrated at market related rates or prices. It has consolidated its business by achieving a significantly higher turnover in its operations in each sector of its activity.

It has been playing vital role in developing an active secondary market in money market instruments. It has effectively made the treasury bill a highly liquid instruments. The presence of DFHI in the secondary markets has facilitated corporate entities to invest their short term surpluses and liquify them whenever necessary.

The entry of the DFHI has to be viewed in the context of the need to broad – base the money market, the size of which has remained quite small. Transactions in treasuring bills also continue to be limited in the absence of an active market. The volume of business in the commercial bills market is very small due to the restrictive rediscounting facilities offered by RBI, insufficient volume of freely negotiable and marketable bills and lack of encouragement for acceptance of bills by banks

7.5 Functions :

The main functions of DFHI are as follows :

1. To discount, rediscount, buy, sell underwrite or acquire and sell marketable securities and negotiable instruments including treasury bills, trade bills, bills of exchange, promissory notes, commercial bills and commercial papers.
2. To undertake buy back arrangements in trade and treasury bills as well as securities of local authorities, public sector institutions, government and commercial and non-commercial houses.
3. To carry on business as a lender, borrower, broker or as a broking house in the inter-bank call money market.
4. To promote and support company funds, trusts and such other organisations for the development of short term money market.
5. To advise governments, banks, financial institutions or business houses in evolving schemes for growth, development and expansion of the money market.

7.6 Financial Instruments and DFHI :

The background for the financial services restructure was provided by the recommendations made by the committee to review the working of the monetary system known as Sukhmoy Chakravarthy committee. Based on these lines, the Vaghul committee spelt out the specific reforms necessary for developing the money market. An important input of the financial liberalisation witnessed many new financial instruments and services like 182 days treasury bills (TB), Inter – Bank Participation Certificates, Certificates of Deposits, Mutual Funds, Commercial Paper, Commercial Bills and a number of other latest instruments. The working of these instruments can be explained as under.

1) **182 days Treasury Bills (TBs) :** Treasury bills have a very long history in India. Prior to the introduction of 182 days Treasury bills, there was 91 days treasury bills and they were traded in primary market and were held by banks, State Governments, and the Reserve Bank only. The introduction of 182 days treasury bills has made these bills liquid assets and since the setting up of DFHI which acts as a market maker for those bills, an active secondary market for these bills has developed. They are no longer a source for financing government expenditure but have become a vibrant money market instrument. Besides banks, financial institutions, corporate bodies and individuals can also deal in them still, the market is dominated by banks, since these are eligible for maintenance of reserve requirements. Their yield on these bills has increased over time to around 9.6% per annum. DFHI on its part provided liquidity to 67% of TB's thus playing its market making role effectively. In the future, more participants are likely to be attracted to these bills due to its liquid character and wide array of maturity dates.

2) **Inter – Bank participation certificates :** Participation certificates (PCS) have been reintroduced by the RBI in Oct. 1988, as an additional instrument for phasing out short term liquidity in the banking system. Originally these were introduced in 1970, when besides banks, other financial institutions also could deal in them. These were discontinued in 1979. This time only banks can deal in PC's which are of two types viz., risk sharing and without risk sharing. The risk sharing PC's are for 91 days to 180 days with a minimum interest of 14% and are to be issued only in respect of advances classified under Health code status 1. The aggregate amount of PC's under any account at the time of issue is not to exceed 40% of the outstanding in the account PC's without risk sharing have a tenure not exceeding 90 days and an interest rate ceiling of 12.5% (This ceiling has been removed later). Risk sharing PC's have also not taken off inspite of their higher interest rates. Probably banks have yet to familiarise themselves with this instrument as regards proper appraisal by the selling bank.

3) **Certificates of Deposits :** Certificates of Deposits which were introduced in the market from July 1989, have become a significant instrument in their short tenure. As such, it is simply a receipt given to the depositor by a bank for funds deposited with it. Their minimum size is of Rs. 1 crore to be issued in multiplies of Rs. 25 lakhs, with a maturity of 91 days to one year. They are issued at discount at market determined rates and attract reserve requirement stipulations for the issuing bank. CD's are freely transferable by endorsement and delivery but only after 45 days from the date of issue. Banks cannot loan against CD's nor can they buy back their own CD's before maturity. Most banks have issued CD's and they have proved to be popular among banks and subscribers. Further CD's of 3 months maturity are only being issued since periods more than this would attract stamp duty. The full potentiality of the instrument can only be realised when they offer marketability and offer more maturity options.

4) **Commercial Paper :** Commercial paper is a short term instrument consisting of unsecured promissory notes with a fixed maturity ranges between 7 days and three months issued on a bearer form and on a discount basis. It is a short term debt instrument meant for highly rated corporate borrowers to diversify their sources of finance. Companies with a minimum net worth of Rs. 10 crore and maximum permissible bank finance of atleast Rs. 25 crore and having their shares listed on the stock exchange can enter the commercial paper market with a credit rating from an approved agency. The companies can issue commercial paper in multiplies of Rs. 25 lakh, subject to a minimum and maximum size of an issue being Rs. 1 crore and 20% of their maximum permissible bank finance. The maturity period of the commercial paper would be three to six months and this would be freely transferable. The issue of commercial paper requires prior approval of RBI. Banks will however get an opportunity to expand its merchant banking activities further. The scope for issue of commercial paper in the primary market has been widened and flexibility to the companies in issuing commercial paper is increased.

5) **Mutual Funds :** Mutual Funds are not new to the Indian market as unit Trust of India, India's largest mutual fund is already there in the market for more than 30 years. It had a monopoly in the market. It is only since 1987 that other mutual funds have been law fully allowed to enter the market. In the near future this is one instrument which is likely to mobilise savings of the people in a big way. Its main attraction is that it gives investors a mixture of liquidity, return and safety in accordance, with their preference, without having to invest in a large number of scripts. At present besides UTI, SBI, Canara Bank, Punjab National Bank, Indian Bank, GIC and LIC have also launched their mutual funds. During the last few years, a large number for private mutual funds are in operation. The interest of various investors are also better protected through mutual funds However, the services provided by mutual funds have been deteriorated and investor grievances have increased SEBI has been looking into the complaints of investors of mutual funds.

6) **Commercial Bills :** Another instrument which is being popularised in the commercial bills which are traditionally considered to be self-liquidating. The Reserve Bank has taken various measures to encourage the bill market for which certain norms have been stipulated of the use of bills for credit purchases and sales. The bill discounting rate has been lowered. In order to facilitate multiple rediscounting of bills, derivative us once promissory notes were introduced in Oct. 1988 thus imparting greater liquidity to the bills. The DFHI on its part in the case of rediscounting of bills, too proved to be an efficient market marker. Although in the slack season, rediscounting of bills was very limited, in the busy season, this facility was reverted to by banks. To further enlarge the scope of bills rediscounting market, new institutions were granted entry into the market. These include IFCI, NABARD, NHB, EX-IM Bank, Tourism Finance Corporation of India etc....

7) **New Instruments :** Besides the above instruments, many other new instruments are also introduced in the money market. These include non-voting shares, detachable equity warrants, participating preference shares, debt-equity swaps, convertible debentures with option, mortgage backed securities, participating debentures, third party convertible debentures etc.,

7.7 Performance of DFHI :

The turnover of the DFHI in the secondary market instruments has been good in call money and treasury bill segments and low in commercial paper market. The performance of the DFHI can be presented as under :

(Rs. in crores)

Activity	1990 – 91	1991 – 92	1994 – 95	2002 – 03
Treasury Bills	32329	23413	30,933	28,112
Commercial Bills	12675	6995	332	2163
Commercial Paper	107	42	-	95
Certificates of deposits	8	22	7	18
GOI dated securities	-	-	12488	14063
Term money	3552	5959	21	18
Call & Notice Money	202792	294373	522154	424494

Source : 1) Vasant Desai, Indian Financial System, Himalaya Pub. House, Bombay, P. 349.

2) RBI reports.

It is seen from the above table, that the operations of the DFHI are not dictated by commercial considerations, but by the requirements of money market conditions and the policy of RBI. It was only in 1992, the DFHI started operations in the government securities market, in addition to its operations in the money market. While the discount or rediscount rates are given in the case of money market instruments, actual purchase and sale prices as offered by the DFHI in the Government securities market are published by the press as released by DFHI.

It should also be noted that the house is operating in crores of rupees in a variety of instruments both in the money market and in the Government Securities market.

Not withstanding the ample liquidity in the system and the growing competition, the aggregate lending by DFHI, in call notice term money market was 4,24,494 crore in 2002. The average daily call money lending was at Rs. 1,137 crore in 2002. Thus despite the several new players in the market, DFHI continued to be a major operator in the market. Further in order to adopt itself to the changing environment and in tune with the recommendations of the management consultants in regard to restructuring its asset portfolio, the company has recorded a turnover of Rs. 118 crore under rediscounting of commercial bills and Rs. 30 crore in commercial papers.

7.8 Limitations :

The DFHI faces the following problems in its functioning :

1. The major problem of DFHI is lack of adequate funds to provide for sufficient liquidity.
2. The market rates are highly fluctuating frequently.

3. Unhealthy competitions from primary dealers
4. Weak inter bank transactions due to lack of modern communication channels with smaller banks.
5. Presence of very few large players in the market.
6. Excessive dependence on aprox bank.

In addition to the above, another problem for DFHI is that it cannot develop money market instruments in a secondary market. Because the treasury bills are not a profitable investment and banks invest in them for the purpose of SLR. Developing a secondary market in these instrument would entail some cost in the initial stages. This is because in case of premature with drawl of funds, the lender would get interest only for the period for which the funds have been lent and would not accept such a proposal. Therefore, unless some one is willing to bear the cost, the secondary market cannot develop.

Thus to enable the house to live up to its name and to be able to achieve the objective of its setting up, there is an urgent need to improve the resource position of DFHI so that it can improve its market share in the short term money market. An easy liquidity position of DFHI is a prerequisite to activation of secondary market in money market instruments. The proposal of RBI to allow entry in call money market of such entities as are able to observe a minimum size of Rs. 20 crore per transaction without any outstanding borrowing from the banking system will in all probability case the funds constraint of DFHI since all such transactions will be permitted only through the latter.

7.9 Conclusion :

In a short span, DFHI has grown into a strong and effective organisation, playing an important role in the call money market, government securities market and bills market. It is the prime objective of DFHI to develop healthy markets to foster a large volume of secondary market transactions. To make concerted effort to expand its operations, especially in the secondary market instruments, DFHI needs autonomy in decision making and functioning and adequate resources to play the role of a market maker during the next century.

7.10 Summary :

The efficiency, stability and minimisation of the risk of insolvency of financial institutions and banks require several institutions, arrangements and services for the best liquidity management in financial markets. Traditionally central banks in all countries have been helping the money market in this context by providing discounting and refinance facilities. The term, discounting, now often refers to lending not only against bills of exchange but also in the form of direct loans and advances. In different countries various institutional arrangements have been made which help to provide and smoothen liquidity flows in the money markets. In India institution like IDBI, NABARD, SIDBI etc. play an important role in the discount market. The DFHI was set up in April 1988, as a specialised institution to operate in the discount market. The DFHI is a joint stock company owned by RBI, public sector banks, and financial institutions. It plays a developmental as well as stabilising role in the Indian money market. It aims at smoothening liquidity imbalances by developing active primary and secondary markets in all money market instruments. It deals in treasury bills, commercial bills, certificates of deposits, commercial paper, short term deposits, call and notice money, inter-bank participations and Government securities. The holdings and turnover of the DFHI in these instruments have enormously increased since its existence.

7.11 Keywords :

1. **DFHI** – Discount and Finance House of India which was setup in April 1988.
2. **Treasury Bills** – Used to be sold by the RBI in auctions every fortnight to raise resources for the short term money market.
3. **Call money** – is that part of the day to day surplus funds mostly of banks.
4. **Commercial Bills** – financial instruments which are traded in the bill market which are popularly called bills of exchange.
5. **Non voting Shares** – Shares which do not have voting power but do not lose management control.
6. **Detachable Equity Warrants** – Issued with non-convertible debentures or other debt or equity instruments.
7. **Debt – Equity swaps** – an offer from an insurer of debt to swap it for common stock.
8. **Mortgage backed securities** – A synthetic instrument other wise known on the Asset backed security for securitisation of debt.
9. **Zero coupon convertible note** – A zero coupon convertible note converts into common stock. If investors choose to convert they forego all accrued and unpaid interest.

7.12 Self Assessment Questions :

1. Explain the evolution of DFHI along with its functions.
2. What are the different money market instruments, used by DFHI to raise resources in the short term money market ?
3. What are the problem of DFHI and suggest measures to overcome them ?

7.13 Reference Books :

1. Vasant Desai – "Indian Financial System" Himalaya Pub. House, Mumbai – 2001.
2. L.M. Bhole, "Financial Institution and Markets – structure, growth and innovations" Tata Mc Graw Hill Pub. Co. Ltd., New Delhi – 2002.
3. B.S. Bhatra and G.S. Batra (Ed) "Management of Capital markets, Financial services and Institutions", Deep & Deep publications Pvt. Ltd., New Delhi – 2001.

Lesson - 8 Capital Market - An Overview

Objectives:

After Studying this unit, you would able to

* Understand the capital market and its role in promoting of capital in India.
* Explain the constituents, features and factors which influence the growth of capital market in India.
* Describe the policy of Government towards changes in the policy framework to attract foreign institutional investors.

Structure:

8.1 Introduction

8.2 Definition of Capital Market

8.3 Role of Capital Market

8.4 Structure of the Capital Market

8.5 Growth of Capital Market

8.6 Instruments in the Capital Market

8.7 Foreign Investments and the Indian Capital market

8.8 Abid Hussain Committee and Capital Market

8.9 Factors influencing Capital Market

8.10 Features of the Indian Capital Market

8.11 Suggestions for development

8.12 Conclusion

8.13 Summary

8.14 Keywords

8.15 Self assessment questions

8.16 Reference Books

8.1 Introduction :

The process of industrial development requires as one of its structural changes, the development of a capital market. The capital market is expected to meet the requirements of credit of trade and industry. The capital market should also help in sustained industrial development. The capital market is to play a vital role in providing long term finance. The promotion of long term finance and capital markets is essential to improve investment incentives consistant with external adjustment as well as to avoid excessive reliance on short term funds to finance investments, a practice which in the past led to liquidity crisis of industries and financial institutions.

8.2 Definition of Capital Market :

Capital Market is an organised market mechanism for effective and efficient transfer of financial resources that flow from the investing class (a body of individuals or institutional savers) to the entrepreneur class (individuals, institutions engaged in industry, business or service) in the public or private sectors of the economy. The term capital market can be defined as under:

In the words of H.T. Parikh "it is a market for all the financial instruments, short term and long term as also commercial, industrial and government paper".

In the words of Goldsmith "the capital market of a modern economy has two important functions i.e. allocation of savings and investment among users, and the facilitation of transfer of existing assets tangible and intangible among individual economic units."

From the above definitions, it can be observed that the function of capital market is the collection of savings and their distribution for industrial development. Thus capital formation is the *sine qua non* of economic development. As such the relationship among the market, investment and institutions is integrated as well as inter-dependant. The capital market provides long term debt and equity finance for the government and the corporate sector. By making long term investments liquid, the capital market mediates between the conflicting maturity preferences of lenders and borrowers. The capital market also facilitates the dispersion of business ownership and the reallocation of financial resources among corporations and industries.

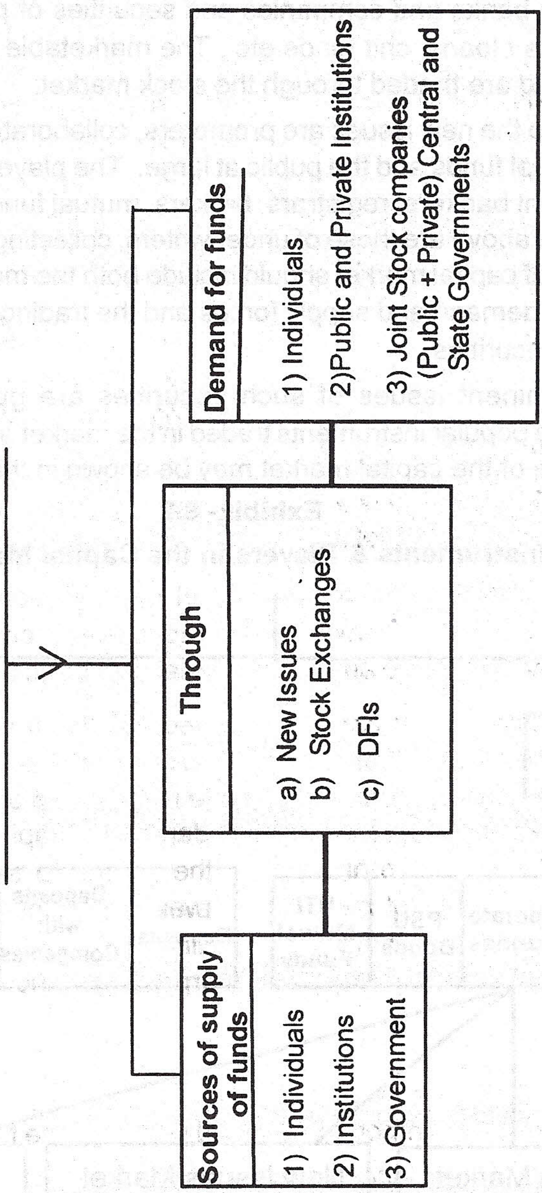
8.3 Role of Capital Market :

The Capital Market play an important role and performs the following activities:

1. Mobilisation of savings for economic development
2. Import of required foreign capital and skill to fill up the deficit in the required financial resources to maintain the expected rate of economic development.
3. Productive utilisation of resources and
4. Directing the flow of funds for higher yields and to strive for balanced and diversified industrialisation.

An economy embarking upon accelerated economic development and industrialists has to make planned efforts to develop an organised and healthy money and capital markets with an adequate institutional set up. Market for both money and capital markets and industrial enterprises has to go hand in hand to ensure quick industralisation in a developing democratic country. The role of Capital Market in a developing country can be shown as under:

Exhibit 8.1
The Statements of Capital Market



8.4 Structure of the Capital Market :

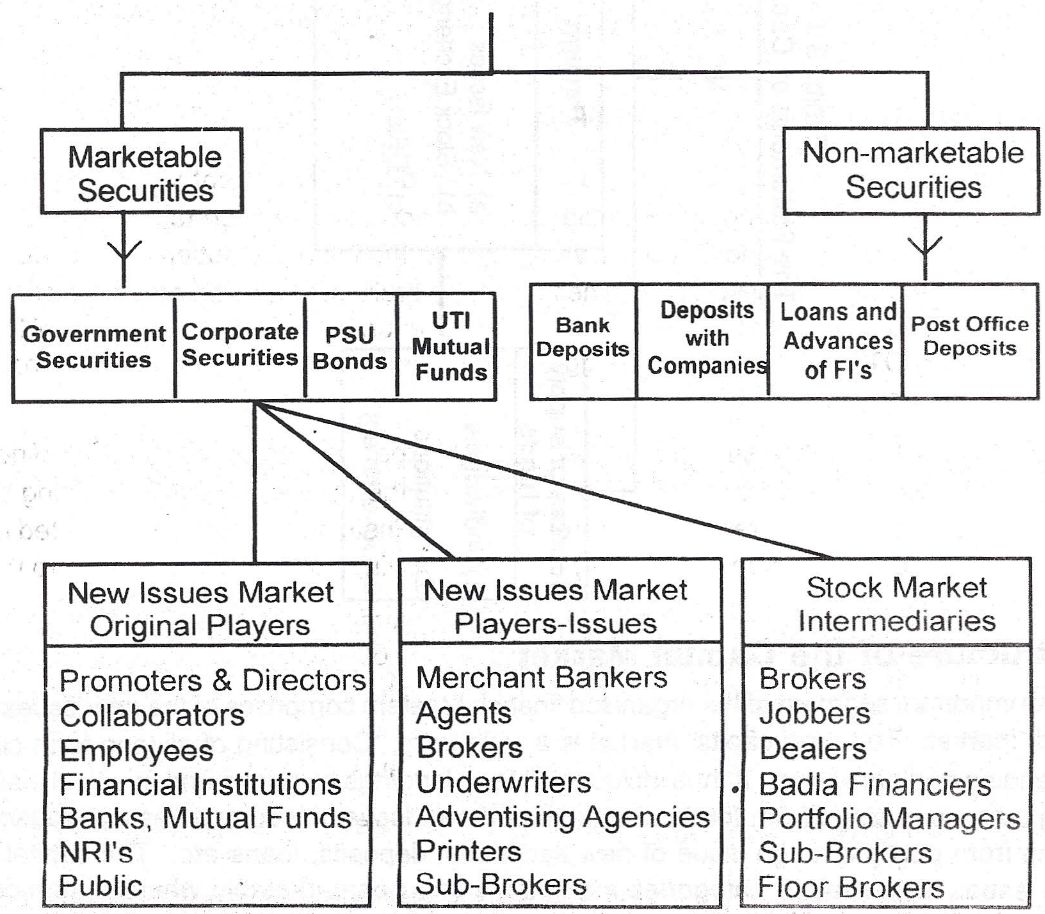
An important segment of the organised financial system comprises of the new issues market and stock market. The term capital market is a wide term; Consisting of all long term claims of money lending and borrowing. It thus includes all term lendings by banks and financial institutions and long term borrowings from foreign markets and new issues by companies and rousing of all resources from public through issue of new securities, deposits, loans etc. The capital market includes issues of two major categories marketable and nonmarketable whether marketable or not, these are issued by Government, Government departments, companies, public sector units mutual funds, UTI etc., LIC and GIC sell polices and collect savings from public which are non-marketable. The other non-marketable securities or claims are issued by post offices as savings certificates, deposit receipts, etc., non-securitised loans and advances of banks and financial institutions, deposits with banks and companies and securities of private limited companies and finance company deposits / loans, chit funds etc., The marketable securities are issued through the new issues market and are thaded through the stock market.

The contributors to the new issues are promoters, collaborators, employees, NRI's, banks, financial institutions, mutual funds and the public at large. The players through which these issues are managed are merchant bankers, registrars, brokers, mutual funds etc. The ancillary functions and complementary to the above are those of under writers, collecting bankers, printers, advertising agencies etc. The study of capital market should include both the marketable and non-marketable segments. However, the demand and supply forces and the trading activity is confined only to the segment of marketable securities.

Thus, more prominent issues of such securities are public limited companies and Government and the more popular instruments traded in the market are : equity shares, debentures, bonds, etc. The structure of the capital market may be shown in the following chart.

Exhibit - 8.2

Instruments & Players in the Capital Market



8.5 Growth of Capital Market :

The constituents of the capital market consists of development banks, specialised financial institutions, investment banks, specialised financial institutions, investment institutions, state level development banks, mutual funds, lease companies, financial service companies, commercial banks and other specialised institutions like SEBI, SHCI, CRISIL, ICRA, OTCEI and NSE. The growth of capital market is understood as these are more than 7500 listed companies and 23 stock exchanges. The Indian capital market is second in size only followed by USA in terms of availability of industrial securities. The Indian capital market offers good potential for further expansion in terms of absorption of large capital flows. It is noteworthy that despite problems faced on account of transactions in the earlier years, the Indian stock markets have shown creditable recovery. As per the reviews published by international agencies, the Indian capital market has appreciated by 44% in US dollar. The rates in other markets are : south Korea (-24 Percent), Singapore (5 Percent), Hongkong (35 Percent), and Malaysia (9 percent). The healthy growth of the capital market depends on broad basing and mature development of the banking system in the country. As such, both are complementary and supplementary. The term capital market refers to designate activities in long term credit, which is characterized by securities. The steady increase in the capital formation, which is slightly higher than the level of gross domestic savings indicates that the development banks have been playing a significant promotional role in mobilising resources and channelling savings into productive investment. The enlargement of their coverage will definitely accelerate the growth process.

8.6 Instruments in the Capital Market :

Financial service industry has gained momentum during the recent years in India. More and more institutions are entering the financial service sector. In addition to the institutions, the investment climate in India has undergone a vast change. Financial institutions and mutual funds are emerging as important market players. The financial liberalisation and the entry of professionals have revolutionalised the market. A committee was set up under the chairmanship of Pherwani, former chairman of UTI. The committee suggested as number of new instruments in the capital market. These can be explained as under:

1. **Non-Voting Shares:** These are like other equity shares but without voting rights. The share holders will have the same rights as to bonus and other issues on par with voting shares. These could be issued to resident, non-residents and institutions who are interested more in return. In case the company fails to pay dividends, voting rights may be revived to them.

2. **Detachable Equity Warrants:** These are warrants attached with the original instruments such as shares and debentures. They are issued free of cost. These give a right to acquire the shares of the issuing company at a concessional rate on a future period. Warrant holders gain advantage when the exercise price is lower than the market price. Lest, there should be no much demand for warrants. Companies take precautions to keep the margin attractive.

3. **Participating preference shares:** These are those preference shares which have a right to participate in the extra profits available after distributing equity dividends. They may also

give rights to participate in the extra profit when the equity share dividends exceeds a specified limit agreed upon earlier.

4. **Participating Debentures:** The holders of these debentures would have a right to participate in the extra profits available after meeting out the demand of equity dividends. They may have agreements with the company to hike interest rate as and when equity dividend exceed a specified limit.

5. **Global depository receipts:** These are popularly known as GDRs. After the lock of period, these securities would be converted into equities of issuing companies.

6. **Debentures:** These are normally long term loans from the market. The debentures may be issued at par or at a premium or discount rates. There are certain types of debentures which are known as negotiable debentures and are transferrable from one person to another person through endorsement and delivery.

7. **Stock Options:** Options are speculative type of instruments. These are two types. They are call option and put option. Call option is a right to buy securities at a specified rate at a specified future time. Put option are securities which are sold at a specified future time. These options would again be quoted in the market. At present in India option trading is banned.

8. **Mutual Funds:** These are different types of mutual funds. They are open ended mutual funds, closed ended mutual funds, income mutual funds, growth mutual funds, Tax savings mutual funds, offshore country funds, etc. The open ended mutual funds are those which are kept open to the investor who can subscribe at any time. The closed ended funds are those which are closed once the subscription reaches the predetermined level.

9. **Money Market Instruments:** These are a variety of money market instruments which include money market funds, commercial paper, certificates of deposits, bankers acceptance etc. The SEBI has issued guidelines in case of money market funds, which specify that these funds would be invested in short term money markets and the profits would be distributed to the unit holders commercial paper, certificates of deposits are the short term fund raising instruments.

10. **Other Instruments:** Other instruments in the capital market include counter receipts which is a document created by OTCEI. Stock invest is another scheme which is introduced by SEBI where by investors can hold the share application money in their own account and earn interest till allotment. Retail asset securities is another mortgage based security where by the securities would be broken down into smaller units and sold in the market as retails securities to the individual investors.

8.7 Foreign Investments and The Indian Capital Market:

Indian capital market had been kept away from the international markets and cross border movement of capital in all these years since 1991, the capital market is also made open to foreign markets. Access to India's markets has been made easier for foreign capital, technology and goods. It is natural that the Indian capital market should have been open to the overseas investors. In the past, overseas investments had been mainly in the shape of direct foreign investment in specific approved industrial ventures. The capital market was open to nonresident Indians and more recently to overseas corporate bodies of Indian nationals in a restricted way. In conformity with various policy measures taken during the recent period, the government announced a new policy to welcome foreign institutional investors to invest in the Indian capital market, both primary and secondary. Some of the policy changes introduced in the foreign investments can be stated as under:

(a) Foreign institutional investors including pension funds, mutual funds, investment trusts, asset management companies, nominee companies and institutional portfolio managers would be welcome to make investments under the new guidelines.

(b) Investments in all securities traded on the primary and secondary markets including the equity and other securities of companies which are listed or to be listed on the stock exchanges in India including OTC exchange of India is permitted.

(c) Foreign institutional investors would be required to obtain an mitral registration with SEBI to enter the market.

(d) Foreign institutional investors seeking initial registration with SEBI shall be required to hold a registration from the securities commission or such other regulatory organisations for the stock market in their country of clamcile or incorporation.

(e) SEBI's initial registration would be valid for five years RBI's general permission under FERA to the Foreign Institutional investors will also hold good for five years. Both will be renewable for similar five years periods later on

(f) There would be no restriction on the volume of investment - minimum or maximum for the purpose of entry of foreign institutional investors in the primary / secondary market and also on the lock in period prescribed for such investments made by foreign institutional investors.

(g) RBI may at any time request by an order, a registered foreign institutional investor to submit information regarding the records of utilisation of the inward remittances of investment capital and the statement of its securities transactions. RBI and SEBI may also at any time conduct a direct inspection of the records and accounting books of a registered foreign institutional investors.

(h) Foreign institutional investors investing under this scheme will benefit from a concessional tax regime of a flat rate of tax of 20% on dividend income and interest income and a tax rate of 10 % an long term capital gains.

(i) All secondary market operations would be only through the recognized intermediaries on the Indian stock exchange, including OTCET Foreign Institutional investors would not be expected to take delivery of purchased and give delivery of sold securities.

8.8 Abid Hussain Committee and Capital Market :

The Abid Hussain committee on development of capital market has suggested creation of two-tier stock exchanges along with a number of fiscal measures to stream line the stock market for bringing stability and restoring investors confidence. It has recommended a long term policy to develop the capital market, so that industries with a proven track record could meet their financial needs from the growing capital market. The public sector financial institutions could then be made to cater to the needs of the newly emerging companies for survival and sustenance. During the stock exchange boom of 1985-86 a number of listed companies disappeared over night giving rise to the fly by right phenomenon. The committee noted that most of the companies were largely promoted by merchant banks, which were found to have received commission in the process. To finance buying or selling of shares, it called for provision of institutional financing through commercial banks. The committee recommended simplification of procedures involved in transferring of shares, which are considered to be complicated and cumbersome at present. This included the creation of a network of corporations similar to the proposed stock holding corporation of India under the leadership of IDBI so that private investors could freely transfer the shares. The report stressed the need for a reputed national level institution be set up to under take multiple membership in stock exchanges throughout the country. The committee also suggested that guidelines be evolved for the proper utilisation of mutual funds for equity raising instead of buying debentures.

8.9 Factors influencing Capital Markets :

The liberalisation of the industrial policy and the introduction of a number of new instruments like convertible debentures and the cumulative preference shares have facilitate the expansion of the capital market. The period 1980's have seen a quantum pump in the new issues and the cult of equity has begin to grow aided by many tax benefits and the operations of mutual funds in the economy. A number of venture capital funds were set up by financial institutions to help new and risky ventures. Many public sector banks also came. LIC and GIC also came out with their mutual funds which have helped the new issues market as well as the secondary market. In addition to the UTI, the mutual funds started mobilising funds for investment in the capital market since 1987. The tax benefits which include the exemption of dividend income upto Rs 3000 from income tax, raising the exemption limit for deduction if income at source from Rs 1000 to Rs 2500 per annum as interest on debentures and tax exemption for investment in new equity issues of new companies upto a limit and fiscal concessions for venture capital funds etc., are the factors which influenced the growth of the capital market in India. Besides financial restructuring and deregulations have also helped the market. Some of the policy measures have in particular helped the growth of capital market. Some of the measures taken include raising of ceiling on inter - corporate investment and loans and the relaxation of the norms relating to the foreign investment. New instruments like partly convertible debentures, NRI bonds and off share funds have helped the growth of capital market in India.

8.10 Features of the Indian Capital Market :

The capital market in India has exhibited the following features which are note worthy.

1. Greater reliance on debt instruments as against equity and in particular borrowing from financial institutions.
2. Issue of debentures, particularly convertible debentures with automatic or compulsory conversion into equity without the normal option given to the investors.
3. Floatation of mega issues for the purpose of take over, amalgamation etc., and avoidance of borrowing from amalgamation and financial institutions for the fear of their market discipline and conversion clause by bigger companies.
4. Avoidance of underwriting by some companies to reduce the costs and avoid scruting by financial institutions.
5. Fast growth of mutual funds and subsidies of banks for financial services, leading to a larger mobilisation of savings from the capital market.
6. The share of small share holders has declined proportionately and the relative share of large share holders increased.
7. The share of corporate units increased while that of individuals declined which is an unhealthy feature due to the fact that the real net savings emanate in India only from individuals and households and not from corporate sector.

8.11 Suggestions for Development :

The following are the suggestions which may be offered to improve the capital market in India.

a) There has been an accelerated growth of the long term capital market in India in recent years. But the absolute size in relation to the economy is still small and the institutional structure is inadequate. Hence it is suggested that a few large national level private sector investing or promoting companies to be established which would have the capability of establishing branches in several centres and in training and appointing its own agents in the smaller towns.

b) The desirability of introducing new instruments is also felt for the improvement of capital market in India. The introduction of new instruments would facilitate the institutions and investors a better deal in the capital market.

c) Supply of venture capital is high risk business but the reward would also be high. Government must allow private investing agencies to be set up which could supply this capital to new ventures.

d) Another suggestion is related to the contribution of institutional funds into the housing sector. The housing finance system must facilitate an adequate flow of institutional finance to the housing sector as one of the priority sectors.

e) Commercial paper having maturity period ranging from 30 days to a year may be introduced as it would relieve pressure in the long-term or medium term funds.

8.12 Conclusion :

The Indian capital market has undergone rapid changes in the post-independence era. More particularly the stock operations have witnessed a spurt of activities with the liberalisation of the economy and active participation of development banks. The most important task of the economy is to strengthen the capital market largely through stimulation of private investment. This could be achieved by affecting structural changes to the capital market. In recent years, various reform measures for blending market to freedom and regulation of the market on prudential lines were introduced. The measures include ablolishing. However, the capital market in India allowing mutual funds to be set up in the private sector, freeing of interest rates on debentures, excluding financial instruments from the purview of wealth tax and permitting foreign institutional investment directly in the capital market. Building a capital market more responsive to the needs of lenders and borrowers would require substantial improvements in the macro economic, legal and regulatory environments.

8.13 Summary :

The capital market is necessary for the development of financial institutions for providing long term finance. The capital market consists of both marketable and non-marketable securities which are operated through individual and institutional intermediaries. The constituents of the capital market include development banks, UTI, LIC, Commercial Banks, Stock Exchanges, Investment Companies and Merchant Banking institutions. There has been a significant growth in the Indian Capital market in terms of availability of industrial securities. There have been many instruments which are introduced in the capital market following the recommendations of a number of committies. There are a number of factors like policy changes, tax concessions and exemptions which are contributing for the development of capital market in India. The important features of the Indian capital market include more debt instruments are used and fast growth of mutual funds in India. However, the capital market in India needs to be strengthened by adopting measures like spreading of capital markets to smaller towns and introduction of new instruments, etc. Financial institutions like commercial banks, development banks, stock exchanges, mutual funds, and merchant bankers etc., have to play crucial role with efficiency and credibility for a sound and vibrant capital market to promote investments and thereby accelerate the process of industrial development and at the same time push up exports to new heights.

8.14 Key Words :

1. **Capital market** - a market for long term finance which consists of a number of instruments organised by a variety of financial institutions.
2. **SEBI** : Securities and Exchange Bond of India to facilitate the growth and regulation of capital market.
3. **Global Depositary Receipts** - These are securities issued in foreign currencies. A widely used international investment in the capital market.
4. **Foreign Institutional Investors** - Institutions of foreign countries to invest in India.

8.15 Self Assessment Questions :

1. Define the capital market ? Explain the structure of Indian capital market.
2. What are the features of Indian Capital market ? Which factors do you think have assisted the growth of capital market in India ?
3. Explain the policy of Government to attract foreign institutional investors.
4. Write an essay on the Instruments of capital market.
5. What are the defects in the Indian Capital market ? What measures to you suggest overcome them ?

8.16 Reference Books :

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Lesson 9 CAPITAL MARKET – REGULATION & PROMOTION

Objectives:

After studying this unit, you would be able to :

* Understand the measures taken by Government of India for the regulation of capital market.
* Highlight the role of SEBI and other institutions for the promotion of capital market
* Analyse the roles of CRISIL and ICRA as credit rating institutions

Structure:

9.1 Introduction:

A regime of financial liberalisation makes it imperative to have strong measures for investor protection in order to ensure that the benefits of liberalisation are not largely cornered by some small sections of the society which consists of mainly company promoters and market intermediaries. It was in the 1980's that India witnessed a phenomenal growth and development of the securities market. For the first time, it showed a potential not only to mobilise the savings of the house hold sector, but also to allocate it with some degree of efficiency for industrial development. Several companies came in the early part of 1980s and raised large resources from the market especially through debt instruments which further sustained investor interest. During that phase India was entering into the period of liberalisation and decontrol which was to accelerate and gather momentum in 1990's. These are some of the factors which spurred the growth of the market. The securities market in India came to be firmly integrated with the financial system of the country. The corporate sector was relying on the securities market for meeting their long term requirement of funds, the securities market competed on equal terms with the development of financial institutions which were the purveyors of long term capital. The emergence of securities market was one of the major economic processes of the 1980s. These changes in the capital structure of the companies give birth to new intermediaries and institutions in the securities market there by creating a new awareness and interest in investment opportunities. However, in spite of these developments, its quality continued to lag behind and there was an absence of adequate professionalism and competition among various players in the market. In order to sustain the growth of the market and form the growing awareness into a committed and discerning group of investors, it was necessary to remove the trading malpractices and inadequacies prevailing in the market. It was also found to be necessary to provide the investors with an organised and well regulated market place.

9.2 Measures Before SEBI and Other Institutions :

The promotional and regulatory measures which were launched since 1947 and before SEBI and other institutions include the following :

(A) Companies Act 1956 : The companies Act covers both the financial and non-financial aspects of the working of corporate sector. It aims at developing an integrated relationship among promoters, investors and company managements. It seeks to protect the intensity of share holders and to promote their effective participation and control it contains specific provisions to regulate.

(a) the issue of capital and the matters incidental there to.
(b) Capital structure of companies.
(c) Dividend distribution
(d) Inter-corporate investment
(e) Matters regarding share holders meetings and the format of annual accounts.
(f) Produce for the allotment of shares.
(g) Voting rights, etc.,

B. **Capital issues (Control) Act 1947 :** The capital issues (control) Act is only of historical interest now as it was repealed by the capital issues (control) Repeal Act 1992. It was administered by the controller of capital issues (CCI) in the Ministry of Finance, Dept of Economic Affairs, Government of India. The objectives of this Act were :

(a) to ensure that investments by the corporate sector were in accordance with the plans and that they were not wasteful and in non-essential channels.

(b) To protect the investing public.

(c) To ensure that the capital structure of companies was sound and in the public interest.

The Act required companies to obtain prior approval for issues of capital to the public and for pricing of public and rights issues. It empowered the Government of India to regulate the timing of new issues by private sector companies, the composition of securities to be issued, interest or dividend rates which can be offered on debentures or preference shares, the timing and frequency of bonus issues, the amount of prior allotment to promoters, floatation costs, and the premium to be changed on securities. In addition to the above-mentioned objectives, the Act is also expected to ensure that there was no undue congestion of public issues in any part of the year and to regulate the volume terms, and conditions for foreign investment.

(c) Securities contracts (Regulations) Act 1956 : The objective of the securities contracts (Regulation) Act 1956 is to regulate the working of stock exchanges or secondary markets with a view to prevent undesirable transactions or speculation in securities and thereby to build up a healthy and strong investment market in which public could invest with confidence. It empowers the Government of India to recognise and derecognise the stock exchanges, to stipulate laws and by laws for their functioning and to make the listing of securities on stock exchanges by public limited companies mandatory. It prohibits securities transactions outside the recognised stock exchanges. It lays down that all contracts in securities except spot delivery contracts can be entered into only between and through the members of recognised stock exchanges. It prescribes conditions or requirements for listing on securities on the recognised stock exchanges. It empowers the Government of India to supersede the governing bodies of stock exchanges, to suspend business on recognised stock exchanges, to declare certain contracts illegal and void under certain circumstances, to prohibit contracts in certain cases, to license the security dealers and to lay down penalties for contravention of the provisions of the Act. It is administered by the Ministry of Finance, Dept of Economic Affairs, Government of India.

9.3 Measures after the establishment of SEBI and other Institutions :

The institutional measures which were introduced after the establishment of SEBI and other institutions include the following :

(a) Establishment of SEBI (1988)
(b) Incorporation of SHCIL (1986)
(c) Commencement of OTCEI (1990)
(d) Birth of credit rating institutions (1987)

(a) Establishment of SEBI (1988) : keeping in view of the regulatory function, the government felt the need for setting up of an apex body wholly for the protection of the investors' potential, existing and prospective. This body would also be crucial for the promotion of orderly and healthy growth of the securities market. As a result, securities and Exchange Board of India was born on April 12, 1988 through an administrative resolution as an interim body under the over all administrative control of the Union Ministry of Finance. With the enactment of SEBI Act in 1992 there were several changes in the regulatory framework for the securities market in India. The SEBI became a statutory and a powerful organisation only since 1992. The objective of the SEBI Act is to "protect the interests of investors in securities and to promote the development of and regulate the securities market and also for matters connected there with or incidental there to".

The Board of members of SEBI consists of a chairman, two members from the officials of the ministries of the Central Government dealing with finance and law, member from amongst the officials of the Reserve Bank of India, two other members appointed by central government who would be professionals with adequate knowledge of the securities market.

9.3.1 Objectives of SEBI :

The objectives of SEBI include the Following:

1. To protect the investor
2. To ensure study flow of savings
3. To help in the fair practices of issuers
4. To promote efficient services
5. To ensure transparency in procedures and practices.

The Board ensures that the interests of the investors is protected and the development of securities market is well promoted. Another major objective is to register and regulate the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, merchant bankers, under writers etc., and regulate the working of collective instrument schemes including mutual funds. It also promotes self regulatory organisation, prohibits fraudulent and unfair trade practices in the securities market. Its other functions extend to regulate substantial acquisition of shares and take over, calling for information, undertaking inspection, conducting enquires and audits of the stock exchanges and intermediaries etc. The objective of a regulatory body for securities market in a country is determined by the stage of development of the securities market in the country. In a country like India, an institution like SEBI is expected to perform two important roles in fulfilment of the above objectives. The two roles are :

(a) Regulation

(b) Development

9.3.2 Roles of SEBI:

The two important roles of SEBI can be explained as under:

(a) Regulation : This role includes

1. Regulating the business in stock exchanges and any other securities markets.

2. Registering and regulating the working of stock brokers, sub – brokers, share transfer agents, bankers to an issue, portfolio managers and investment advisers.
3. Registering and regulating the working of collective investment schemes including mutual funds.
4. Prohibiting inside trading in securities
5. Prohibiting fraudlent and unfair trade practices relating to securities markets
6. Regulating substantial acquisition of shares and take over of companies.
7. Calling for information from undertaking inspection, conducting enquires and audits of stock exchanges and intermediaries and self regulatory organisations in the securities market.
8. levying fees or other changes for implementing various objectives.

(b) Development :

This role includes

1. Promoting investors education
2. Promoting self regulating organisations
3. Training of intermediaries
4. Promotion of fair practices and code of conduct
5. Conducting research and publishing information

In fulfilling the above roles, the SEBI will undertake the following activities:

1. It shall devise necessary laws with a unified set of objectives, single administrative authority and an integrated framework to deal with all the aspects of the securities market.
2. It shall also play an active role in interaction with the Institute of Chartered Accountants of India in upgrading and making accounting and auditing standards more effective.
3. It shall introduce a system of two stage disclosure at the time of initial issue and make compulsory for the companies to provide detailed information to all the stock exchanges institutions and investors on demand.
4. It will examine the feasibility of introducing a dealers network by which securities can be bought or sold over the counter as in a retail shop. This will help to smoothen liquidity and investment opportunities.
5. It shall work as an authoritative institution to see that the intermediaries are financially sound and equipped with professional and competent manpower.
6. It will ensure that the rules are versatile and non-rigid to provide automatic and self-regulatory growth. It shall also make law making and observance flexible enough to suit to the prevailing market conditions and circumstances.

9.3.3 Guidelines issued by SEBI :

Since the commencement of SEBI, a number of financial institutions, agencies and market intermediaries are now being governed by the guidelines, rules and regulations notified by SEBI from time to time. The following are some of the important guidelines issued by SEBI so far :

(i) Primary Securities Market :

(a) the issues of capital by companies no longer require any consent from any authority either for making the issue or for pricing it

(b) Efforts have been made to raise the standards of disclosure in public issues and enhance their transparency. The SEBI has accepted and implemented almost all the recommendations of Malegam Committee appointed in 1994 – 95.

(c) The offer document is now made public even at the draft stage.

(d) For issues of Rs. 100 crores, book building requirement has been introduced.

(e) Companies making their first public issue are eligible to do so only if they have three years of dividend paying track record preceeding an issue.

(f) The pricing of preferential allotment has to be made at market related levels.

(g) Bankers to an issue and portfolio managers have to be registered with SEBI. At present there are more than 100 bankers to issue and more than 125 permitted portfolio managers.

(ii) Secondary Markets :

(a) The Governing Boards and various committees of stock exchanges have been reorganised, restructured and broad based.

(b) Inspection of all stock exchanges has been carried out to determine inter-alia the extent of compliance with the directives of SEBI.

(c) Computerised trading has been achieved in almost all the exchanges except in smaller ones.

(d) Corporate membership of stock exchanges is now allowed, encouraged and preferred. The articles of association of stock exchanges have been amended so as to permit their membership.

(e) A process through which investor grievances against brokers may find redressal through a complaint to the SBI has been implemented.

(f) In accordance with the recommendations of G.S. Patel committee, Bombay stock exchange has been allowed to introduce a revised carry forward system of trading. Other stock exchanges can introduce forward trading only with the prior permission of the SEBI.

(g) The brokers are required to ensure segregation of client account and own account.

(h) The capital adequacy of norms of 3% for individual brokers and 6% for corporate brokers introduced.

(i) The trading hours in all the stock exchanges have now been increased from hours $2\frac{1}{2}$ to [illegible] hours per day.

(j) Insider trading has been prohibited and such trading has been made a criminal offence punishable in accordance with the provisions of SEBI Act.

(k) Compulsory audit of the brokers books and filing of the audit reports with the SEBI has now been made mandatory.

(iii) Investor protection Measures:

(a) The SEBI has introduced an automated complaints handling system to deal with investor complaints.

(b) To create an awareness among the issuers and intermediaries of the need to redress investor grievances quickly, the SEBI has been issuing fortnightly press releases relating to the complaints received and solved.

(c) To help investors in respect of delay in receiving refund orders in case of over subscribed issues, a facility in the form of stock invest has been introduced.

(d) It has also accorded recognisation to several genuine, active investor associations.

(e) It issues advertisements from time to time to guide and enlighten investors on various issues related to the securities market and of their rights and remedies.

(f) The complaints received by the SEBI are categorised into five types Viz., non-receipt of refund orders, non-receipt of dividend, non-receipt of share certificates, non-receipt of debenture certificates and non-receipt of annual reports.

(iv) Mutual Funds:

(a) Mutual funds are required to have a Board of Trustees separate from the asset management company and securities belonging to the various schemes are required to be kept with an independent custodian.

(b) Regulations were revised to provide for portfolio disclosure, standardisation of accounting polices, valuation norms for determining net asset value and pricing.

(c) UTI has also been brought under the purview of SEBI since July 1994. As a result, new schemes of UTI are also brought under the introduction of SEBI.

(v) Miscellaneous Guidelines:

(a) All the financial institutions are also required to be registered with SEBI.

(b) It is required that the capital of companies to be registered as depositories must be Rs. 100 crores.

(c) Venture capital funds allowed to invest in unlisted companies, to finance turnaround companies and to provide loans.

9.3.4 Performance of SEBI :

The performance of SEBI can be analysed as under :

(1) The SEBI claims that it has successfully settled a number of complaints of investors. However,

the market surveys reported that the system of dealing with complaints is ineffective. Price rigging has become a serious menace to the investors and has become more common in recent years.

(2) The guidelines issued by SEBI have been changing from time to time. In the process, the guidelines have become incomprehensible. They are chaotic and confusing that it is difficult for any body to determine what rules are currently in force. As a result, officials of SEBI may wield under power by providing their own interpretation of the rules.

(3) There is a widespread feeling in the financial markets that he SEBI is not really serious about reforming the system and protecting the individual and small investors. It has quite often failed to penalise the people for causing abnormal price fluctuations on the stock market. Even certain well publicised market manipulations have gone unpunished.

(4) The regulatory ineffectiveness of the SEBI in certain cases has been due to its concentration on symptoms rather than the root causes. The present settlement or delivery system is highly conducive for manipulative operations and unhealthy speculation.

(5) SEBI is having insufficient authority and powers. Many of the provisions the SEBI act clearly imply that it functions as a branch office of the union ministry of finance. The Government of India has sweeping powers regarding appointment, and removal of chairman and other members of SEBI.

9.3.5 Incorporation of SHCIL (1986) :

The stock holding corporation of India Ltd., is a company offering post-trading and custodial service to institutional investors. The corporation came into being in 1986 and its actual operations commenced in August 1988. Its paid up capital is 21.05 crores. Its promoters consisted of major financial institutions who are responsible for 60-70 percent of the trade conducted on all exchanges in India. Its promoters include:

i) Industrial development bank of India.
ii) Industrial finance corporation of India.
iii) Industrial credit and investment corporation of India.
iv) Unit trust of India
v) Life Insurance Corporation of India
vi) Industrial reconstruction bank of India.
vii) General insurance corporation of India and its subsidiaries.

9.3.6 Mission of SHCIL :

The SHCIL is committed to give effect to the government mandate requiring to establish:

a) A national clearing and settlement system
b) A central securities depository and
c) A securities facilities support corporation.

A national clearing and settlement system is to ensure that clearing of securities transactions takes place nationally on a standard basis with matching and netting of transactions. This would prepare the trades for depository settlement.

A central securities depository would provide transfer of securities in exchange for payment by book entry on electronic ledgers of depository. A securities facilities support corporation would provide fully automated infrastructure support services for national clearing and settlement and also depository services. It would also link the various stock exchanges at the national level.

9.3.7 Services provided by SHCIL:

SHCIL has been providing a number of services, which include the following:

1. Custodial services today have emerged as a unique business proposition which despite being capital intensive is simultaneously labour intensive also. The SHCIL in its capacity as the market leader in custodial services continued to grow in all spheres of custodial. activity- maintaining its lead in services level, technology, infrastructure, manpower, skills, and technical know-how.
2. In order to minimise the risk associated with handling of securities by private courier agencies, the corporation opted for the services of speed post for despatch of securities.
3. SHCIL has created necessary infrastructure and support services to cater to the demands of the participants trading in this segment and is presently providing clearance services tot he wholesale debt market segment of National Stock Exchange.
4. In its attempt to modernise the capital market the corporation participated in the equity capital of Investor Services of India Limited, a company promoted by IDBI, for setting up registrar and transfer agents services.
5. Its services also include prosessing of purchases and sales orders. It also provided services like collection of dividends, interest and redemption benefits due to its corporate clients.
6. It has floated two companies – National Depository corporation of India Ltd., and Indian Securities Depository Nominee Company Limited to execute the introduction of a surplus trading system when the depository legislation is passed.

The corporation plans to immobilise securities in a phrased manner with highly traded Scrips being taken up first and the rest following in descending order of liquidity and market capitalisation going fully scripless will take another five years after the depository legislation is being introduced.

9.3.8 Over The Counter Exchange Of India (1990) :

The genesis of the term over the counter exchange dates back to the late 18th century and was evolved almost simultaneously with the development of securities trading in USA. In India, the OTCEI came into existence following the GS Patel Committee report on Stock Exchange reforms and the Abid Hussain report on capital market. The OTCEI was incorporated in the year 1990 as a company under the companies Act 1956 and became fully operational on 1st September 1992. The OTCEI exchange is recognised by the Govt. of India as a recognised 'Stock Exchange' under securities contracts regulation Act 1956.

9.3.9. Features of OTCEI :

This is a ringless and electronic national stock exchange. It is an exchange without a specified trading floor. Its other features include .

1) It has a nation wide reach. The market is spread across the country through numerous counters of the operators of the exchange.
2) Small and medium sized companies between Rs. 30 lakhs and Rs. 25 crores can be enlisted.
3) It deals in equity shares, preference shares, bonds, debenture, warrants etc.,
4) The trading will be screen based. Transactions would take place through satellite communication telephone lines.
5) A company which is listed on any other recognised Stock Exchange will not simultaneously be eligible for listing on the OTCEI.

9.4.0 Promoters and participants :

The exchange has been promoted by a consortium of premier financial institutions namely UTI, ICICI, IDBI, SBI Capital Market Ltd., IFCI, LIC, GIC and its subsidiaries and can bank financial services ltd. The various participants in the exchange are.

1) Members, dealers and representative offices which operate OTC counter and are linked to a central OTCEI.
2) Companies whose securities are listed an the OTCEI and are sponsored by members.
3) Investors who trade and avail of investor services through any of the OTC counters.
4) A registrar for transfer and related activities.
5) A settlement bank which clears the payment between counters.

9.4.1 Listing on OTC Exchange :

The OTC Exchange can list companies with issued capital from Rs. 30 Lakhs to Rs. 25 Crores. The eligibility for listing are

i) The issue size should be a minimum of Rs. 20 Lakh or 25% of its paid up capital whichever is higher.
ii) Companies engaged in line – purchase, finance, leasing, amusement parks etc., shall not be eligible for listing on the OTC Exchange.
iii) Companies covered under the FERA may be listed on the Exchange, if they satisfy listing guidelines of a recognised stock exchange.
iv) The minimum number of contours for collection of application forms for issues of securities shall be four.

9.4.2 Advantages :

The advantages of trading in OTCEI can be explained as under :

(a) Small, growth oriented companies would be able to grow faster as they would raise the required capital through the OTC market at a low cost.

(b) The cumbersome process of obtaining the listing of the shares etc., which may not be there for listing of the shares on OTC.

(c) These would be easier valuation of securities on the exchange.

(d) Companies which require listing on the OTC Exchange may have to offer low percentage of share capital for listing as against high percentage being the offer to the public in case of regular stock exchanges.

(e) The problems of out dated transfer forms, problems of verifying signatures, etc., and related secretarial work would be reduced.

9.4.3 Disadvantages :

The disadvantages of OTECI can be stated as under :

(a) Since this is a new concept, the use of this system depends on the perception of the investors and potential use by them.

(b) The success of the OTCEI depends on the efficiency of the use of telephone system.

(c) Its serious limitation is that it cannot handle large volumes of business.

9.4.4 Suggestions :

The following suggestions may be forwarded to make the working of OTCEI more effective :

1. The OTC Exchange is a remedy for the illiliquidity of the scrips of smaller companies which are not sure of a good response to their public offers of equity. The scrips of these companies become more acceptable to the public with the backing of a member of the OTCEI acting as the sponsor. However, the sponsor company has to assume much responsibility in making the scrips viable through OTC Exchange.

2. The companies tapping the primary capital market do so to meet their investment requirements. Moreover, after a project is completed, the concerned company may not even need primary capital and may not want to sell scrips, through the investor is interested. Hence the sponsor company is required to ensure full flow of investment funds which clearly implied that the several projects would be left high and dry.

3. Companies listed on the OTECI will be those falling within the capital ceiling of Rs. 3 crore and the minimum public offer of 10% of the paid up capital of Rs. 30 lakhs whichever is less. These is no indication of the proportion of equity to be held by the management and the sponsoring institutions and whether there is any provision for Jobbers. Normally it would be difficult to run a secondary market on a mere 10% and these would be practically no floating stocks available.

4. The issue of OTC market becoming a state monopoly has been raised. As the OTCEI was established with the help of financial institutions, it is feared that this is bound to create a state monopoly in the capital markets. Hence, there is a need to regulate the trend.

9.5 Credit Rating Institutions :

Credit rating is essentially the symbolic indication of the current position of the rating agency on the relative ability and willingness of the issuer of a financial instrument to meet the service obligation as and when they arise. A rating is specific to a debt or financial instrument and is intended to grade different and specific in terms of credit risk associated with the particular instruments. Although it is an opinion expressed by an independent professional organisation, on the basis of a detailed study of all the relevant factors, the rating does not amount to any recommendation to buy, hold or sell an instrument as it does not take into consideration factors such as market prices, personal risk preferences, of an investor and such other consideration, which may influence an investment decision. As a fee based financial advisory service, credit rating is obviously extremely useful to investors, borrowers, banks and financial institutions. Although credit rating has been a long established part of the financial mechanism abroad, it is of relatively recent origin in the country. The following institutions were set up in the country.

1. Credit Rating Information Services of India Ltd. (CRISIL – 1988).
2. Information and Credit Rating Limited (ICRA – 1990)

The services of these institutions can be explained as under :

1) **Credit Rating Information Services of India Ltd., (CRISIL) :** As the first credit rating agency in India, it was promoted in 1987 jointly by ICICI Ltd., and the UTI. Other shareholders include the Asian Development Bank, Life Insurance Corporation of India, HDFC Ltd., General Insurance Corporation of India Ltd., and several foreign and Indian Banks. It commenced its operations on January 1988. Initially CRISIL was setup to rate debt obligations which would guide investors as to the risk of timely payment of interest and principal. Over the years of its operation, it has crystallised the following main objectives.

   a) To assist both individual and institutional investors in making investment decisions in fixed interest securities.
   b) To enable companies to mobilise funds from a wider investor base in larger amounts at a fair cost.
   c) To enable intermediaries place debt instruments with investors by providing them with an effective marketing tool.
   d) To provide regulators with a market driven system for bringing about discipline and a healthy growth of capital markets.

   To achieve these objectives, the functions performed by CRISIL include :

   1. Credit Rating services
   2. Advisory services
   3. Research and Information services.

The functions of CRISIL can be explained as under :

i) **Credit Rating Services :** The principal function of CRISIL is to rate mandated debt obligations of Indian companies, chit funds, real estate developers, LPG / Kerosene, dealers, non-banking finance companies etc., The debt obligations include rupee denominated credit instruments like debentures, preference shares, deposits, certificates of deposits, commercial papers and structural obligations of manufacturing or finance companies, banks, financial institutions, insurance companies, collective investment schemes and so on. The rating methodology adopted by CRISIL takes into account the aspects like credit associated with securities in the fund portfolio, the systems and procedures followed by funds and management quality and expertise.

ii) **Advisory Services :** The credit advisory services offers consultancy services which aim at identifying and mitigating risk and formulating and executing strategies for the same. The main focus of these services is transaction and policy level assignments in the areas of transport, energy and urban structures, banking and finance, and disinvestment, privatisation and valuation. These services are rendered in the form of cons..itancy to various State Governments in the selection of private sector participation in infrastructure development, the disinvestment commission of the Government of India, on disinvestment plans for public sector enterprises, and expert assistance to take up privatisation process in the efforts of State Governments, major port authorities, state electricity boards and so on. The other clients availing advisory services from CRISIL are the public sector enterprises, banks, financial institutions, and infrastructure project developers.

iii) **Research and infrastructure Services :** The CRISIL research and information services discriminates value added research and under takes customised studies in four areas namely Indian economy, Indian capital markets, Indian industries and the Indian corporate sector. It has a large client base both in India and overseas, comprising institutional investors, investment bankers, commercial banks, financial institutions, corporate planners, mutual funds and asset management companies. It covers a set of activities like sectors, view, international information vending and index services. CRISIL sector wise is an in depth analysis of the important and potential growth industries in India. The contents of sector wise analysis include study of brief of the industry, structure of the industry and its characteristics, an analysis of the different projects in the industry based on factors like product specifications. cost structure, capacities, technology etc., CRISIL view provides an analysis of and opinion on the business and financial outlook of company based on which investors can take decisions with regard to individual risk preferences. It also provides a useful basis for fund managers in their portfolio allocation decisions. As a part of providing international information vending, it has ties up with leading information vendors like Reuters, Knight – Ridder Information Inc., Internet Securities Inc., etc..., CRISIL also provides another service called CRISIL Index Services which include CRISIL 500 Equity Index, Midcrop 200 Equity Index, CRISIL Industry Indices like CRISIL MNC Index, Indian Business Group Index etc.,

2) **Information and Credit Rating Services (ICRA) :** The ICRA Ltd., has been promoted by the IFCI Ltd., as the main promoter to meet the requirements of the companies of the country. Apart from the main promoter which holds 26% of the share capital, the other shareholders are the Unit Trust of India, banks, LIC, GIC, Exim Bank, HDFC Ltd., It started its operations in 1991. The main objectives of ICRA are :

i) To assist investors, both individual and institutional, in making well informed decisions

ii) To assist issuers in raising funds from a wider base in large amounts and at lower cost for highly related entities.

iii) To enable banks, investment bankers, brokers and placing debt with investors by providing them with a marketing tool.

iv) To provide regulators with market driven systems to encourage the healthy growth of the capital markets in a disciplined manner without an additional burden on the Government.

The ICRA provides three types of services, which include :

i) Rating Services

ii) Information Services

iii) Advisory Services

Rating services includes rating of rupee denominated debt instruments issued by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and municipalities. The obligations include long term instruments such as fixed deposit programmes and short-term instruments such as commercial paper programmes and certificates of deposit. It also rates structured obligations and sector specific debt obligations such as instruments issued by power, telecom and infrastructure companies, other rating services offered include credit assessment of large, medium and small scale units for obtaining specific lines of assistance from commercial banks, financial institutions and financial service companies.

The infrastructure services division of ICRA focuses on providing authentic date and value added products used by intermediaries, financial institutions, banks, asset managers, institutional and individual investors. The value added services include equity grading, providing a critical import on a company's earnings prospects and inherent risks in the decision making process of equity investors, other products include corporate reports, equity assessment, mandate based studies and sector/industry specific publications.

The advisory services offers wide ranging management advisory service. Under the umbrella of advisory services, ICRA seeks to share its understanding of the business processes and relevant organisational issues with different players of financial markets such as investors, regulators, intermediaries and the media. To acquire expertise and bring international experience and practices to the Indian capital market, ICRA signed agreements with companies like Financial Performs Inc., a Moody company, The advisory Services include strategic consulting, risk management and inputs for policy formulation. The ICRA segment focus on the sectors like banking and financial services, infrastructure sector, manufacturing and services sector and Government, regulatory authorities and municipalities.

9.6 Conclusion :

The developments in the Indian capital market can be understood with the help of various measures like companies Act., capital issues (control) Act, securities contract regulation Act and SEBI. Institutions like SHCIL and OTCEI also contributed to the growth of the Indian Capital Market. After the establishment of SEBI, the capital market has undergone rapid changes. Institutions like CRISIL and ICRA were established for rating of shares, securities, debentures and loans. These institutions provide a wide range of services which include rating, advisory, information and research in the capital markets. With the establishment of these institutions, the capital markets are expected to grow further to meet the growing needs of Indian capital markets.

9.7 Summary :

It was the Indian companies Act 1956, that initiated the developments in the capital market in India. The Capital Issues Act controlled and regulated the issue of capital by companies in India. The Securities Contract Regulation Act also focussed on the control of capital flows in India. However, these acts could not result in the promotion and regulation of adequate capital in India. The establishment of SEBI as an institution which provides guidelines for the issue of shares, debentures and loans made a significant land mark, in the capital market in India. Other institutions like SHCIL and OTCEI were promoted to develop the Indian Capital Market. To assist the investors in the investments of various securities CRISIL and CARE were promoted. They not only provide services to investors but a number of different companies in the different sectors.

9.8 Keywords :

1. **Indian Companies Act 1956** – A comprehensive Act which covers a number aspects relating to companies in India.
2. **Capital Issues (Control) Act 1947** – an Act which was passed to protect investors and to regulate the flow of public capital into Indian companies. This Act was now repealed.
3. **Securities contracts (Regulation) Act 1956** – The Act which was passed to regulate the working of Stock Exchanges in India.
4. **SEBI** – An apex body which was set up for the promotion of healthy growth of the stock market.
5. **SHCIL** – A company which offers post – trading and custodial service to institutional investors.
6. **OTCEI** – A ringless and electronic national stock exchange.
7. **CRISIL** – India's first credit rating agency which was set up to rate the different securities and to provide other related services.
8. **ICRA** – another credit rating agency which was set up to meet the requirements of companies based in the North India.

9.9 Self Assessment Questions :

1. Write an essay on the companies Act and other institutions, which were setup for the regulations of capital markets in India.
2. What is the role played by SEBI ? Discuss the guidelines issued by SEBI for the protection of capital markets in India.
3. Write a detailed note on the performance of SHCIL.
4. What are the advantages and disadvantages of OTCEI.
5. CRISIL provides a variety of services to investors. What are they ? Explain in detail.
6. Elucidate the services rendered by ICRA for the promotion of capital market in India.

9.10 Reference Books :

1. M.Y. Khan, 'Financial Services' Tata Mc. Graw Hill Pub. Co., Ltd., New Delhi, 2003.
2. Vasant Desai, 'Indian Financial System' Himalaya Pub. House, Mumbai. 2001.

UNIT - 10

STOCK EXCHANGES
STOCK EXCHANGES IN INDIA

Objective :

The objective of this unit is to briefly introduce to you the features, functions and working of stock exchanges in India. Stock exchanges constituting a component of the capital market greatly influence the flow of capital to industry. Hence the need for proper understanding of stock exchanges can hardly be over emphasized for a student of commerce. Their structure and operations have undergone significant changes since 1991 and therefore they have become more disciplined, transparent and effective. This lesson also aims at creating an awareness of the latest developments relating to stock exchanges besides providing the theoretical framework.

Structure :

10.1 Components of securities market.

10.2 Instruments of securities market.

10.3 Definition of stock exchange.

10.4 Growth and Organisation of stock exchanges.

10.5 Functions of Stock exchange.

10.6 Regulation of stock exchanges.

10.7 Stock exchange operators and operations.

10.8 Systems of trading.

10.9 Steps in stock exchange transactions.

10.10 Settlement procedures.

10.11 National Stock Exchange and Over the Counter Exchange of India.

10.12 Summary

The developing countries need financial resources for their economic development. The economic development depends upon industrial development, which will be possible, only when the investors invest their savings through purchases of the various types securities of such enterprises.

The market where the investors invest their savings and where from the industrial enterprises collect funds is called Industrial securities Market. The industrial enterprises generally mobilize funds from the securities market through market issue of equity and preference shares and convertible/non-convertible debentures/bonds. The acceptance of public deposits and borrowings from the banks and other financial institutions also serve as sources of finance for industrial enterprises. The role of industrial securities market is very significant in developing countries which, in turn, depends on increasing per capita income and savings.

10.1 Components of Securities Market :

The industrial securities market generally comprise two important constituents for smooth operations in the securities dealings namely:

(i) Primary Market or New Issue Market, and

(ii) Secondary Market or Stock Market or Stock Exchange. (See Fig 10.1)

When a company wishes to raise capital by issuing securities or other entity intends to raise funds through units, debt instruments, bonds, etc, it goes to the primary market which is the primary segment of the capital market where issuers (firms) and (Companies) exchange financial securities for long term funds. The primary market facilitates the formation of capital.

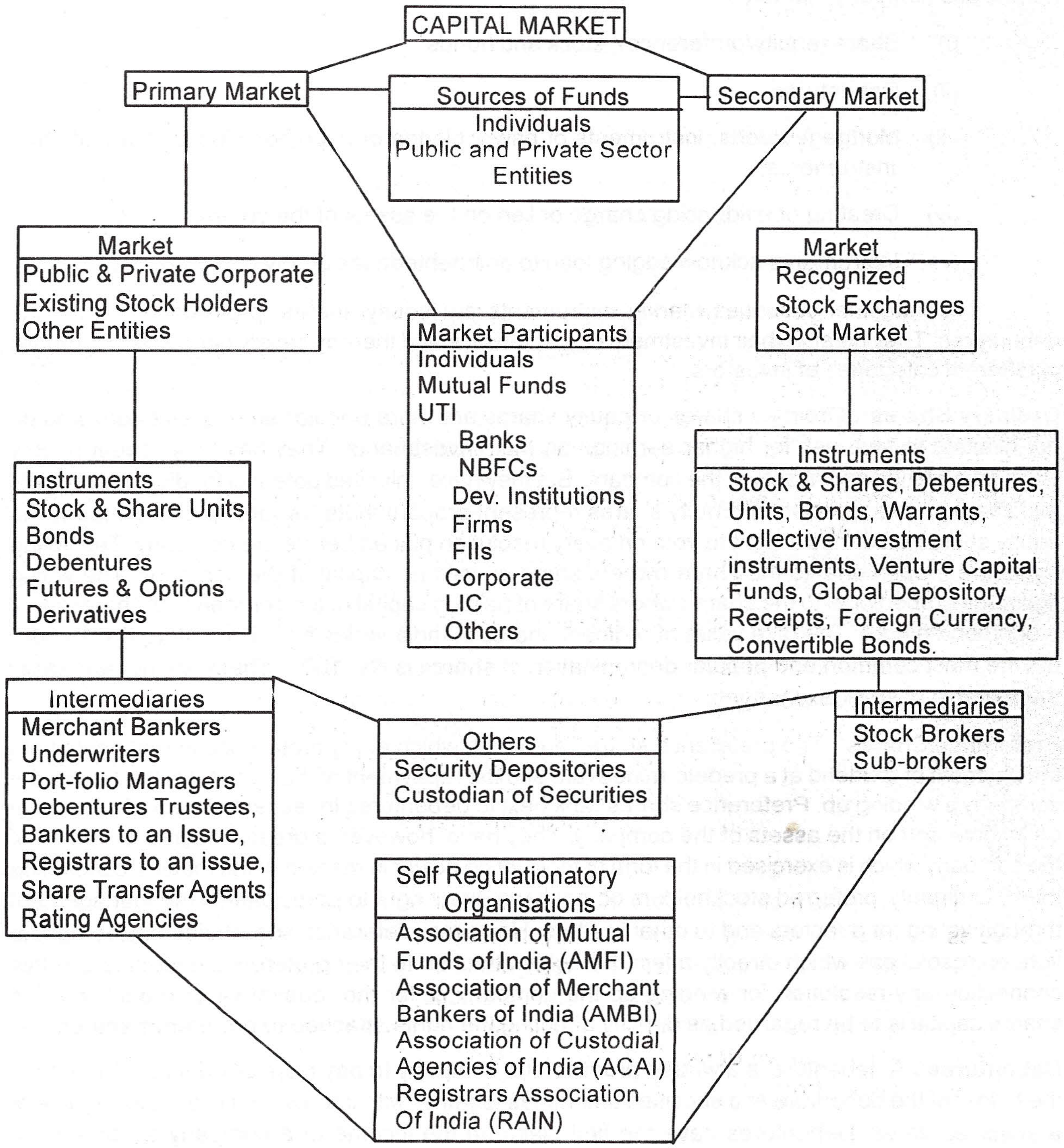
There are three ways in which a company may raise capital in the primary market: public issue, rights issue and private placement. Public issue which involves sale of securities to members of public, is the most important mode of raising long term funds. Rights issue is the method of raising further capital from existing shareholders by offering additional securities to them on a pre-emptive basis. Private placement is a way of selling securities privately to a small group of investors.

The primary market is a mechanism through which the resources of the community are mobilized and invested in the various types of industrial securities. The secondary market, that is, the stock exchanges, taken together is a mechanism, which provides easily liquidity, transferability and continuous price formation of securities to enable investors to buy and sell them with ease. The secondary market in India where outstanding securities are traded, consists of the stock exchanges which are self regulatory bodies under the over all regulatory purview of the Government SEBI.

The new issue market is a perennial source of trends to the industry. The secondary market activates the primary market when it is buoyant and vice-versa. The primary market provides securities to the investors and assists the corporate sectors in raising funds through new issues. The secondary market provides liquidity and marketability to the existing securities. The primary and secondary markets have a symbiotic relationship. which is confirmed by Granger's causality test conducted by Reserve Bank of India on the basis of monthly data on new capital issues and BSE sensitive index from April 1986 to March 1996.

Fig 10.1

Components of Indian Securities Market



Source : Indian Stock Market – A.K. Sharma and G.S. Batra. (P. 13)

10.2 Instruments of Securities Market :

The securities refer to any of the following instruments issued or to be issued by or for the benefit of a company, namely :

(i) Share (equity/preference), stock and bonds

(ii) Debentures,

(iii). Mortgage deeds, instruments of pawn, pledge or hypothecation and any of other instruments,

(iv) Creating or evidencing charge or lien on the assets of the company; and

(v) Instruments acknowledging loan to or indebtedness of any company.

The industrial securities market instruments are equity shares, preference shares and debentures. They differ in their investment characteristics and thereby satisfy different preferences of different categories of investors.

Ordinary Shares : Ordinary shares or equity shares are more popular among investors who do not hesitate to take risk for higher earnings on their investments. They have the lowest priority claim on earnings and assets of the company. But they have unlimited potential for dividend receipts and share price appreciation. Equity shares represent proportionate ownership of a company. An equity share holder has a right to vote on every resolution placed before the company. The voting rights are proportional to the share owners share or paid up capital of the company. The voting rights are proportional to the share owners share of paid up capital of the company. All shares carry proportionate right. The face value of ordinary shares in India varies from Rs. 10/- to Rs. 1,000/-, but the most common and popular denomination of shares is Rs. 100/-. These shares are easily transferable at stock exchanges.

Preference Shares : The preference shares are those which enjoy preference in respect of both the payment of dividend at a predetermined rate and the repayment of their capital at the time of the company's winding up. Preference shares rank next to debentures in respect of both of their claim on income and on the assets of the company. They have, however, a greater degree of control of the company which is exercised in the form of their voting power in respect of the matters concerning them. Ordinarily, preferred stockholders do not have direct right to participate in the management through voting for directors and to other matters. However, preference shareholders have right to vote on resolutions which directly affect the rights attached to their preference shares and in this connection any resolution for winding up the company or for the repayment or reduction of its shares capital is to be regarded as directly affecting the rights attached to preference shares.

Debentures : A debenture is a written promise of a company to pay a specified sum of money to the holder of the debenture at a specified time/times together with interest at a fixed rate payable at a specified dates. Debentures have the first claim on the income of a company as also on its assets in the event of its winding up. Normally, they do not gave any control over the management of the company unless the same is reserved to a limited extent. Thus, the debentures assume the minimum risk and as a result, have a minimum income and control, Unsecured debentures in our country are known as bonds bondholders have also priority over stockholders in respect to their claim on assets. Preference shares lie in between these two extremes. They assume less risk and have less income and control as compared to debentures.

10.3 Definition of Stock Exchange :

Stock exchange is any organization, association or group of persons incorporated or not, which constutes, maintains, or provides a market place of facilities for bringing to gather purchasers and sellers of securities and includes the market place and facilities maintained by such an exchange.

Under Securities Contract Regulation Act 1956 a stock exchange is defined is any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. The SCR Act stipulates that a stock exchange must be recognized by the Government of India. The twenty three exchanges that are operating in the country are recognized by the Government.

10.4 Growth and Organization of Stock Exchanges :

The stock exchange in Bombay formed in 1875 was the first stock exchange. It is one twenty eight years old. The Calcutta and Madras stock exchange were formed in 1908 and Delhi in 1947. The organization of stock exchanges varies. Some are public limited companies, (14) while others are limited by guaranties (6) or voluntary non-profit making organizations. (3) The Securities Exchange Board of India (SEBI) ensures broad uniformity in structure while granting recognition.

Only nine Stock Exchanges have got permanent recognition other have to renew it every year until permanent recognition is granted. Each member of the stock exchange has to pay an entrance fee or acquire specified number of shares. The value ranges from Rs. 250/- to Rs. 1,00,000/ and more security deposit to be made by the members wages from Rs. 10,000 to Rs. 2,00,000 /- . The annual subscription by members varies from Rs. 1,000/- to Rs. 5,000/-.

The stock exchange is managed by a Governing Body which consists of President, a Vice-President, Executive Director, Elected Directors, Public representatives and nominees of the Government. The Governing body is responsible for policy formulation and for ensuring smooth functioning of exchange. The executive functions are discharged by Executive Director or Secretary.

Table 1

RECOGNISED STOCK EXCHANGES IN INDIA

SL. No.	Name of Stock Exchange	Year of Establishing
1.	Bombay	1875
2.	Calcutta	1908
3.	Madras	1908
4.	Indoor (M.P)	1930

5.	Hyderabad	1943
6.	Delhi	1947
7.	Bangalore	1957
8.	Cochin	1978
9.	Kanpur	1982
10.	Pune	1982
11.	Ludhiana	1983
12.	Gauhati	1984
13.	Ahmedabad	1984
14.	Jaipur	1984
15.	Manglore	1985
16.	Magadh	1986
17.	Bhuvaneswar	1989
18.	Saurashtra	1989
19.	OTC Exchange of India	1990
20.	Vadodara (Baroda)	1990
21.	Coimbattore	1991
22	National Stock Exchange	1992
23.	The Inter Connected -------------- Stock Exchange of India	1995

10.5 Functions of Stock Exchange :

The stock exchanges provide an organized market place for the investors to buy and sell securities freely. The market for these securities is an all most perfectly competitive because a large number of sellers and buyers participate. The stock exchanges provide an auction market in which members of the stock exchange participate to ensure continuity of price and liquidity to investors. The active bidding and the resulting two way auction trading ensures that the bargains struck are the fairest, predetermined by the basic laws of supply and demand.

The basic function of a stock market is the creation of a continuous market where securities are bought and sold in volume with little variation in the current market price as trades succeed one another. A continuous market provides liquidity through the sale or purchase of securities quickly and easily, at a price that varies a little from the previous selling price. The indicators of a continuous market are (a) frequency of shares. (b) narrow Spread between bids and offers. (c) prompt execution of orders. (d) minimum price changes between transactions as they occur.

They protect the interests of investors through strict enforcement of their rules and regulations. In the absence of organised stock exchanges, the innocent may easily be deceived by the clever brokers dealing in securities.

They offer to capital opportunities to flow into the most profitable channels. The securities of relatively less prosperous concerns may be sold by investors in favour more profitable concerns.

They play very active role in capital formation. The publicity they give to the various industrial and government securities and their prices makes even dis interested people feel interested in investment. In other words stock exchanges create a habit of saving, investment and risk taking among the members of the general public.

They enable a company to market further issues successfully by creating a continuous market for public issues and for the rights also. The market prices established by the stock exchange trading by the interplay of the forces of supply and demand are also useful for tax purposes.

The conditions relating to disclosures and transference ensure that the investors have access to information on the listed companies particularly with regard to their financial conditions. These serve to protect the investor's interest by eliminating the dishonest and irregular practices rampant in the brokerage trade.

10.6 Regulation of Stock Exchanges :

The legislative jurisdiction over stock exchanges is vested in the Union Government by the Constitution of India. The Union Government enacted the Securities Contracts (Regulation) Act in 1956 (SCR ACT) for the regulation of stock exchanges and contracts in securities traded on the stock exchanges.

The Securities Contracts Regulation Act, 1956 provides inter alia for recognition of stock exchanges and regulation of their functioning, licensing dealers, recognition of contracts, controlling speculation, restricting rights of equitable holders of shares and empowering government to compel any public limited company to get its shares listed.

Under the Securities Contracts Regulation Act, Government has promulgated the Securities Contracts (Rules, 1957) for carrying into effect the objects of legislation. The rules are statutory and constitute a code of standardized regulations applicable to all recognised exchanges.

The SCR Act and the Securities Contracts Rules (1957) constitute the legal framework for the regulation of stock exchanges and protection of the interests of investors.

The year 1991 witnessed a big push give to liberalization and reforms in the Indian financial sector. For some time there after the volume of business in the primary and secondary securities markets increased significantly. On the other hand the globalization or internationalization of financial system made it vulnerable to external shocks. The multi crore securities scheme rocked the financial market in 1992. All these developments impressed on the authorities the need to have in place a vigilant regulatory body or an effective and efficient watch dog. It was felt that the then regulatory frame work was fragmented ill coordinated and in adequate and that there was a need for an autonomous, statutory, integrated organization to ensure the smooth functioning of the financial system. The SEBI came in to being as a response to these requirements.

The SBEI was established on April 12th 1988 through an administrative order, but it become a statutory and really powerful organization only since 1992. The Capital Issues (Control) Act, 1947 was repealed and the office of the Controller of Capital Issues was abolished in 1992 and the SEBI was set up on 21st February 1992 through an ordinance, which was replaced by the Act on April 4th 1992. Certain powers under certain sections of SCR Act and Companies Act 1956 have been delegated to SEBI. It is under over all control of the Ministry of Finance and has its regulatory frame work in India.

Note: For a detailed account of SEBI, refer the lesson on SEBI

At the stock exchange level, the Board of Governors regulates the activities of stock brokers. Stock exchanges are designed to be self-regulatory. Actually the Government of India grants recognition to no stock exchange unless its rules and byelaws are in conformity with such conditions as may be prescribed with a view to protecting the interests of investors.

10.7 Stock Exchange Operators And Operations At Floor Level :

Brokers, Sub-Brokers and Jobbers : The investing public cannot deal directly on the stock exchange. A non member can purchase or sell securities only through a broker. A broker is a commission agent who transacts business in securities on behalf of non members. He is a member of stock exchange. A sub broker is not a member of a stock exchange. He acts as an agent of stock broker or other wise assists the investors in buying, selling or dealing in securities through such stock broker. Registration is compulsory for both brokers and sub brokers.

A jobber on the other hand is an independent dealer in securities. He purchases and sells securities in his own name. He is not allowed to deal with non-members directly. However he can deal either with a broker or with another jobber. He resembles TARAWANIWALA of Bombay Stock Exchange.

Bulls and Bears : A bull is a speculator who expects a rise in the price of a certain security and buys the same to sell it in future at the expected high price. He is an optimist.

A bear is a speculator who expects a fall in the price of the shares of a company and agrees to sell for delivery on a fixed date such securities as he may or may not posses. When the date of delivery comes he purchases securities at a lower price and fulfils his promise at higher price. Thus he makes profit from a fall in the price of security. If he sells securities, which he does not posses, it is called short selling.

When a bear finds it difficult to meet his commitment he is said to be struggling like a lame duck.

Market Makers : When a dealer creates and maintains a market in a security, he is said to make a market. He is a single, designated specialist in specified securities. Market makers make both bid and offer at the same time. The quoted price, which they would pay to the prospective seller of a security, is known as bid price. The price they would change from a prospective buyer is offer price or asking price. Market maker is exempt from margin requirement. He has to abide by byelaws and rules and regulations of stock exchange.

10.8 Trading Systems :

1. Order/Customer Driven and Quote/Dealer Driven Trading System: Stock exchanges trading based on the auction system on a trading floor is known as order/customer driven trading. In case of order-driven trading the purchase orders and sale orders of securities are matched on the floor of the stock exchange through auctions. In case of quote/dealer or a quote-driven system, the dealers compete to give their customers the best purchase price or the best price, as the case may be.

2. Auction System : An auction system is based on current high bid and low offer. Buyers and sellers find a mutually agreeable price through options, with no intervention of broker - dealer. Buy and sell orders get automatically matched because the market maker fills in the gap if an imbalance occurs in bid and offer prices. On the other hand the broker - dealer market is a negotiation market between dealers who regularly buy and sell a particular security. These dealers make a market in a particular security. Quotations are electronically transmitted for most of the active shares.

Bombay stock exchange has an auction system as well as quote driven system. BSE also has an informal system of jobbers who continuously announce two way quotes for regularly traded scrips at specific locations called trading posts. Stock markets in the rest of the country are mainly order driven which ensures better price to investors but hampers growth of the stock market.

Margin Trading : The term margin is applied to the deposit which the members are required to maintain with the clearing house of the stock exchange. This percentage is a certain percentage of the price of the security, which is traded by the members. If a member buys/sells share marked for margin above the limit, a certain amount per share has to be deposited with the clearinghouse. Margins are required to cover defaults/deficits in the event of adverse price movements. They are stipulated on the basis risk involved in the securities. They are required to regulate or restrain forward trading, over trading and unhealthy, reckless, excessive speculation by putting financial burden or curbs on the traders. In essence they are meant to reduce the volume of trading. Three types of margins are imposed by the stock exchange and the Ministry of Finance imposes two more types of margins. They are daily margins, carry over margins, adhoc margins, automatic daily margins and additional volatility margins.

Insider Trading : Trading by insiders is insider trading. An insider is a person connected with the company directly or indirectly having access to unpublished price sensitive information in respect of securities of the company. They may include Directors, stock exchanges, merchant bankers, registrars, brokers, top executives, auditors, bank dealers, agents and employees. Insider trading may be attempted to benefit the company through unethical purchase and sale of the company's shares by withholding price sensitive information and or benefit the individual insider. S.E.B.I takes necessary steps for prohibiting insider trading basically for protecting the investor interest by curbing unhealthy and manipulative dealings by insiders and also for protecting the interest and reputation of the company, as well as to maintain confidence in stock exchange operations among the public. S.E.B. I has powers to investigate the affairs of insiders and impose a penalty up to Rs. 5,00,000 / - on an insider.

On Line Trading : Bombay stock exchange has started online trading in 1994 and has extended it nation wide which has led to its business growing by hundreds of crores. SEBI allows any stock exchange with a computerized screen based trading system to expand nation wide online trading subject to certain conditions. On line trading will help in widening base of investors and depository participants, there by augmenting securities trading.

10.9 Steps in Stock Exchange Transactions :

There are various steps in completing and executing transactions at a stock exchange.

1. Placing an order : The buyer or seller of securities can place an order by telegram, telephone, letter fax etc or in person.
2. Execution of orders : On receipt of an order to buy or sell, the members of the stock exchange have three alternatives to execute the order. Go to the trading ring, set off matching the transactions of purchase and sale and purchase and sale out of the stock held by him. In the trading ring jobbers-market makers stand at specific locations called trading posts and announce continuously the two way quotes for the scripts traded at the post. The order is executed either by auction or negotiation. The final price at which the deal takes place is settled down by mutual acceptance between the two brokers-one buying the security and the other selling it at negotiated price. Once the transaction is finally settled the details are recorded in a chupri which is compared at the end of each working day to ensure that all transactions are matched. At the end of the trading period, all deal details are transferred to a souda sheet, which is handed over to the BSE computer department for processing. The prices at which the different scripts are traded on a particular day are published in the news papers the very next day. These prices are available from the jobbers.
3. Preparation of Contract Notes : A transaction gets materialized with the issue of contract note which a written agreement between the broker and the client for the executed transaction
4. Delivery of Share Certificate and Transfer deed : The delivery of share is in the form of share certificate and transfer deed. The transferor that is seller signs the transfer deed and the particulars of the transfer deed are filled in by the transferee that is buyer. The delivery is of four types. a) Spot delivery –delivery and payment on the date of the contract or the next day.

b) Hand delivery-delivery and payment with in 14 days. c) Specified or Special Delivery-delivery and payment after 14 days as specified at the time of bargain. d) Clearing – Delivery and clearing of security take place through a clearing house.

Most of the transactions are conducted on the basic of hand delivery.

10.10 Settlement Procedure :

Settlement procedure varies for specified and non specified securities. The settlement for specified securities is done at the end of each settlement period. An accounting year of a stock exchange is divided in to settlement periods, generally, of two weeks duration. These are settled through the clearinghouse.

In the case of non – specified shares, weekly system of settlement on uniform basis has been introduced in all exchanges. In weekly settlement trades are settled only at the end of the week and pay-in/delivery takes place during the subsequent.

Badla System to Rolling System : The earlier system of settlement for trading in specified shares called Badla System involved trading for clearing with a facility of carry forward the transaction from one settlement period to the other. The buyer was not required to pay the entire amount at the time of purchase against the security of a blank transfer deed and share certificates. However he is required to pay badla charges for the favour shown to him by postponing the settlement. This facility of carry forward provides liquidity and breadth to the market. This ensures that large purchases are absorbed with minimum price fluctuations. But badla system lent it self to malpractices and abuses with speculative excesses at time, price rigging, market manipulation, non reporting of transactions, evasion of margins and neglect of interests of small investors.

On December 13th 1993 SEBI issued an order preventing undesirable speculation in securities following a steep rise share prices, thereby banning carry over facilities or badla. However in view of utility of carry forward system in expanding capital and money market despite its defects and the, adverse influence of ban on badla, the G.S. Patel Committee was appointed to suggest an alternative to badla system. The Committee submitted its report in April 1995, recommending a new scheme for forward transactions. Basing on the recommendations of the Patel Committee SEBI introduced a Revised Carry Forward System (R.C.F.S) in July 1995. This revised system was subjected to stringent conditions regarding quantum of forward business and other operational aspects and as such was not implemented by B.S.E, which sort a revision of some of the stipulated conditions. SEBI diluted the stringent conditions and announced a modified forwarding trading system in October 1995. This action of SEBI could no satisfy the stock exchange functionaries. SEBI had to constitute J.R. Varma Committee in March 1997 to review the revised carry forward system. This committee submitted its report in July 1997 recommending a new, modified carry forward system (MCFS) because RCFS was not success. The Varma committee reversed the direction given by the Patel Committee and recommended the reintroduction of single track of carry forward system or virtually the old system. The recommendations of this committee were also subjected to criticism.

After evaluating the various pros and cons of Varma committee recommendations, SEBI adopted the Committees recommendations on October 15th 1997 after some modifications. They are 1. SEBI retained crucial condition of twin track system and 90 day limit for settlement of transactions. 2. Daily margin on carry forward trades reduced to 15 to 10 percent. No margin on cash Scrips. 3. The overall carry forward limit has been enhanced to Rs. 20,00,00,000/- per broker per settlement . No sublimities for purchase and sale positions and individual Scripps. 4. Rs. 10 Crore limit for financier has also been withdrawn. Shares received by vyaj badla financiers would continue to be deposited with the clearing house.

SEBI also accepted the Varma Committee's recommendations regarding strict enforcement of capital adequacy and other prudential safe guards and effective monitoring and surveillance system. That Scripts chosen for carry forward should have sufficient floating stock and high liquidity has also been approved.

Rolling Settlement : In 1997 The SEBI announced that the transactions on dematerialized shares should be settled on rolling basis on the 5th day after the transaction. Accordingly trading in demat shares commenced on the basis f T+5 rolling settlement cycle with effect from January 15th 1998 on optional basis.

Rolling settlements are quicker. Speculation is limited to a day rather than one-week. The other benefits are a) Reduction of risk since each trading days position would come up for settlement. b) The process of price formation in the cash market would improve considerably. c) The anomalies of the present system in which the cash forward market are mixed up would be avoided. Rolling settlement system started with 10 scrips has been extended to all scrips by 2002.

Pherwani Study Group Report (1991) : The high powered study group on establishment of new stock exchanges (1991) on a review of the operations of existing stock exchanges identified major areas of concern which directly effect the interest of the investor and have rendered transactions in the capital market to be costly, risky and dilatory affair. The identified areas of concern are lack of liquidity, infrastructure facilities, and inefficient and out dated trading systems, and out dated settlement systems lack of a single market. The study groups that the setting up of new stock exchanges would not serve the purpose of spreading the equity cult or enchasing liquidity in the secondary market. Improvement can be achieved only by establishing close links between exchanges. An integrated national market system with a three-tier stock market structure was recommended by the study group.

The national market system consists of (a) Principal stock exchanges namely Bombay, Delhi, Calcutta, Madras and Ahmedabad. (b) Regional Stock exchanges comprising of other stock exchanges and (c) Additional trading floors sponsored and managed by either a principal or regional stock exchange.

The study group observed that due to physical constraints, trading in Bombay stock exchange was limited to about 900 companies. Out of 2,600 listed companies, 1,700 companies were traded infrequently or not traded at all. It further observed that the exchange was unable to develop a debt market due to shortage of space and un willing ness of members to act as market makers. On account these factors, the study group strongly recommended that a new stock exchange be promoted immediately at New Bombay as model exchange and to act as National Stock Exchange (N.S.E). In the opininon the study group N.S.E would provide access to investors from all across the country on an equal footing and work as an integral component of national market system. This recommendation of study group has been implemented by starting National Stock Exchange in November 1992.

10.11 National Stock Exchange of India (N.S.E) :

NSE was incorporated in November 1992 with an equity capital of Rs. 25,00,000/-. It is sponsored by the IDBI and co-sponsored by the other term lending institutions; LIC,GIC and other Insurance Companies, Commercial Banks and other Financial Institutions namely, SBI Caps, SHCIL and ILFS. NSE transcends geographical barriers and overcomes fragmentation by providing a fully automated electronic, screen based trading system instead of the conventional trading ring. This results in greater depth and liquidity of the market and reduces the transactions costs. NES is not an exchange in the traditional sense where brokers own and manage the exchange. It has a two tier administrative set up involving a company board and a governing board of the exchange. NSE is a professionally managed national market for shares, PSU bonds, debentures and government securities with all the necessary modern infrastructure and trading facilities.

Its objectives are (a) to provide nation wide equal access and fair, efficient completely transparent securities trading system to investors by using suitable communication network. b) to provide shorter settlement cycles and book entry settlement system. c) to bring the Indian stock market in line with international markets, and d) to promote the secondary markets in debt instruments such as government and corporate bonds.

It has two separate segments viz, 1. The Whole Sale Debt Market Segment (WDMS) which caters to banks, financial institutions and other institutional participants and which deals in PSU bonds, units, treasury bills, government securities, cell money, commercial papers etc. Every thing is big in this segment. There are mega players, mega investors and mega deals in it. 2. The Capital Market Segment (CMS) which deals in equities convertible debentures etc. These include securities that are traded on other stock exchanges also. Recently the RBI has identified the NSE as the only conduit for inter-bank security deals.

The NSE is an order driven and not a quote driven market and it allows trading members to trade from their offices through a communication network. It has already spread its business in more than 200 cities with more than 1,000 terminals.

In less than 3 years, its business has exceeded the business of the 125 year old BSE. It was expected the NSE will be free from speculation. But in reality it has become a speculators paradise primarily a speculative market. It was setup as a cash and delivery market but in effect it has become a primarily a secular market. There are large scale defaults on it too and it is also afflicted by price rigging. Its auction system is not transparent.

Over The Counter Exchange of India (OTCEI) : It was set up in 1992 and was the first stock exchange in India to introduce screen based automated ringless trading system. It is promoted by UTI, ICICI, IDBI, IFCI,LIC,GIC,SBI Caps and Can Bank as a company under Companies Act 1956 with head quarters at Mumbai. It s objectives are a) to help companies to raise capital from the market at the cheapest costs and on optimal terms; b) to help investors to access capital market safely and conveniently c) to cater to the needs of the companies which can not be listed on other official exchanges; d) to eliminate the problems of illiquid securities, delayed settlements and unfair prices faced by the investors.

The securities traded on OTCEI are of 3 categories; listed, permitted and initiated. These securities cannot be traded on other stock exchanges. However they can be bought and sold at any of the OTCEI counters all over India. It has 2 players; members and dealers instead of brokers who can perform the functions of brooking, trading on their own accounts, and market making. While the members can engage in sponsorship, the dealers cannot. Banks, banking subsidiaries, mutual funds, Fis, merchant bankers, venture capital funds, and NBFCs other than finance and leasing companies having a minimum of net worth of Rs. 2.5 crores can become members of OTCEI.

It has an online trading cum depository, quote driven and transparent system of trading. It follows T+3 settlement system which is the fastest in the country. It provides a liquid cash market for the retail investors. The existence of market makers and the modern trading and settlement system on it ensures deliveries vs payment on time. There are no problems of bad deliveries or short deliveries because the system allows the execution of trades only on the basis of electronic inventory of scripts. It encourages domestic and foreign institutional investors also to trade on it by offering them netting facilities for both intra – custodian and inter – custodian transactions. OTCEI is a cash and retail market for small investors and small companies. With the passage of time, however, the focus of its activity is shifting to bigger permitted scripts among which Reliance is one.

In spite of its many advantages, OTCEI has been languishing since its inception in terms of its business, mostly an account of the stringent market making norms, settlement conditions, banks aversion to finance market making etc. Worried by the stagnant activity on OTCEI, the SEBI appointed two committees — Malegam and Dave committees — with in a short period of two-three years to review its working and to suggest measures to improve its operations. The Dave committee recommended relaxation of the maximum size of issues that may be listed on OTCEI, relaxation in listing criteria and a shift from a rolling T+3 settlement to five day account period settlement being followed by other stock exchanges. These and most of the other recommendations of the committee have been accepted by SEBI and are being implemented.

10.12 Summary :

Stock Exchanges play a crucial role on the development of an economy. The process of mobilisation of funds is influenced by the efficiency of Stock market operations. Exchanges play a significant role in improving the efficiency of secondary market. The securities contracts Regulation Act , 1956 guides the functioning of stock exchanges in India. As per the provisions of the Act, only recognised stock exchanges can function in India. We have 23 exchanges recognised by the Govt. The stock market operations are undergoing a transformation. IPO market is improving. Similarly, secondary market operations are moving towards efficiency with changes in trading and settlement procedures.

MODEL QUESTIONS :

1. Define Stock Exchange. Discuss the features, functions and growth of Stock Exchanges in India.
2. What are the components of Securities Market. Examine the role of Securities Market in Economic growth and development and interrelationship between primary market and secondary market.
3. Critically examine the characteristics of different securities traded on stock exchange.
4. Discuss the systems of trading and settlement on Stock Exchanges.
5. Who are the major functionaries in Stock Exchanges? Discuss their characteristics and role.

6. Critically examine the latest developments relating to Stock Exchanges since 1991.
7. How are the Stock Exchanges regulated? Critically examine the role of SEBI in stock exchange regulation.
8. Write short notes on

   1. National Stock Exchange 2. Over the Counter Exchange of India.

Further Readings :

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Unit – 11 DEVELOPMENT BANKING - A GLOBAL PERSPECTIVE

Objectives of the lesson :

The objectives of this lesson are :

- To understand the origin and concept of Development Banking.
- To trace the growth of Development Banking globally
- To examine the objectives of Development Banks
- To know the types and functions of development banks in developing countries.
- To examine the organisation, Management and capital structure of Development banks.

Structure :

11.1 Origin and Concept :

The origin of Development Banking may be traced back in 1822 when the "Society General may De Belgique" was founded in Belgium. "Credit Mobiliser of France was established in the year 1852 which acted as industrial financier. This was followed by Germany, Australia, Netherlands, Italy, Switzerland and Spain. In the western countries, development banking had a long period of evolution. In Japan, Industrial Bank of Japan was established in 1902 on the model of "French Credit Mobiliser" for the purpose of financing its industrial development. Japanese Industrial Bank was not a specialist institution designed to provide finance and enterprise for industrial development but a 'hybrid' institution combining in itself the functions of an issue house, a commercial bank and a mortgage institution.

There is no precise definition of development bank. William Diamond and Shirley Boskey have considered industrial finance and development corporations as development banks. Development Banking activity is essentially a multipurpose financial activity with a broad development outlook of the countries. A development bank is defined as a financial institution offering all types of financial assistance, both medium and long term to business units in the form of loans, guarantees, underwriting and other promotional activities. During the post second world war period, several newly liberated and under developed countries in Asia, Africa and Latin America became restless to shown their problems of squalor and poverty and to solve the problem of industrialisation, they set up specialised financial institutions to supply basic ingredients of development like capital knowledge and entrepreneurship for rapid industrial growth.

Development bank is a mined institution, which combines in itself the function of 'finance corporation' and 'development corporation'. A finance corporation is defined as an institution concerned primarily with long term loan capital and a development corporation, concerned with equity capital and with fostering and managing specific companies as well as providing financial support. Development banks which have come to be established in different underdeveloped countries of the world are so diverse in their form and structure and method of operations that there is no universal model suitable for every developing or underdeveloped country. Every country tended to design the model which could best suit to the peculiar social, political and economic situations in the country. Despite wide diversity, there is a close similarity among them so far as scope of their basic functions and purposes are concerned.

Development banks are not only financial agencies which are merely engaged in providing medium and long term assistance to business undertaking in the form of loans. They also act as catalytic agents in promoting a balanced and liable process of development by assuming promotional role of discovering of investment projects, undertaking the preparation of project reports, providing of technical advice and managerial services and finally, the establishment and management of industrial units. Thus, providing financial assistance and rendering promotional services are the minimal functions of development banks. Between these two extremes, at the one extreme is the term tending which is the sheet anchor of a development bank and the other end are the promotional activities such as development of infrastructures and social utilities are now included as functions of development banks.

11.2 Growth of Development Banking in other Countries :

The development banks like the French credit mobiliser and industrial Bank of Japan were the pioneering financial institutions. Which engaged the attention of different countries in the world. Every country in Europe saw certain specialised financial institutions to provide industrial finance for reconstruction, modernisation and development of war industries. Among the most important development banks were the industrial mortgaged Bank of Finland Ltd.; the National Hingarian Industrial Mortgage Institute Ltd., the provisional Mortgage Bank of Saxony and the National Economic Bank of Poland. These banks played an important role in the reconstruction and development of the war shattered economies by providing long term loans to various categories of industries. The post depression period witnessed the establishment of specialised financial institutions in several countries. The industrial credit company of Ireland was set up to carry out the function of capital under writing and direct subscription along with lending activities. Besides, 'Netherlands company for Industrial Financing' which was set up, to participate in the share capital of industries enterprises in addition to the grants of term loans.

Since 1944, several interesting developments had taken place in the machinery for financing and promoting post war industry in Great Britain and other advanced countries. "The Industrial Development Bank of Canada"(1944). "The Financial Corporation for Industry Ltd" (FCI) and "Industrial and Commercial Finance Corporation Ltd" (ICFC) of Great Britain (1945) and "Industrial Finance Department of the Common Wealth Bank of Australia" (1946) are important examples of machineries being established in developed countries. Further, Industrial Reorganisation Corporation was set up in UK in 1966. The "Industrial Finance Department of Common Wealth Bank of Australia was established to assist in the development of industrial undertakings in addition to the provision of industrial finance although it was not described as development bank. These institutions were closely similar not only in their basic functions and their underlying objectives but also with respect to methods of financing enterprises. Thus they made not only term loans against the security of fixed assets of industrial undertakings but also participating in risk capital of companies.

11.3 Progress of Development Banks :

During the last 50 years, an increasing number of developing countries have promoted development banks. These banks have been created in response to the particular needs like political, social and economic. In consequence, there is considerable variety among these institutions both in organisational structure and in the scope of activity. However, such institutions have been sponsored by the governments, which exert a varying degree of influence on their policies and operations. Some are exclusively owned by the governments. For example, the Industrial Development Bank of Nepal - 1959, Industrial Development Bank of Indonesia - 1960, The National Development Bank of Brazil – 1965 etc., some banks were setup by the private parties, for example, the Industrial credit and Investment Corporation of India and Pakistan, The Industrial Finance Corporation of Thailand etc., Some more banks were set up by the government and the private interests jointly. For example The Industrial Finance Corporation of India, The Pakistan Industrial Development Bank, The Industrial Development Finance Corporation of Malaysia etc., In some cases, development banks have been created as the departments of the central bank of a country or of the government.

Some development banks like the Eti Bank of Turkey, The Suner Bank of Turkey etc., are fully devoted for the promotion and financing of government enterprises, some others exclusively to private investment and still others to both fields. Some development banks in certain countries are concerned with the entire economy and others may be with a single sector. Some development banks located abroad are regional in nature, others national and a few of them inter-regional. For example, Inter American Development Bank (1960), African Development Bank (1964), Asian Development Bank (1966) etc., some banks would provide local currency loans, while others provide foreign as well as native currency loans.

It is evident from the above discussion that the development banks in various countries were designed to broaden the existing source of finance particularly for the development of small and medium sized industries during the process of transactions from a war time to a peace time economy. The financial institutions that emerged in developed countries bear the characteristics of a term financing institution and can at best be designated as finance corporation. In sharp contrast, the institutions which have been devised in underdeveloped countries have been fostering accelerated economic growth through adequate financing coupled with promotional activities. Infact, the modern concept of development bank is closely related to the upsurge on the part of underdeveloped countries to accomplish a quick rate of all round economic development through the provision of finances.

11.4 Objectives of Development Banks :

Following are the objectives of development banks of underdeveloped, developing and developed countries.

1. The principal objective of a development bank in a country is to help alleviate endemic problems of squalor and unemployment and for that matter, it acts as catalyst for fostering industrial development. They will also assume promotional role by undertaking industrial potential surveys and identifying growth projects, preparing feasibility studies and providing technical, managerial and other assistance to interested entrepreneurs right from the stage of project formulation to the commissioning and operation of the project.
2. Another objective of a development bank is to serve as an agent of development in various sectors ie., industry agriculture and foreign trade.
3. Development banks are aimed at for rapid industrialisation particularly in the private sector so as to provide more employment opportunities in the country.
4. Development banks in all countries assume a special role in planning, promoting and developing industries to fill the gaps in those economies.
5. They also assume the role of coordinating the working of all institutions engaged in financing, promoting or developing the industries in the countries.
6. They also provide technical administrative and managerial assistance required by the prospective industries and develop entrepreneurial skills through conducting Entrepreneurial Development Programmes (EDPs) for the prospective entrepreneurs.
7. Development banks have been promoted to provide financial facilities like subscription to shares and debentures of industries, guaranteeing loans raised by them from other sources, guaranteeing deferred payment in respect of imports of plant and equipment and also underwriting the issue of stocks, bonds and debentures of industrial enterprises.
8. Development banks have been promoted to take the responsibility of developing material infrastructure and social utilities for the people in the economies.

11.5 Types of Development Banks :

The urge for economic development has stimulated the need for a variety of developing banks in all most all countries of the world. The variations in development banks are found in respect of sectors of operation, ownership, types of assistance, geographical coverage, size of the limits and assistance. A brief account of different varieties of development banks is presented below :

1. Sectors of Operation : On the basis of sectors of operation, development banks can be categorised broadly in two groups : general development banks and specified development banks. General development banks are established to assist projects of all sectors including agriculture, power, transport and manufacturing. They make no distinction between public sector and private sector projects.

Specialised development banks confine their operations to only one sector. Thus, separate development banks for assisting industrial and agricultural projects exist. Further, a number of development banks have been set up only to promote and assist enterprises in private sectors. It is to be noted that certain development banks to assist only public sector projects have come into existence. Mixed type of development banks which are authorised to help both public sector and private sector have gained popularity in recent years. The scope of operation of several development banks which were initially set up to assist public sector projects has of late, been broadened to cover government projects. The scope of a development banks business should not be unduly restricted. As a development bank gains experience in one line of activity, it may extend its operations to other fields, which will help in improving its profitability. Experiencing of both the Canadian and British Institutions which extended their business into the spheres of trade and services bears testimony to this fact.

2. Private or Public : From the view point of ownership, development banks may be classified as (i) government owned, (ii) central banks owned, (iii) privately owned and (iv) mixed, being owned jointly by government, central bank and private interests. Majority of the development banks belong to the first and second categories. It is obvious to find few such institutions to be established by private entrepreneurs because they are doubtful of entering in the field of experimental and risky ventures like those of development banks. Besides, profit prospects are remote in such institutions. Even if private capital is available, a privately owned development bank will need some sort of government support in the form of guarantee of principal and interest of the bank's capital and bond issue etc.,

Privately owned banks have definite advantages over the public banks in that they are free from political pressures and frequent interferences by the politicians to which the public banks are subjected. They will have the opportunity to take investment decisions in its right earnest. Government development banks have also certain advantages over their counter parts in private interests. Unlike private banks, public banks need not worry every time for declaring dividend. They can extend their area of operation to assist large, medium and small industries. They can also venture into new and pioneer fields and can undertake growth potential surveys if the situations warrant so. Privately owned banks cannot engage themselves in these activities in view of the limited financial resources.

3. Lending or Promotional or Mixed : On the basis of forms of financial assistance, development banks fall into three categories : (i) development banks confining to lending activity, (ii) development banks confining to loans and guarantees and underwriting activity, (iii). Development banks providing assistance in all forms including managerial and technical services. There is general tendency for mixed type of development banks which are authorised to provide both loan and risk capital to industrial concerns.

4. National and International : Development banks may be international and provincial depending on the geographical area of their operations. An international bank is one which is authorised by its charter to satisfy financial and promotional needs of business enterprises of different countries of the world. International Bank for Reconstruction and Development (IBRD) or World Bank was established in 1946 to assist in the reconstruction and development of territories of member countries. International banks do not confine their activities with in the nation but extend beyond it and provide assistance for expansion and development of industrial enterprises in other countries. National development banks such as the IFCI, ICICI and IDBI limit their operations with in the country. Since it may not be practically feasible for a national development bank to take care of the needs of a large number of business enterprises of varied nature, it is felt that regional development banks with in the country may be established to supplement the efforts of national level banks. The geographical area of operation of such institution is restricted to the state level. In order to avoid overlapping and proliferation in the efforts of national and provincial level development banks, some sort of demarcation in their activities is made on the basis of size of the units to be assisted. Thus, national development banks may be authorised to assist only large and giant industrial projects while smaller projects are left for the regional banks.

Functions of Development Banks : Development Banks have two fold functions – financial and promotional. Their functions are much more closely related to those of the investment banking institutions of the advanced countries. Generally speaking, or development bank is a multipurpose institution in the sense of financing projects in various sectors of the economy.

11.6 Functions of Development banks are discussed hereunder :

1. Commercial Banking Business : in the developing countries where the banking system is immature and credit facilities are inadequate, development banks may have to step forward to fill the vacuum and provide short term credit to their customers for working capital purposes. Industrial development corporation of Nepal, The Mexican National Financiers and the South African Industrial Development Corporation provide working capital when their loanee companies are unable to raise it from other sources. As regards other kinds of commercial banking business such as accepting of deposits, opening letters of credit or discounting of bills etc., by development banks, there is no uniform practice. The IFCI, IDBI, SFCs in India, Industrial Development Corporation of Pakistan and Burma have been permitted to accept fixed deposits with than one year maturity.

2. Joint Finance : A special feature of considerable importance in the development bank's operations, in recent years is the joint financing of projects in close collaboration with other financial institutions. It is difficult for one single institution to meet the entire financial requirements of a project both loan capital and underwriting of share capital. In the case of projects such as fertilisers, petro chemicals, ferrous and non ferrous metals, cement paper etc., requiring large capital outlay and therefore, substantial financial assistance is given either through joint finance or through a consortium of long term financial institutions, commercial banks etc.,

The members of the consortium work in close cooperation with each other by mutual exchange of views and coordination of policies and procedures. So far as appraisal of projects involving joint financing is concerned, there is joint appraisal by a team of technical and financial officers of the institutions concerned. The coordination is also achieved through periodical inter-institutional meetings convened under the aegis of the central bank of the country where the chief executives of the institutions meet and discuss problems of common interest.

3. Credit Guarantee : The main deterent to the extension of loan by financial institutions to small scale industries is the element of risk generally associated with it. To overcome the risk, credit guarantee scheme and credit insurance (CGSCI) has been introduced in several countries like Japan and India etc., in India, the credit guarantee scheme was introduced in 1960 by the Government of India. The objective of the scheme is to enlarge the supply of institutional credit to small industrial units by granting a degree of protection to the lending institutions against possible losses in respect of such advances. In Japan, besides, credit guarantee and credit insurance the credit agency system (CAS) is also highly developed. The financial institutions use the services of these agencies to get information on the credit worthiness of applicants and take decisions on their loan applications with the guidance of the agencies. In Netherlands, a Guarantee Fund (GF) was established in each of an industry by businessmen to help deserving colleagues in getting loans for a new venture.

4. Refinance : Another incentive which encourages financial institutions to increase their commitment into industrial finance is the availability of the refinance facility. Granting term loans to industries greatly affects the liquidity of the financing institutions because a considerable amount of money is getting locked up fairly for a longer period. But when refinance is made available to the lending institutions, it increases latter's liquidity thereby, enabling it to take up fresh investment proposals. In India, IDBI provides refinance facility against term loans granted to industrial concerns by state finance corporations, commercial banks and state cooperative banks etc.

5. Entrepreneurial Gap Filling : Though the hardcore of the activities of a development bank is financing it has to undertake the task of bringing together the elements essential to quicken the pace of economic development through providing entrepreneurial skills. Indeed, in some cases, the promotional role is more significant than the role of the industrial financier.

Discovery of investment projects, the promotion of industrial enterprises, the provision of various kinds of technical and managerial assistance, the undertaking of economic and technical research conducting of survey work and feasibility studies, stimulation of capital markets etc., constitute the important aspects of the promotional functions of a development bank. While discharging these functions, they act on one side as agents for expecting for governments investment projects and on the other side, act as catalysts for investment in the private sector. this involves an evolution of investment projects in the light of the declared objectives of the industrial policy of the government. Thus, development banks are aptly described as the cornerstone of the modern industrial financing system.

6. Development of the Capital Market : Development of the capital market is the most important non-financial activity of a development bank. The association between the institutional arrangements of a country's capital market and its economic progress is very close. To achieve self sustaining economic growth, the easy availability of savings for financing productive projects is very essential. This requires an effective capital market to mobilise savings to the desired channels. In order to stimulate efficient allocation of available funds into competing ends, it is imperative for the capital market to create a variety of financial assets and to ensure their liquidity, marketability, stability and satisfactory yield. The development banks as the keystone of the capital market in developing economies are expected to perform these functions.

Development banks can help capital market through some of the following functions.

- Sale of their own obligations in the capital market
- Placement of their industrial security holding
- Under writing the issue of new securities
- Inducing investors to participate in their financial operations.

Besides, these banks can mobilise savings from the public by way of accepting deposits, assist stock exchanges by engaging themselves in the sale and purchase of corporate securities and devise new forms of securities to suit different sectors of the investing public.

7. Issuing Bonds : Most of the development banks have found it convenient to issue their own obligations. This is mainly due to the fact that the bond issues of many banks are guaranteed by government with regard to minimum rate of return and repayment of the principal. For example, IFCI, SFG and Tamilnadu Industrial Corporation (TIIC) have the legal authority to issue bonds and debentures with government.

8. Under writing Stocks and Debentures : Development banks acquire industrial securities through either direct subscription, or underwriting or both. Sometimes, they also acquire securities through their promotion of companies and by conversion of their loans into equities. Thus, they can build up portfolios of industrial stocks and bonds. But it is to be noted that these securities usually are not meant for permanent retention. This is because that a development bank should not hold on the stocks/bonds and these securities should be disinvested slowly but steadily without upsetting the stock market. This is necessary because a sudden disposal may cause a glut in the stock market resulting either in the price fluctuation or even passing the securities into the hands of any particular party who may acquire controlling interest in a company. It is even more desirable to consult the company which issued them before offering such securities to the public.

For Example, the IFCI sells shares generally in small lots through recognised stock bookers and at times in bigger lots to the institutions like Life Insurance Corporation (LIC) of India or Unit Trust of India (UTI).

9. Sale of Securities : By offering such securities for public sale, the development banks significantly contribute to the growth of capital market. Such operations may result in enlarging the supply of marketable securities and may even attract new buyers and create favourable attitude and confidence among investors for buying and holding industrial securities. The sale of securities from portfolio is not only beneficial but also necessary for development bank. This operation enables them to get back the funds already locked up for further investment. Thus, underwriting by development banks in the developing or under developed countries is not only a marketing function but also an investing function.

The ICICI, IFCI, SFCs and the South African Industrial Development Corporation (SAIDC) have followed the practice of selling shares and bonds, out of their own portfolio from time to time and utilising the proceeds for new investments which may latter on augment the market supply of securities. In few cases, there is an obligation on the part of the development bank to dispose any shares, it acquired as a result of underwriting. The ICICI sells securities from its own portfolios to investors whenever it can get a reasonable price for them. Generally, it does not retain successful investment merely because they are profitable. In underdeveloped and developing economies with inflationary conditions, equities may be more readily marketable than bonds. However, if bonds are of fairly short maturity and economic conditions are comparatively stable, bonds may find favour with investors.

When the capital market is continuously sluggish and stagnant, development banks which have engaged in share underwriting operations may have to take up and hold considerable amounts of their underwriting commitments and may also have to wait for a favourable turn of the market to be able to dispose of the securities. Thus, it is clear that underwriting will be meaningful only when there is a fair prospect of success for a public issue. To sum up it may be said that the growth of development banking is now a worldwide phenomenon. Development banks have become well recognised segment of the financial system. They are artificial limbs created to compensate for the relatively show growth like normal sources of finance to industries. Development banks are often expected to play an important role in the promotion of the widespread ownership of industrial securities particularly in developing countries, what role they actually take will be dependent on the environment in which they operate.

11.7 Development Banks in other Developing Countries :

The technique of promoting and financing of industries through the development banks has developed stupendously in developing countries. Following is the country wise list of development banks.

Burma	-	The Industrial Development Corporation (1952),
		The Industrial Development Bank Burma (1961)
Ceylon	-	The Agriculture and Industrial Credit Corporation (1943)
		Development Finance Corporation of Ceylon (1955)
China (Taiwan)	-	China Development Corporation (1959)
Iran	-	The Industrial and Mining Development Bank of Iran (1959)
		Industrial Credit Bank of Iran (1963)
Iraq	-	The Industrial Bank of Iraq (1946)

Indonesia	-	Bank Pembangunan Indonesia (1960)
		(Development Bank of Indonesia)
Korea	-	The Korean Reconstruction Bank (1954)
Laos	-	Credit National Lao (National Credit Bank of Laos)
Malaysia	-	Malaysia Industrial Development Finance (1960)
Nepal	-	The Nepal Industrial Development Corporation (1959)
		The Industrial Promotion and Productivity Centre Private Ltd (1965)
Pakistan	-	Industrial Development Bank of Pakistan
		Pakistan Industrial Credit and Investment Corporation Ltd.,
		Pakistan Industrial Development Corporation
		The Small Industries Corporation
Philippines	-	The Development Bank of Philippines (1958)
		National Investment and Development Corporation (1963)
		Private Development Corporation of the Philippines
Singapore	-	Economic Development Board of Singapore
Thailand	-	Industrial Finance Corporation of Thailand (1959)
Vietnam	-	Societe financere Pour We Development De L' Industries An Vietnam (1961)
Ryukyu	-	The Ryukyu Development Loan Corporation (1959)
Cyprus	-	The Cyprus Development Corporation Ltd (1963)
Ethiopia	-	The Development Bank of Ethiopia (1951)
Ghana	-	The National Investment Bank, Ghana (1963)
Nigeria	-	The Nigeria Industrial Development Bank Ltd., (1959)
Uganda	-	The Uganda Development Corporation Ltd (1952)
Latin American	-	The National Financiere of Mexico (1934)
Countries	-	The National Bank For Economic Development (1952)
		The Chilean Development Corporation (1939)
		The Bancode Credito Industrial Argentina (1949)

11.8 Organisation and Management of Development Banks :

Incorporation of development banks can be done in a number of ways i.e., through special statutes for the individual development banks or for a group of them or incorporation under the general law relating to joint stock companies or corporations. Broadly speaking, there can be two broad patterns of organisational structure namely, Function oriented and Expertise oriented structure. The organisation is structured according to the functional areas involved in the organisation; Project appraisal, legal disbursement, accounting follow up, project promotion and development and training. Each department is staffed with the expertise required by it to perform its functions and, whenever necessary professional from other departments is also resorted to.

In expertise oriented pattern, departments are created around individual disciplines such as technical, financial, analysis, legal and economic research. Under the aegis of a coordinating department individual experts are deployed in suitable teams of projects, project follow up and supervision, project development and promotion. The Secretary and Treasurer or other functionaries are charged with the duty of documentation, disbursement as also house keeping and secretarial functions.

Technical and financial appraisal of projects is the heart of a development bank's operations. The development banks must build up a fairly elaborate staff for this purpose. Even so, it is not possible for a development bank to have an army of experts relating to the various economic sectors – agriculture, power, transport and other groups of industries. It has to employ experts on an adhoc basis and also consultants. Consultations with government technical departments are also helpful. It is also useful especially in the early years to get experts from abroad. The operations Departments' main function is to disburse assistance promptly after completing the necessary verifications including in particular examination of titles to fixed assets. Sales of investments acquired by the development banks could also be entrusted to this department.

Infact, the legal and operations department should work closely as the two constitute a single department. A separate follow up section or department is essential especially when the number of companies to which assistance from the development bank is outstanding is large. There is an advantage in the staff for the follow up work being separate from those who appraised the projects and recommended sanction of assistance. As in most organisations, a certain amount of overlapping may be unavoidable, i.e., between the Appraisal and operations departments or between the operations and the follow up wings of the development banks.

Another matter for decision would be whether development banks must have branches. This depends on, among other things, the size of the country and the scope of its operations. Regional offices are atleast helpful in disseminating information on the development bank's scope of assistance, operations, etc. An alternative arrangement would be to make use of selected banks for the purpose, especially those having a country wide network of branches. More important than the establishment of branches is the need for the top executives to keep in close touch with the pulse of the entire economy by travel and other means.

Management set up of the Development Banks :

The composition of the Board of directors is very important because the ultimate success of a development banks, as in the case of other business enterprises depends on the board. While constituting the board, every care should be taken to see that persons of expertise knowledge and experience in the field of institutional financing are included in the board. Further, men with wide practical knowledge of industry, business and finance and also representative of the different regions and sub regions should be included in the board. More precisely economists, chartered accountants, managerial experts, financial analysts should be considered for the directorships of development banks. Where the development bank is government owned either wholly or partly, the whole or substantial part of the board is nominated by the government. On the Contrary, in the case of privately owned or mixed type of development banks, the Board members are generally elected by the shareholders and only a few directors are nominated by the government. Nomination of members in the board by the government is intended to safeguard the public interest and to coordinate the operations of the institution with the governments' policies and procedures.

Furthermore, the Board of Directors in a privately owned bank chooses a chairman from amongst themselves but in the case of the government controlled institutions, the appointment of the chairman is subject to approval of the government. In such cases, government indicates its choice and the chosen person who is generally a top ranking government official is elected. The Board of directors in a development bank is generally concerned with formulating, tending, investing and other policies. Details operations relating to lending and investing of the institution are looked after by a committee known as executive committee comprising some members of the board including the chairman. The board members cannot meet very often to attend to the minute derails of the loan and investment proposals. The executive committee being a smaller body, can meet very frequently to attend to details of loan and investment affairs. The committee has the authority to take final action on behalf of the Board or to subject to rectification by the Board of directors.

However, it is to be remembered that the executive committee armed with overwheliming powers to deal with all the problems of the institutions, may sometimes, prove dangerous in that, it may tend to become an absolute authority and weaken the functioning of the board. In any event, the effective management should rest with the full time executives who should be chosen on the basis of their ability and integrity, dynamism and missionary zeal and also practical wisdom. The executives must be equipped with necessary financial and technical acumen and critical knowledge to take decisions quickly and objectively.

11.9 Ownership pattern of Development Banks :

There is or wide variety of ownership pattern for development banks. In most cases, the initiative to establish a development banks has come from governments. Hence, the participation by the government and / or the central bank of the country in the capital and management is common. Public sector ownership, where it occurs generally constitutes majority. The categories of private sector shareholders could be institutional such as banks, insurance companies, cooperative societies as well as individuals. Some development banks have restrictions with regard to shareholding by certain categories of domestic with regard to shareholding by certain categories of domestic investors. Segregation and compartmentalisation is not helpful, though often, this is done to ensure a certain minimum subscription of capital initially.

In several cases, there is shareholding by foreign institutions, including the international finance corporation, though such ownership generally constitutes a minority. Foreign share ownership is beneficial as it helps the inflow of funds from abroad not only to the development banks but also to industrial units directly, it makes for a wider understanding at the international level of the problems of the developing countries. In the case of wholly privately owned development banks, government guarantee is not common and so, no ceiling is prescribed to the dividends on the share capital. The above position is perhaps true regarding the payment of interest and repayment of principal, in respect of bonds issued by development banks.

It should be mentioned that there is often undue importance given to the matter of public Vs private development banks. There may be examples of public sector institutions doing well and private sector banks not so well and vice versa. Much depends upon the degree of autonomy given to the development banks in its day to day operations and the people incharge of institutions.

Capital Structure of a Development Bank :

The Management of a development bank must decide about the composition of capitalisation. What types of funds should a development bank seek to meet its financial needs and in what proportion these funds would be raised are the basic issues that the management has to deal with under capital structure.

Following are the main sources of funds of a development bank

- Equity capital
- Long term interest free loans from government
- Free reserves created out of business earnings
- Borrowings from the central bank
- Foreign currency loans from foreign lending institutions
- Repayment from borrowers of rupee and foreign currency loans
- Saie of investments
- Refinance of loans and public deposits

Broadly speaking, there may be two fundamental pattern of capital structure in a new development bank. They are 1. Financing of capital requirements exclusively by equity stock, 2. Financing of capital requirements by equity and bonds. In the case of existing development bank, a portion of financial needs may be met out of reserves which is built out of profits. There is no hard rule to guide the management with respect to the pattern of capital structure that would suit to a development bank. As a matter of fact, the decision on this has to be taken in the light of multiple circumstances with in which the institution is operating.

It is to be noted that an adequate equity base is an important in a development bank as in other business concerns. With strong equity position, a bank can meet financial needs of deserving projects regardless of market situations. Besides, it serves a cushion to absorb losses that may occur. It serves as a guarantee fund to creditors against losses and protects the institution against the costly situation of liquidation. In this sense, capital serves both shareholders and creditors. This is why development bank with comfortable capital position can inspire, enjoy and maintain the confidence of investing community, which in turn, facilitates the bank in raising the funds from the market conveniently. However, exclusive reliance on equity capital for meeting financial needs of the bank may not be considered financially expedient because, debt is relatively a cheaper source of financing. Due to relatively lower interest rate that a bond usually carries and tax deductibility of interest cost, debt offers the cheapest source of financing. Debt as a source of financing is significant also because, it does not disturb the voting position of the existing stockholders. That is the reason why shareholders are interested in relatively high leverage – higher doses of debt to expand resources for lending operations. However, creditors would not appreciate the financial institution introducing more and more doses of debt because in that situation, the institution runs the risk of insolvency particularly when its earnings are not sufficient to service debt. Thus, the management is saddled with the problem of striking compromise between the conflicting interests of shareholders and creditors by determining an appropriate mix of debt-equity in the bank. This has to be decided in the context of operational environment in which the development bank has to work.

11.10 Factors Influencing Capital Structure of Development Banks :

Following are the factors which decide the capital structure in development banks :

1. **State Regulation :** Decision regarding debt equity mix should be taken with in parameters of law. In many countries respective statutes of development banks have contained restrictive provisions regarding proportion of debt which can be mixed with equity. These provisions cannot be ignored. In the case of IFCI in India, a ceiling has been placed under the IFCI act that the bonds and debentures issued and outstanding as also contingent liabilities in the form of guarantees or under writing agreements together with borrowings from the Central Government / Central Bank shall not, any time, exceed 10 times the aggregate of the paid up share capital, the Reserve Fund, the Special Revenue Fund, the Benevolent Reserve Fund and other reserves of the corporation excluding the reserves for bad and doubtful debts.
2. **Restrictions Imposed by articles of Association :** In many development banks, Articles of Association places limit on borrowing by the bank. In such a case, decision regarding debt equity mix must be taken with in the imposed limit. For example, it is provided in the Articles of ICICI in India that the corporation can borrow up to three times of its paid up capital and government deposits.
3. **Restrictions Imposed by Creditors :** Where loan agreement contains restrictions on the amount of total borrowings that a development bank can make the management must take due note of it. For instance, in the case of some state level financial institutions, creditors have imposed the borrowing limits ranging from three to six times of the equity.
4. **State of Capital Market :** Study of trends of capital market should be undertaken in depth since cost and availability of different types of funds is essentially conditioned by them. In a bearish state of the market when investors are unwilling about shares, management should take recourse to debt financing because of strong preference of the investing people for the bond issues as that would ensure fixed return to their holder. Contrary to this, if the stock market is in a state of buoyancy issue of equity shares could be considered.
5. **Scope of Business of Development :** The scope of business of a development bank bears on the proportion of equity to total capitalisation because, amount of risks involved in financing activity is very much related with scope of business of the financial institution. Thus, a financial institution who has confined its business to lending only need not build as strong equity cushion to absorb any unforeseen setbacks as is necessary for an institution which has diversified its operations to underwriting and direct investing.

6. **Age of Development Bank :** Young Development banks generally find themselves in a difficult situation to raise capital in the initial years because of greater uncertainty involved in them and also because they are not known to the suppliers of funds. They have, therefore, to depend largely on equity share capital. In a sharper contrast to this, established banks with good earnings record are always in a comfortable position to raise capital from whatever sources they like. Such institution should choose debt from raising capital.

7. **Stability of Earnings :** With greater stability in earnings a development bank can depend on debt financing. But a company with irregular earning will not choose to burden itself with fixed charges. Such an institution should, therefore, depend upon the sale of stock to raise capital.

8. **Government Support :** Proportion of debt to equity in a development bank depends upon the magnitude of government support and types of such support. In case of government sponsored institutions, this could be in the form of guarantees for share capital, bonds or debentures and low interest bearing loans. In other cases, the government could heep by extending long term interest free loans or using its good offices with banks and institutional investors to subscribe to development bank's share capital.

9. **Reserve Policy :** In order to strengthen equity base of a financial institution it is imperative for it to build suitable reserves out of profits year after year besides making provision for bad and doubtful debts. The ploughed back profits of financial institution depend on the spread between their borrowing and lending rates and the burden of administrative expenses. While SFG in India are able to get concessional refinance in respect of their confessional assistance, the all India Development Bank which makes adequate provisions for reserves and follows stable dividend policy will have the advantage of raising additional share capital without any difficulty. A strong reserve position also increases the borrowing ability of the financial institution. Against high reserves, a development bank can obtain loans at reasonable rate which would otherwise not have been possible.

10. **Access of Development Banks to the Capital Market :** Where the development bank, because of its strong and stable financial position and highly reputed management, has easy access to the different sources of the market, the management must place greater reliance on bond financing. However, in case of those banks whose access to the market is limited as is the case with regional financial institutions, bulk of the funds will have to be procured through equity share capital and that too from a closely held circle. The management must see which taking loans that the spread between the cost of the borrowings and lending rate is attractive enough to meet not only administrative expenses but also to provide a reasonable profit margin.

Thus, decision with respect to ratio of debt to total capitalization in a development bank at a given period calls for a careful evaluation of the circumstances with in which the institution works.

Methods of Reducing resource Requirement :

Following are the methods of reducing Resource Requirement in development banks.

1. **Shortening of Repayment Period :** By Shortening the period of repayment of loans, management can reduce resource requirements because, the resources will flow back to the development bank in lesser number of years. Flexible repayment schedule may also be helpful.

Under this scheme, minimum amount of each instalment is fixed. The assisted concern will have the freedom to repay higher than the agreed minimum, if its profitability and liquidity position so warrant

2. **Grant of Assistance in the form of Marketable Securities :** Resource constraint can, to some extent, be minimised, if financial institution decides to invest in debentures of the 'corporate enterprises instead of providing them loans because, in that case, in times of need, debentures could be liquidated in the market for cash'.

3. **Convertibility option :** If convertibility clause is inserted in the loan agreements, the development bank can after certain stipulated period convert the loan into equity shares. This will enable the lending institution to share the prosperity of the concerns and make capital gains on its investment by liquidating a portion of its holding when share prices rule high in the stock market.

4. **Proper Development of Resources :** In a country like India, where capital and foreign exchange resources are scare, adequate attention has to be paid to proper deployment of the funds so that these projects which do not assure an adequate return are weeded out from the social point of view.

11.11 ANNEXURE

Main Functions of Development Banks Abroad

Country Name of the Bank	Established in	Main Functions
1. Advanced Countries		
United Kingdom		
Industrial and Commercial Finance Corporation	1945	Providing financial assistance for development and expansion of small & medium enterprises.
Finance Corporation for Industry (FCI)	1945	Providing long term finance for big industrial concerns
Commercial Development Finance Corporation (CDFC)	1953	Providing financial assistance for economic development
United States of America		
Reconstruction Finance Corporation (RFC) (This was dissolved in 1954)	1932	To help the growth of agriculture commence and industry and to induce the small units to maintain economic stability and accelerate output and employment in U.S.A.,
Small Business Administration (SBA)	1954	Providing financial and developmental assistance to small units

Development Credit Corporations (DCC)		Channelising small savings into the Small enterprises.
Canada		
Industrial Development Bank (IDB)	1944	Providing financial assistance to small and medium scale industrial concerns.
Australia		
Commonwealth Development Bank Of Australia (CDBA)	1959	Providing financial assistance to small and medium scale industrial Concerns
Development Refinance Corporation (DRC)	1967	Providing Refinance facilities to trading banks.
Japan		
The Industrial Bank of Japan (IBJ)	1951	Providing long term finance to Industry
The Long Term Credit Bank of of Japan	1952	Long term credit bank system system we created to substitute the The Nippan Credit Bank 1952 under developed capital market in Japan.
Germany		
The Kreditanstalt Fur Widereffan (KW) (Reconstruction Loan Corpn)	1948	Taking care of the financial requirements of German Credit institution and of German Capital and to under developed countries
Industri Kredi Bank AG	1949	Providing medium and long term Finance to small and medium size Enterprise in Gernmany
German Development Company(GDC)	1962	Providing financial assistance to To private enterprises, especially Those which are floated / run with German collaboration.
II. Developing Countries		
Burma		
The Industrial Development Corporation (IDC)	1952	Setting up and encouraging the growth of industries
The Industrial Development Bank of Burma (IDBB)	1952	Burma, Mobilisation of internal / external capital for private industrial development and stimulation of investment share and security markets.

Sri Lanka The Agriculture & Industrial Credit Corporation (AICC)	1943	Providing term loans for the development of agriculture and industrial ventures.
Development Finance Corporation of Sri Lanka (DFCS)	1952	Assist the growth of private enterprise in Sri Lanka
Taiwan China Development Corporation	1959	Providing development finance in the form of term loans, equity, underwriting guarantees etc; to industries.
Iran The Industrial and Mining Development Bank of Iran (IMDBI)	1959	To accelerate the investment of local and foreign capital in industry, mining, transportation etc.,
Iraq The Industrial Bank of Iraq (IBI)	1946	Providing loans, equity capital and development services to industry
Indonesia Bank Pambangunan Indonesia (Development Bank of Indonesia)	1960	To promote and finance such projects in Indonesia as would lead to over all economic growth. It provides finance for agriculture, industry & mining.
Korea The Korean Reconstruction Bank (KRB)	1954	Providing financial aswellas managerial / technical assistance to industry
Laos Credit National Lao (CNL)	1956	To accelerate social and economic growth of Laos through the development of Private / Public Industries, agriculture, crafts, etc...
Malaysia Malaysian Industrial Development Finance Ltd., (MIDFL)	1960	To induce the growth of Malaysian economy's private industrial sector through provision of loans, underwriting facilities and other services.
Nepal The Nepal Industrial Development Bank (NIDB)	1959	Providing financial assistance for the growth of Nepalese industry
Pakistan The Industrial Development Bank of Pakistan (IDBP)	1961	To cater to the credit requirements of medium and creation of a class of entrepreneurs.

Pakistan Industrial Credit & Investment Corporation Ltd., (PICIC)	1957	To accelerate the growth of the industrial sector through the provision of financial assistance to new and existing industries in the private sector.
Pakistan Industrial Development Corporation (PIDC)	1952	To ensure planned and proper growth of large and medium sized industrial enterprises.
Small Industries Corporation (SIC)	1955	To provide financial and developmental services to small industries in Pakistan.
Philippines The Development Bank of the Philippines	1958	To provide financial and developmental services to enterprises in the public and private sectors. It assists agricultural, industrial, mining, public utilities, fisheries enterprises.
National Investment and Development Corporation (NIDC)	1963	To extend assistance to industrial, agricultural and commercial projects.
Private Development Corporation of The Philippines (PDCP)	1963	To assist the growth of private industry through its financial and developmental services. It plays significant role in the metamorphosis of Philippines economy.
Singapore Economic Development Board of Singapore (EDBS)	1961	To assist the economic and industrial growth of Singapore through financing industries and to provide other developmental services.
Thailand The Industrial Finance Corporation of Thailand (IFCT)	1959	To help the growth of Private industry in Thailand
Vietnam Societe Financiere We Development De'L industries Au – Vietnam (SOFIDIV)	1961	Providing long term finance to big and medium sized private industries
Ryukyu The Ryukyu Development Loan Corporation (RDLC)	1959	It is a loan corporation and provides long term loans only to private sector covering industry, agriculture, fisheries, housing, tourism etc.,

Cyprus The Cyprus Development Corporation Ltd., (CDCL)	1959	Developing, encouraging and stimulating productive enterprises in Cyprus, particularly in the fields of manufacturing and industrial processing, mining etc.,
Ethiopia The Development Bank of Ethiopia (DBE)	1951	Providing finance to industry and agriculture
Ghana The National Investment Bank (NIB)	1959	Designed for the growth of Ghanaian Industry, agriculture, commerce etc., It caters to the needs of the both the two sectors.
Nigeria The Nigerian Industrial Development Bank Ltd., (NIDB)	1959	is an instrument for the growth of private sector industry and mining in Nigeria.
Uganda The Uganda Development Corpn, Ltd.,(UDC)	1952	Providing financial and developmental assistance to industry, mining, agriculture, tourism etc.,
Mexico The National Financier of Mexico (NFM)	1934	It has created and financed enterprises, stimulated domestic and foreign capital, regulated the stock market and has acted as an agent of the Government.

11.12 Self Assessment Questions :

1. Discuss the genesis and growth of Development Banking in various countries of the world.
2. Bring out the objectives and types of development banks in the world.
3. Explain the functions of Development Banks.
4. Outline the organisation and Management of Development Banks.
5. Examine the Factors influencing capital structure of Development Banks.

Glossary :

Development Banks : These are the financial agencies engaged for the purpose of providing medium and long term financial assistance to business enterprises in the form of loans, under writing and investments.

Development Functions : They include the promotion of new industries, provision of technical, managerial and administrative consultancy, conducting of techno economic market and investment surveys.

Industrial Finance : Financing of industries to meet their short term, medium term and long term requirements.

Recommended Books :

NP Srinivasan & P. Saravanavel : Development Banking in India & Abroad
Kalyani Publishers, New Delhi.

UNIT – 12 Development Banking in India

(Role, Functions – operational Policies & Practices)

Objectives :

The objectives of this lesson are :

- To trace the evolution of Development Banks in India
- To understand the Role, objectives and functions of Development Banks in India
- To analyse the operational policies and Practices of IFCI, IDBI, ICICI, SIICs, SIDS, SFCS

Structure

12.1 Evolution of Development Banks in India
12.2 Objects of Development Banks
12.3 Role and Functions of Development Banks
12.4 Working & Development Bank
12.5 IFCI
12.6 IDBI
12.7 SIDCs / SIICs
12.8 SFCs
12.9 Summary
12.10 Self Assessment Questions
12.11 Further Readings

12.1 Evolution of Development Banks in India :

The setting up of a network of development banks in India is the post – Independent period constitutes an important land mark in the annals of institutional developments in the country. Soon after independence in 1948, the country found itself faced with the dilemma as the people had the aspirations for a fast rate of economic development and social advancement. The country had a general inadequacy of the basic ingredients of development. The country also suffered from extremely low levels of incomes and savings and the absence of well developed capital market institutions to mobilise whatever savings were available for productive purposes. The entrepreneurship was largely confined to certain communities such as parsis, Marwaris, Vaishyas etc., and there was a death of managerial and technical skills to plan and operate industrial enterprises. The financial and socio-economic structure of the country was also by and large inhibitive of rapid economic progress.

The patriotic elements among the educated Indians, exposed as they were to the developments in the Western world, felt convinced that in the face of meagre savings and an almost complete absence of capital market institutions to almost complete absence of capital market institutions to mobilise the available savings and to channelise the same into productive avenues, the 19th century development bank of the west was the only hope to drag the economy out of the problem of stagnation. Indeed, vigorous attempts were made, first in the wake of the Swadeshi Movement (1906 – 13) and later in the immediate post world war. 1st Period to transplant the German system of Industrial banking on the Indian soil. These attempts unfortunately met with failure for a variety of reasons but they did succeed in underscoring the need and significance of financial institutions as an instrument of rapid industrialisation.

12.1.1 Expert Committee on Industrial Finance :

The question of setting up such institutions was examined by several expert bodies. The first such body was the Indian Industrial Commission appointed in May 1916 under the chairmanship of Sri T.H. Holland. The commission found that the banking system in India was generally inelastic and insufficient to meet the long term financial requirements of industrial development. Accordingly, it recommended the establishment of industrial banks in the country and suggested the appointment of an expert committee to work out the derails. It may be mentioned here that the Indian industrial conference held in Bombay in 1915 had also advocated the establishment of industrial banks. Another committee appointed in 1924 to consider the flow of capital into India had also the occasion to study the availability of capital inside the country. This committee known as the "External Capital Committee" has observed, "India possesses a vast store of dormant capital awaiting development and in order to make this available for investment, banking facilities must be increased and extended". It further emphasised the importance of a specialised system of banking to mobilise the idle resources.

Five years later, the government of India appointed the "Central Banking Enquiry Committee" in July 1929 to investigate into the development of banking in the country. The committee recommended that a provincial corporation with branches if necessary, should be established to supply required finance for development of industries. The committee suggested that the proposed corporation should be a specialised source of long term finance to industries and it may act as an agency of state aid to industries as well. From the evidence produced before the committee, it was clear that a specialised system of banking to finance industries was a common demand. Opinions however, differed with regard to the shape and structure of the institution to be setup. Some advocated an All India Industrial Corporation, other suggested Provincial Industrial Banks and still others, a combination of the two. Although the committee recommended the establishment of provincial corporations, it did not rule out the formation of a central institution. Despite these differences, it goes to the credit of this committee that, it revived the idea of establishing industrial banks which had originated with the Industrial commission.

12.1.2. Creation of Development Banks :

Success in the implementation of programmes for planned industrial development depends, to a large extent, on the availability of adequate financial resources for a wide variety of projects. Since commercial banks in India, patterned on the British model of banking, had traditionally confined themselves to financing working capital requirements of trade and industry. It was felt necessary to setup financial institutions to ensure an adequate flow of assistance to industrial projects. The first step towards building up a structure of development financial institutions was taken with the establishment in the year 1948 of the Industrial Finance Corporation of India (IFCI) with a view to provide medium and long term credit to units in the corporate sector and industrial cooperatives.

In view of the immensity of the task and the vast size of the country it was also decided to set up regional development banks to cater to the needs of small and medium enterprises. In 1951, the Indian Parliament passed the State Financial Corporation Act. Under the Act, the State Governments established State Financial Corporations (SFCs) for their respective regions. By 1955 – 56, 12 SFG were setup and by 1967 – 68, and the number of SFCs in the country has gone up to 18 SFCs grant financial assistance to public limited companies, private limited companies, partnership firms and proprietary concerns. Even as the SFCs were being setup a new corporation was established in 1955 at all India level it was known as the National Small Industries Corporation (NISC), to extend support to small industries. A fully government owned corporation, the NSIC is not primarily a financing institution. It helps small scale industries (SSIs) through various promotional activities - such as assistance in securing orders, marketing the products of SSIs, arranging for supply of machinery under the hire purchase scheme, development of prototypes and training of industrial workers.

The Industrial credit and Investment corporation of India Ltd (ICICI) was setup in 1955 as a joint stock company with support from the government of India, the World Bank, the Common Wealth Development Finance Corporation (CDFC) and other foreign institutions. In 1958, another institution known as the Refinance Corporation for Industry Ltd (RIC) was setup by the RBI, the Life Insurance Corporation of India (LIC) and commercial banks with a view to providing refinance to commecial banks and subsequently to SFCs against term loans granted by them to industrial concerns in the private sector. When the industrial development Bank of India(IDBI) was setup in 1964 as the central coordinating agency in the field of industrial finance, the RCI was merged with it.

Another type of state level institution, namely, the State Industrial Development Corporation (SIDC) was established in the sixties to promote medium scale industrial units. These SIDCs which are owned by the state governments have promoted a number of projects in the joint sector and assisted sector and setup some industrial units as fully owned subsidiaries. In recognition of the crucial role played by them in the promotion of industries in different states, the SIDCs were made eligible for IDBI refinance facilities in 1976. Thus, they became an integral part of the development banking system of the country. The State Small Industries Development Corporation (SSIDCs) were also established to cater to the requirements of industry at the State level by setting up and managing industrial.estates, supplying of raw materials, running common service facilities and supplying machinery on hire purchase basis. Some of the states have also established specialised corporations for the development of infrastructure, agro industries etc.,

An important feature of industrial finance system in the country is the participation of major development banks in consortium financing. The Unit Trust of India was setup in 1964, LIC was setup in 1956, General Insurance Corporation of India established in 1973, work closely with other all India financial institutions to meet the financial requirements of the industrial sector. The Industrial

Reconstruction Corporation of India (IRCI) was setup in 1971 to cater to the financial needs of rehabilitation of sick industrial units, export finance etc., and this has been reconstituted in 1984 as Industrial Reconstruction Bank of India (IRBI). The Export Import Bank of India was setup in 1982 to meet the credit needs of export and import operations in the country.

12.1.3 Featuring of a Development Bank :

Following are the main features of a development bank

- It is a specialised financial institution
- It provides medium and long term finance to business units
- Unlike commercial banks, it does not accept deposits from the public
- It is not just a term lending institution, it is a multipurpose financial institution.
- It is essentially the development oriented bank. Its primary objective is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
- It provides financial assistance not only to the private sector but also to the public sector undertakings.
- It aims at promoting the saving and investment habit in the community.
- It does not compete with the normal channels of finance ie., finance already made available by the banks and other conventional financial institutions. Its major role is a gap-filler ie., to fill up the deficiencies of the existing financial facilities.
- Its move is to serve public interest rather than to make profits. It works in the general interest of the nation.

12.2 Objectives of Development Banks :

The main objective of a development bank is to serve as an agent of development in various sectors namely, industry, agriculture and international trade. Its' first and foremost task is to accelerate the growth of the economy. Other objectives are as follows :

- Rapid Industrialisation
- Provide additional employment opportunities
- Development of Entrepreneurial skills
- Rural Development
- Financing Projects of great importance to the economy.
- Providing finance to medium and large industries
- Achieving balanced regional development
- Promotion of Export and import substitution
- Monitoring sick industrial units and
- Providing technical know how.

12.3 Role and Functions of Development Banks :

The Development Banks have a special role to play and perform various functions in the areas of planning, promoting and developing industries in the economy. Industrial establishments need financial resources for various purposes, viz., for the purpose of setting up of a new industry or for taking up a new project for modernisation, expansion and renovation etc;., Development banks will also coordinate the working of the institutions which are engaged in financing, promoting or developing industries, agriculture and trade etc.,

Following are the functions of development banks

(1) **Sanction of Loans :** The most important function of most of the development banks is to provide long term and medium term loans to industrial concerns. Loans are provided by certain development banks in both local and foreign currencies.

(2) **Underwriting :** Another important function of development banks is to underwrite the issue of shares, bonds or debentures by industrial concerns. Almost all such institutions undertake the function of underwriting.

(3) **Guarantee of Loans :** Most of the development banks assist industrial concerns by providing guarantees of various types i.e., guarantees on behalf of the industrial concerns in respect of (a) the loans raised by them in the open market or from local / foreign financial institutions. (b) the deferred payments due from such concerns arising out of the domestic purchase or import of capital goods. (c) issue of clients, securities etc.,

(4) **Subscribing to the shares and debentures :** In addition to underwriting, the development banks also directly invest by subscribing to the shares and debentures of industrial concerns.

(5) **Development functions :** The other type of functions of development banks are called developmental functions. These functions include the promotion of new industries, provision of technical, managerial and administrative advice and the conducting of techno economic, market and investment surveys.

12.3.1 Managerial Pattern :

The Managerial pattern of the development banks normally depends upon the role of different agencies in their formation, financing and operation. The development banks on the basis of ownership can be classified into different types, viz; wholly state owned, wholly private owned, partly state owned and partly private owned. The government, the central bank and the local and foreign shareholders all nominate their representatives to serve on the Board of Directors of the development banks.

With increasing globalisation and burring of the distinction between different segments of financial intermediaries, F I^s and banks, are developing sound and prudent financial practices for financial stability. Narasimham Committee on Banking Sector reforms has recommended that development financial institutions, over a period of time, should convert themselves into banks and be subjected to the same discipline of regulating and prudential norms as applicable to the commercial banks. The committee further suggested that those DFI^s, which do not become banks would be categorised Non Banking finance companies (NBFCs), the committee also suggested mergers between banks, and DFIs based on synergies, locational and business specific complements. The RBI has issued guidelines for DFIs to become commercial banks. Presently, quite on few financial players which are in various businesses qualify for universal banking. But due to regulatory restrictions, they followed the subsidiary route ot provide all services, ICICI has announced to became a universal commercial bank by proposing a reverse merger with its subsidiary ICICI Bank. IDBI is actively considering different options to transform itself into universal banking. These development banks are set to change the face of development banking as practiced in the past in India.

Table 12.1 - Assistance Sanctioned and Disbursed by all Financial Institutions (AFIs)

(Rs. in Millions)

Year	Sanctions	Growth rate %	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
1991 - 91	191961.0	32.8	128101.0	32.9
1991 - 92	223148.0	16.2	162729.0	27.0
1993 - 93	331933.0	48.8	231525.0	42.3
1993 - 94	331933.0	48.8	231525.0	42.3
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
Cumulative upto end - March 2001	**7729037.1**	--	**5434527.5**	--

12.4 Working of Development Banks in India :

During the last three decades, the term lending institutions operating at the national and regional levels have emerged as a significant source of long term finance in India. Table 1 depicts the aggregate sanctions and disbursements made by the development banks in the country. It can be seen from the Table, that the aggregate assistance sanctioned by these development banks has shown a steady increase over the years. During 1980 – 81, the total sanctions stood at Rs. 29269 million and the disbursements were Rs. 18479 million. Sanctions and disbursements have increased significantly to Rs. 1293377.9 millikon and Rs. 810470.3 million respectively by the year 2000 – 2001. The cumulative sanctions up to the end of March 2001 were Rs. 7729037.1 million and disbursements were Rs. 5434527.3 million.

Co-ordination of Development Banks : At present, the country in served by over 60 development financial institutions in the field of industrial finance. The IDBI co-ordinates the activities of these institutions at the national and state levels. At the national level, the IDBI maintains close working relationship, with other financial institutions in all matters relating to policy formulation, procedural improvements, project appraisal and followup. Such coordination is ensured through the forum of Inter Institutional Meetings (IIMS) and Senior Executive Meetings (SEMs). IIMS are held once a month where the chief executives of all India institutions discuss common policy matters and other issues of mutual concern as also issues concerning specific projects At SEMs which are normally held twice a month, senior executives of all India institutions appoint lead institutions for processing the proposals and consider issues concerning policy mattes and specific projects.

Future of Development Banks in India : Over the years, the Development banks have come to occupy a place of importance in the planning and promotion of industries in the country. Responding to the energing requirements of industrial and economic growth, they have not only continuously increased the flow of assistance, but also developed a coordinated approach towards industrial financing, with in a span of 40 years or so, a wide network of Development banks have been established, some of which have specialised specific areas of development finance. They have also introduced important organisational changes including decentralisation and delegation of powers to their branch offices. Lending procedures have undergone changes in response to energing requirements. As a result, the process of appraisal of project finance proposals as also the sanctioning and disbursal of assistance has become considerable simpler and quicker. Simultaneously, consistent with their role as a catalyst in economic development, the financial institution have been continuously enlarging the scope of their operations from providing financial assistance to identification of industrial opportunities, identification and training of entrepreneurs provision of techno economic consultancy facilities, industrial research and other promotional activities.

The participation and involvement of these banks in the process of economic development can be expected to grow with in years to come as they intensify their efforts at the development of entrepreneurs, backward areas, small industries and export oriented, units as also the upgrading of technology in traditional sectors. The tasks ahead are varied and challenging. Newer demands may not only call for a substantial increase in source mobilisation efforts to keep pace with the growth of the volume of financial assistance but also the reorienting of the policies and priorities for allocation of assistance. Equally important will be the demands for the multifarious promotional and developmental activities.

12.5 Industrial Finance Corporation of India (IFCI) :

12.5.1 Origin and Objective :

After the second world war, most of the industries were in dire need to replace their machinery which had become absolute, depleted and crippled. For this purpose of meeting the needs of repairs, replacement, rehabilitation, the industries looked for sources of finance to provide term loans. When India became free the parliament has passed a bill bringing into existence the first development bank i.e.; Industrial Finance Corporation of India (IFCI) in 1948. It has been established for the purpose of making medium and long term credit available to industrial concerns in India, particularly in circumstances where normal banking accommodation is inappropriate on recourse to capital issue methods is impracticable.

In order to provide greater flexibility in its operations and thereby respond to the changing needs and to provide greater access to capital market, the constitution of IFCI was changed from a statutory corporation to a company under the companies Act 1956, IFCI was incorporated as IFCI Ltd in May 1993. The entire operations, assets, liabilities and business of erstwhile IFCI were transferred to the company in July 1993.

12.5.2 Functions of IFCI :

Following the functions of IFCI

- It sanctions loans and advances to industrial units and also subscribes to the debentures issued by them, provided they are repayable with in 35 years from the date of issue.
- It guarantees loans floated by the industrial concerns in the open market, provided they are repayable with 25 years.
- It under writes the issue of stocks, shares, bonds and debentures floated by the industrial concerns.
- It can subscribe directly to the stocks and shares of industrial units.
- It can sanction loans and advances to public limited companies and co-operative societies, but not a private limited company or a partnership firm.
- It can grant only medium and long term assistance to industrial units.
- The credit assistance is given by the corporation either in Rupee currency or in foreign currency in the areas of manufacturing, shipping, mining and electricity generation etc.,
- The corporation also guarantees deferred payments in respect of machinery imported from abroad or purchased with in the country.
- It guarantees foreign loans raised by industrial concerns in foreign currencies in foreign markets or loans obtained from scheduled commercial banks with in the country.
- The corporation also provides for projects financing and related financial services. In recent years, it has extended its scope of activities to promotional services which include funds support for technical consultancy, risk capital, venture capital and technology development.

12.5.3 Resources of IFCI :

The authorised capital of IFCI is Rs. 500 million which may be raised to a maximum of Rs. 1000 million or as may be fixed by the government of India from time to time. As in Sep 1983, the paid up capital of IFCI stood at Rs 250 million of which, 50% was held by IDBI, 20% by scheduled banks, 21.4% by insurance companies, investment trusts and others like financial institutions and the balance 8.6% by co-operative banks. Apart from the paid up capital, reserves built up out of profits constitute an important source of funds. The major source of rupee funds for IFCI's operations has been market borrowings by way of bond issues which carry government's guarantee with regard to their repayment and payment of interest thereon. By the end of March 31, 2001 the paid up share capital of the IFCI stood at Rs. 198795 million and reserves to the extent of Rs. 5051.4 million. The borrowings from RBI and other agencies stood at Rs. 199668 million.

IFCI's foreign currency resources comprise loans from Kreditanstalt fur Wiederauffau (KFW), West Germany, loans from the Agency for International Development, USA and 'Equipment Credit' from Banque Francaise due commence Exterieur, France (BFCE). Another source of funds is the allocation made by the government of India under the UK. India capital Investment loans / grants and Indo-Swedish development corporation agreements.

12.5.4 Management of IFCI :

The management of the IFCI is entrusted to a Board of directors comprising 13 members including the chairman. The chairman is appointed by the government of India after consulting IDBI. The Chairman works on a whole time basis and his term of office is 3 years which may be extended by the government. Out of the remaining 12 directors, 4 are nominated by the IDBI, 2 by the Union Government, 2 by scheduled banks, 2 by cooperative banks, and the remaining 2 by other financial institutions like Insurance companies and other financial institutions. It has been the practice of IDBI to have three outside nominees who are experts in the field of industry, labour and economics. The fourth nominee is the central manager of the IDBI. It is evident from the composition of the Board of the IFCI that majority of the Board members (7 out of the 13 members) are nominated by the central government and the IDBI. This is one of the major factors which has influenced the operational strategy of the corporation. The directors nominated by banks and Insurance companies etc., hold office for a term of four years. The Board meets once in a month and it is supposed to act on business principles and shall have due regard for the interests of industry, commerce and general public.

12.5.5 Operational Policies and Practices :

The IFCI has laid down the following policies with respect to the sanction, disbursement and recovery of assistance provided by it.

(1) Policy on Magnitude of Assistance : The corporation's policy is to cater to the needs of medium and large sized projects, either singly or jointly with other all India financial institutions like the IDBI, ICICI, UTI, LIC and GIC. Where the assistance required is in nature of rupee loans only, the IFCI ordinarily entertains applications from those eligible industrial concerns whose project cost is more than Rs. 2 crores. Projects costing over Rs. 2 crores may be considered by the IFCI independently; In case it feels that the financial participation of some other institution ina project cosing of Rs. 2 crores to Rs. 3 crores will be desirable, the IFCI arranged such participation itself by contacting the other institutions and finance the project under consortium financing by acting as lead institution. The endeavour of all India financial institutions is to ensure that as far possible, an applicant concern should deal with only one institution for the appraisal of the project, the disbursement of funds and post sanction follow up. In 1992, the public financial institutions liberalised the consortium lending arrangement by permitting individual institutions to fund projects up to a maximum cost of Rs. 50 crores.

(2) Policy Regarding the purpose of the loan : IFCI has made it a policy to render financial support for setting up new projects, expansion and diversification of existing projects, modernisation programmes are for meeting the part of project cost and for rehabilitation etc., In 1994, IFCI decided to enter for the first time in short term financing activity by deploying a certain portion of its funds for financing working capital needs of corporates.

(3) Policy on Duration of Assistance : The maximum period for which assistance may be provided by the corporation has been fixed under the IFCI Act. Under this Act, the corporation is authorised to grant loans repayable within period not exceeding 25 years, and underwrite the issue of stock, bonds or debentures by industrial concerns, subject to their disposal by the corporation with in a period of seven years.

(4) Policy on Bridging Loans : The IFCI together with IDBI and ICICI, has been operating a scheme of granting bridging loans to such borrowers as have been sanctioned loans but are not in a position to create a substantive security immediately for the loans urgently required by them. Under the scheme, loans ranging between 75% and 90% of the sanctioned loans are granted against the execution of regular loan agreements or bridging loan agreements and hypothecation of machinery and other movable assets etc., subsequently, public issue of shares was introduced at a concessional rate of interest of 10% per annum.

(5) Interest Rate Policy : The IFCI follows a subsidised interest rate policy under which, it charges a lower interest rate to its borrowers. The normal rate of interest charged by the corporation is 14% per annum. This is in contrast with the market rate of interest, which is between 15 and 18%. The underlying idea behind this policy is to assist relatively weaker business entrepreneurs who are not in a position to secure funds from the existing normal channels. Besides, the corporation pushes a differential interest policy in that, it charges different interest rates for rupee and foreign currency loans.

(6) Policy Regarding Convertibility : Following the government guidelines in 1971, the IFCI reserved the right of convession of a part of the rupee loans extended by it into the equity capital of the assisted concerns in cases where the aggregate financial assistance exceeded Rs. 25 Lakhs. It was mandatory when such assistance exceeded Rs. 50 Lakhs. Wherever, the convertibility clause was utilised, the terms and conditions relating to the conversion of the loan into equity were negotiated and settled with the assisted concerns in advance. With the governments' decision, the convertibility change will apply to financial assistance exceeding Rs. 1 crore instead of Rs. 50 Lakhs.

(7) Policy Relating to Entrepreneurs and Technologies : The IFCI has formulated a specific policy of encouraging new entrepreneurs and technologists to set up industries so as to fill in the gaps in the institutional infrastructure for the promotion and growth of industries, or to provide guidance and training to new entrepreneurs particularly those, who are entering in the field of times, small scale, medium, large scale industry. Following are the several schemes introduced to help the entrepreneurs.

(i) Technical Consultancy Organisation (TCOs) : All India financial institutions including (IFCI) have sponsored the TCOs in association with the state level institutions and banks to provide the necessary impetus, in particular to the rapid industrialisation of less developed regions. The basic idea underlying the creation of the Tcos is to provide guidance and advice to new entrepreneurs during various phases of the project cycles, namely, project identification, project formulation, project implementation and project operation, so that the project undertaken is brought to a state of fruition. These TCOs are now reasonably well equipped with information and data and expertise in different disciplines. Often, TCOs organise entrepreneurial development programmes for the benefit of small entrepreneurs.

(ii) Risk Capital Scheme : In 1975, the corporation decided to sponsor the Risk Capital Foundation (RCF) with a view to providing special assistance to new entrepreneurs particularly technologists and professionals for the promotion of medium sized industrial projects. The assistance is provided to entrepreneurs by way of interest free personal loans on soft terms to enable them to meet a part of the promoter's contribution to the equity capital of the projects promoted by them and for which financial assistance has been sanctioned by one of the all India term lending institutions viz; IFCI, IDBI or ICICI singly or jointly. The personal loan granted by the RCF is normally limited to 50% of promoter's contribution to the equity of the project, subject to an upper limit for a single project of Rs. 10 lakhs where there is only one promoter and Rs. 10 lakhs where there are two or more promoters.

(iii) Promotional Schemes : To give importance to industries in the rural, cottage, tiny and small scale sectors including the much needed guidance in modernisation, market research, marketing assistance, control of pollution etc., IFCI introduced several promotional schemes. Steps are being taken to promote technological research and development (R&D) in the industries and improving the productivity of material and human resources. Emphasis is being given to women entrepreneurs and entrepreneurs belonging to weaker section of the society.

8. **Policy Relating Backward Area Development :** In line with the government's policy of reducing regional imbalances, the IFCI has followed a policy of fostering industrial growth in less developed states and areas. As part of its policy, the corporation offered in 1970, a package of concession to new projects in such areas. In 1972, similar concessions were extended for the expansion of projects. The main features of the scheme are concession in the rate of interest (12.5% as against the basic lending rate of 14%), longer grace period (5 years against 3 years), reduced margin of security, lower contribution by the promoters to the cost of the project, larger participation by the corporation in the equity and preference capital of assisted projects and a 50% reduction in its normal service charges in respect of commitment charge, underwriting commission and legal charges.

9. **Consultancy Fee and Interest Subsidy Schemes** : The Corporation has introduced the following schemes for the benefit of the entrepreneurs.

- Scheme of subsidy to new entrepreneurs for meeting cost of market research / surveys (1977)
- Scheme of subsidy to small entrepreneurs in the Rural, cottage, tiny and small scale sectors for meeting cost of feasibility studies (1978)
- Scheme of subsidy for promotion of Ancillary and small scale industries (1978)
- Scheme of subsidy for revival of sick units in the tiny and small scale sectors (1982)
- Scheme of subsidy for control of pollution in the small and medium scale industrial units (1985)
- Scheme of interest subsidy for encouraging the adoption of Indigenous Technology (1977)
- Scheme of Interest subsidy for self development and self employment of unemployed young persons (1982)
- Scheme of interest subsidy for women entrepreneurs (1985)
- Scheme of interest subsidy for encouraging quality control measures in small scale sector (1986)

12.5.6 Parameters for the grant of financial assistance :

As all the industrial projects seeking assistance are in the nature of business risks. Some of the basic parameters in relation to the appraisal of the projects are as under :

(i) Promoters capability and competence
(ii) Project preparation
(iii) Liability of the project
(iv) Project Appraisal – Technical Aspects
(v) Project Appraisal – Financial Aspects
(vi) Debt Equity Ratio not to be higher than 2:1
(vii) Promoter's contribution
(viii) Project Appraisal - Commercial Aspects
(ix) Project Appraisal – Ecological Aspects
(x) Project Appraisal – Economic Aspects
(xi) Project Appraisal – Social and other related aspects

Management Development Institute : With a view to developing and improving the quality of day to day management , which is so crucial for the success of any industrial venture, IFCI setup in 1973 the "Management Development Institute" (MDI) which has now its own campus near Delhi. The Institute which is an autonomous body, seeks to fulfil the needs of industry in the field of management development and research in an effort to promote the application of management science generally to industrial concerns. MDI's various programmes have been helping technocrats and entrepreneurs in running their enterprises on sound business lines, in maintaining reasonably good professional standards as also in developing the managerial skills in various areas of functional management in their respective fields of industry.

12.5.7 Critical Evaluation :

The IFCI completed 54 years by 2002. During this period, the corporation as a pioneer in the field of long term industrial financing played an effective role. The loans sanctioned and disbursements made during this period are given in the Table 2. By the end of March 2001, the cumulative sanctions and disbursements aggregated to Rs 435670 million and Rs. 412840 million respectively. The assistance given by the IFCI in the early years after its establishment was conferred to traditional industries like sugar, textiles, Jute etc., But subsequently, in pursuance of the national priorities and objectives, the IFCI has extended considerable assistance in recent years to non-traditional industries like basic metals, fertilisers, chemicals and a wide range of engineering industries. As a matter of policy, the IFCI has been paying particular attention to projects promoted by new entrepreneurs / technician entrepreneurs with a view to enlarging the entrepreneurial base of the country.

The IFCI Act has of late, removed all limitations on its borrowings. The enlarged scope and extension of activities also enable the IFCI to participate in most of the activities which IDBI, as an apex institution, is authorised to undertake.

Table :: 12.2

(Rs. Million)

Year	Sanctions	Disbursements	Disbursements as % of sanctions
1964 – 65	30.36	28.27	93.1
1965 – 66	33.98	44.28	130.3
1966 – 67	23.11	40.35	174.6
1967 – 68	18.40	32.14	174.7
1968 – 69	21.00	21.25	101.2
1969 – 70	17.03	18.06	106.0
1970 – 71	323.0	174.0	53.8
1971 – 72	287.0	233.0	81.2
1972 – 73	457.0	280.0	61.3
1973 – 74	419.0	319.0	76.1
1974 – 75	292.0	370.0	126.7
1975 – 76	513.0	347.0	67.6
1976 – 77	766.0	549.0	71.7
1977 – 78	1134.0	575.0	50.7
1978 – 79	1385.0	735.0	53.0
1979 – 80	1379.0	910.0	65.9

1980 – 81	2066.0	1089.0	52.7
1981 – 82	2181.0	1694.0	77.6
1982 – 83	2302.0	1961.0	85.2
1983 – 84	3219.0	2245.0	69.7
1984 – 85	4154.0	2729.0	65.7
1985 – 86	4992.0	4039.0	80.9
1986 – 87	7981.0	4516.0	56.6
1987 – 88	9226.0	6571.0	71.2
1988 – 89	16355.0	9975.0	60.9
1989 – 90	18170.0	11218.0	61.2
1990 – 91	24298.0	15743.0	64.5
1991 – 92	24212.0	16044.0	66.3
1992 – 93	23479.0	17334.0	73.8
1993 – 94	37459.0	21631.0	57.7
1994 – 95	43270.0	28387.0	65.6
1995 – 96	65797.1	45865.2	69.7
1996 – 97	39522.3	51755.3	130.9
1997 – 98	57215.3	56531.7	98.8
1998 – 99	38721.1	48935.1	126.4
1999 – 2000	21392.0	33312.7	155.7
2000 – 2001	18664.1	21289.0	114.1
Cumulative up to end – March – 2001	**435669.8**	**12839.8**	**94.7**

The Corporation was also diversifying its activities in the field of merchant banking to provide additional financial services to the industrial concerns. The IFCI has now been converted into a company under the Indian Companies Act 1956.

The working of IFCI has been subjected to criticism on several grounds – It is pointed out that the credit assistance granted to industries has not been adequate, taking into account their total requirements of finance. The corporation cannot be blamed for it because, the financial resources at its disposal are meagre considering the massive requirements of Indian industries. The corporation has invested over 50% of its financial resources in traditional industries like sugar, cement, jute, cotton textiles etc., If the corporation is to make a real contribution to India's industrial development, it should increase its financial assistance to non-traditional industries such as synthetic fibres, fertilisers etc., It can be further pointed out that IFCI has been charging rather high rate of interest as credit assistance extended in industries.

12.6 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI) :

12.6.1 Origin and Objectives :

The multiplicity of financial institutions in Indian Capital market operating in the same field with hardly any demarcation of their specific activities led to the overlapping and duplication in the efforts of financial institutions with the result that financially well off concerns could manage to procure financial assistance from a number of institutions while weaker industries were left and dry. Coordination of functions and working of existing financial institutions was therefore, necessary so that they may play a more useful role in the industrial development of the country. Many gigantic projects of national importance remained held up due to the absence of adequate financial arrangements. It was beyond the means industrial financial institutions to finance these projects because of tidy amount of their capital requirements. Further, a large number of industrial projects were envisaged to be set up during the fourth and succeeding plans to achieve self sufficiency in industrial sector and this required substantially large amounts of capital provision for which the existing financial institutions, was not possible in view of their limited resources.

Therefore, establishing a financial institution with substantially large amount of resources and capable of functioning undeterred by statutory rigidities for establishing proper relation among the existing financial institutions and fostering industrial development in the country became inevitable. The answer was the establishment of Industrial Development Bank of India in July 1964, as a wholly owned subsidiary of Reserve Bank of India. It was designed as an apex body to

- Co-ordinate the activities of other financial institutions.
- Furnish direct or indirect term finance to industry
- Keep in view both the needs of the industry and requirements of the economy

It was designed as an agency to take up systematic co-ordination of the activities of various financial institutions, demarcate their sphere of operations and help them channel the financial resources into the priority areas. Until February 1976, the IDBI continued as subsidiary of the RBI. Since 1976, it has been an autonomous corporation fully owned by the government of India.

12.6.2 Functions of IDBI :

The over all activities of IDBI can be classified into three broad areas namely, coordinating, Financing and Promotional.

1. **Coordinating Function** . As a coordinator, the IDBI coordinates functions and operations of all the financial institutions including IFCI, ICICI LIC, UTI into a single integrated financial structure so that each might contribute to the total efforts as it could.

2. **Financing Functions :** As an industrial financier, the IDBI would assist all deserving projects regardless of their size which are experiencing problems in assembling funds from normal channels. The IDBI's endeavour in this regard is to ensure that no worth while project, however small, is allowed to languish for insufficiency of institutional support. IDBI can assist a project directly and indirectly. As direct financier, it can assist industrial concerns in the following ways.

(i) Granting term loans

(ii) Subscribing to or underwriting of the issue of shares and debentures.

(iii) Guaranteeing deferred payments due from industrial concern to third parties and other financial institutions.

As indirect financier, the IDBI assistance can take the following forms :

(i) Refinancing of industrial loans provided by commercial banks and other financial institutions.

(ii) Providing financial assistance to other financial institutions by way of subscribing to their shares and debentures.

(iii) Rediscounting of bills arising out of sales of indigenous machinery on deferred payment basis.

3. **Promotional Function :** In its role as the apex development bank of the country, the IDBI undertakes a variety of promotional activities for achieving the socio-economic objectives. Such activities relate mainly to balanced regional development (BRD), creation of new class of entrepreneurs and improvements in formulation, appraisal and implementation of projects. For these purposes, IDBI sponsors industrial potential surveys, entrepreneurship development programmes and programmes for training of personnel of development banks. It is also authorised to perform promotional activities for bringing about liable industrial development especially in the less developed areas.

12.6.3 Resources of IDBI :

The authorised capital of the Bank is Rs. 4000 million. At the end of March 2001, the paid up capital was Rs. 6528 million. During 2000 – 2001, IDBI mobilised Rs. 88419 million (Rs. 91870 million) by way of rupee and foreign currency borrowings. Rupee resources aggregating Rs. 78168 million comprised omni Bonds – on tap (Rs. 31,220 million) omni private placement (Rs. 11978 million), certificate of deposit (Rs. 15417 million), flexible series 9 and 10 (Rs. 11610 million) fixed deposits (Rs. 1473 million), capital going bonds (Rs. 1035 million), term money bonds (Rs. 136 million) and ICDS (Rs. 5299 million). Rupee resources raised during 2000 - 2001 were less by 8% as compared to previous year (Rs. 85000 million).

The incremental cost of rupee borrowings declined from 12.14% in 1999 – 2000 to 11.21% in 2000 – 01 due to declining interest rate regime as also the lower maturity profile of funds raised. IDBI borrowed in the short term segment through ICDS to take advantage of softer interest rates and to maintain a more balanced asset liability portfolio. FC borrowings including drawls under existing lines of credit aggregate Rs. 10250 million(Rs. 6870 million last year). During 2000 – 2001, IDBI contracted foreign currency borrowings through floating rate note and syndicated loan with Standard Chartered Bank, Tokyo, Mitsubishi International Ltd., and Sumitomo Bank, Japan.

12.6.4 Management and Organisation :

The management of the IDBI is vested in a Board of Directors consisting of 22 persons including a full time Chairman – cum – Managing Director appointed by the Government of India.

The other Board members comprise a representative of the RBI, 2 officials of the central government, a representative each of the all India financial institutions, 3 representatives each of the public sector banks and SFCs and 5 persons with special knowledge and professional experience of industry. The Board has constituted an executive committee consisting of ten directors including the chairman and managing director. The Board of Directors deals with the over all policy matters and the Executive committee with proposals for the sanctions of financial assistance and other matters.

The IDBI has formed a panel of Technical advisers and consultants by drawing upon experts from various sectors of industry. Adhoc Advisory committees are constituted for various projects and members of the committees are drawn from the panel. The adhoc committee is charged with the responsibility of reviewing the project appraisal report before it is placed before the executive committee and offering suggestions wherever necessary. It is the experts on such committees who are found to posses the required technical and financial acumen to assess the desirability of projects.

12.6.5 Regional and Branch Offices :

IDBI with its headquarters at Mumbai has setup five regional offices at Calcutta (Eastern Region), Chennai (Southern Region), New Delhi (Northern Region), Ahmedabad (Western Region) and Guwahati (North Eastern Region) and Brach offices at Bangalore, Bhopal, Bhubaneswar, Chandigarh, Cochin, Hyderabad, Vijayawada, Jaipur, Jammu, Kanpur, Patna and Simla. The Regional offices are empowered to sanction all rediscounting and refinance assistance and direct assistance upto Rs. 50 lakhs where no other all India financial institution is involved. The Branch office can give refinance and bill rediscounting assistance up to Rs. 10 Lakhs.

12.6.6 Operational Policies and Activities of IDBI :

IDBI performs two types of activities viz; Financial and Developmental. The first caegory can be further sub divided into (I) Direct Financial assistance and (ii) Indirect Financial Assistance.

(1) **Projects to be Assisted** : The IDBI has pursued the policy of assisting the industrial units which were established as public limited companies in the private, joint, public and cooperative sectors. It concentrates on projects involving a large capital outlay or sophisticated technology and promoted by technician – entrepreneurs located in less developed areas of the country. The IDBI assistance is usually granted to new projects as well as for the expansion, modernisation or renovation of existing units. The amendment of IDBI Act which came into force with effect from August 1986, has enlarged the definition of industrial concern to cover diverse range of industrial activities including the services sector industries like informatics, health care, storage and distribution of energy and other services contributing to value addition. It has also widened the possible scope of business of IDBI by addition of such activities or consultancv, merchant banking and trusteeship activities.

(2) **Policy of underwriting / Direct Subscription :** The IDBI underwrites the public issues of shares, bonds etc., made by the industrial concerns. It provides financial assistance to industrial units though direct subscription to the public issues. This mode of financing is adopted to safeguard the interest of smaller units promoted by technicians or professionals with limited resources.

(3) Guarantees for loans and deferred payments : IDBI guarantees deferred payments due from the industrial units and loans raised by the industrial units. The purpose of this facility is to instil confidence in the minds of the lenders which may include banks, other financial institutions.

(4) Refinance of Industrial Loans : This function was earlier performed by Refinancing Corporation of India (RCI) which was set up in 1958. When IDBI was set up refinance activity was entrusted to the Apex body and the RCI was closed, under the scheme, the IDBI provides refinance facility to State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs), commercial and cooperative banks in respect of loans given by them to industrial establishments.

Each financial institutions is eligible to refinance facility to the extent of three times of its capital and reserves. Generally IDBI refinances 75% to 80% of the original loan. But in the case of small scale units, small transport operators and units in the backward areas of 90% of the loan is refinanced.

Automatic refinance scheme for loans below Rs. 7.5 lakhs, equipment refinance scheme in respect of small and medium scale units up to Rs. 1 crore, foreign currency refinance schemes are various refinance facilities offered by IDBI. Refinance is available in respect of composite loans to artisans, cottage and village industries, to units promoted by persons belonging to SC / STs to small scale industries and to projects located in backward areas.

(5) Policy on Duration of Assistance : The direct loans granted by IDBI are normally repayable over a period of 8 to 10 years after a grace period of 2 to 3 years. The period of loans eligible for refinance is up to 7 years for scheduled banks and State cooperative banks and up to 10 years for the SFCs.

(6) Policy on Security and Margin : Although the status of the IDBI have not prescribed the nature and type of security that it may accept when making the loans, the management has adopted a security policy similar to that of IFCI and ICICI. It requires that loans should be secured by a first equitable mortgage of the borrower's fixed properties and a hypothecation of all movables. Regarding the margin requirements it follows a policy of uniform margin requirement of 50%: but it relaxes this limit in certain cases.

(7) Bill Financing (Rediscounting / Discounting) : This facility is introduced in order to give a boost to the capital goods industries which make and sell plants, machinery etc., This facility helps a machine manufacturer to offer the sale of machinery on deferred payment basis. The period of deferrment could be between 2 – 5 years. Under this, sanctions are made to State Electricity Boards (SEBs) and State Road Transport Corporations (SRTCs). The maximum limit for rediscounting of the bills which was limited to Rs. 3 Lakhs has been removed with effect from July, 1985.

(8) Interest Rate Policy : Until recently, the IDBI adopted a uniform as well as a differential interest rate policy. The interest rate charged by the Bank was uniform because it was the same for all the categories of borrowers, irrespective of their credit standing and the risks involved in extending the financing facility to them. These rates were also differential because there was no uniformity in the rates interest charged for rupee and foreign currency loans, for loans given under the soft loan scheme, the loans to units in developed and backward areas and refinance loans to different institutions.

Following the recommendations of the Narasimham Committee regarding deregulation of interest rates so as to reflect emerging market condition. IDBI decided to adopt variable interest rate policy from December 15, 1993 in addition to the fixed rates in vogue now. The variable interest rate would be on the basis of percentage points over the "long term prime lending rate' (LTPR) which will be determined by the Bank periodically.

Other Financial / Developmental Functions :

(1) Policy on Modernisation of Industries : With a view to facilitating modernisation, renovation and technological up-gradation of industrial units so as to achieve higher and more economic levels of production, IDBI introduced a scheme in Nov, 1976. Since 1984, Soft loan scheme for Modernisation was introduced to cover all industries. This scheme helps in the replacement of plant and machinery where rate of technology obsolescence is very high and Technology up gradation scheme helps capital goods industries to introduce advanced technology when the existing technology becomes outdated.

(2) Policy on Backwards Areas Development : The IDBI right from its inception, decided to foster industrial development in the backward areas of the country with a view to bringing about regionally well balanced growth of the country. As part of its policy, the management introduced certain specific schemes of financial assistance. These schemes are as follows.

(i) Concessional Direct Financial Assistance

(ii) Concessional Refinance Scheme

(iii) Special Concession to North Eastern Areas under Bills Rediscounting Scheme

(3) Promotion of Industries Through Seed Capital Scheme : IDBI encourages the establishment of industrial units by providing the seed capital. Before a unit goes for public issue of shares and debentures, the promoters of a company may have to mobilise funds to float a company. For example, a technician entrepreneur, who needs the initial capital may approach the IDBI for seed capital. Generally, this seed capital is repayable when the company goes for public issue.

(4) Consortium finance : Projects which need heavy capital with high project costs are assisted by consortium with other development banks. Recently, IDBI in its attempt to coordinate the activities of the other institutions, has evolved a consortium financing approach, under which a system of common appraisal has been devised. Under this system, the entrepreneurs are required to submit the applications on a common application form to only one of these institutions. The institutions will then appoint one of them as the lead institution which will process, sanctions, disburse and recover the loans.

Under the consortium approach, projects with capital cost up to Rs. 2 crores are expected to be financed by the state level financial institutions and banks and if necessary with the participation from the initial stage of IFCI and ICICI. The projects with capital cost up to Rs. 5 crores can be processed either by IFCI or ICICI, individually or jointly in participation with state level financial institutions and banks. Further, projects costing up to Rs. 10 crores are now considered under the newly introduced scheme of "Projects Financing Participation Certificate". The institutions involved, adopt a uniform interest rate policy. Rate of interest is uniform irrespective of the credit standing of the borrower and risk involved.

(5) **Soft Loan Scheme :** The IDBI provides soft loans on Concessional terms to all types of industries for modernisation, renovation and technological up-gradation. The terms are relaxed in regard to :

- Rate of Interest
- Promoter's contribution
- Debt – Equity Ratio
- Repayment Period
- Initial Moratorium etc.,

Assistance is also provided to industrial units for the replacement of plant and equipment which have been in use for less than 10 years where the rate of technological obsolescence is high.

(6) **Venture Capital (Risk Capital) :** IDBI provides risk capital assistance to projects promoted by technocrats / professional entrepreneurs setting to introduce an innovative product / service in the Indian market. It has expanded the scope of its venture capital scheme to include a wider spectrum of projects. Both new technology and new products and processes with or high elementary risk and high potential returns are covered.

Cumulative Assistance by IDBI :

The progress of IDBI has been spectacular in whole of the period of its existence but particularly so in recent years. The cumulative assistance sanctioned by IDBI till the end of March 1997 aggregated Rs. 1, 39, 010 crores. In fact, it is almost equal to the amount of financial assistance provided by all other special industrial financing institutions taken together. The amount of assistance disbursed by IDBI till the end of March 1997, from the date of establishment, totalled Rs. 92856 crores. During 1997 – 98, assistance sanctioned and disbursed by IDBI stood at Rs. 24199 crores and Rs. 15165 crores respectively.

IDBI as a Merchant Banker :

In the first year of operations, the Merchant Banking Division (MBD) of the Bank has managed 12 public and 23 rights issues aggregating Rs. 1450 crores and Rs. 3337 crores respectively. In the second year of its merchant banking operations, the Bank entered into the area of mergers and amalamgamations loan syndications and private placements with foreign institutional investors and Mutual Funds. Issue management, however, remained through area of the Bank's merchant banking operations. It also advised the government on disinvestment in select public sector enterprises.

The bank managed 77 rights issues for mobilising Rs. 7306 crores; these include mega issues of Reliance Petroleum Ltd and State Bank of India. The Bank has so far successfully managed 118 rights and public issues for mobilising Rs. 12341 crores from the capital market.

IDBI Mutual Fund : So as to exploit opportunities arising out of the financial sector reforms leading to expansion of capital market and the surge in the growth of domestic investors, IDBI in 1994 launched IDBI Mutual Fund a close ended scheme with a safety net and the facility of buying back units at Net Asset Value (NAV) without any discount. The scheme is designed to cater to small individual investors.

Debenture Trusteeship : The IDBI has also started rendering debenture trusteeship service 1992 – 93. During the past two years, it has accepted 67 debenture trusteeship assignments in respect of non-convertible debentures, partly convertible debentures, fully convertible debentures and bond issues.

12.6.6 Working Performance of IDBI :

Loans Sanctioned : The IDBI completed 39 years by 2003. The trends in assistance sanctioned and disbursed during 1964 – 2001 can be seen from the Table 3. The cumulative sanctions at the end of March 2001, stood at Rs. 2231343 million, the disbursements Rs. 1523921 million respectively. Sanctions under direct finance, constituting 95.1% of over all sanctions, increased by 9.2% to Rs. 273035 million as compared to a growth of 19.2% in 1999 - 2000. While sanctions under project finance, constituting 45.9% of total sanctions declining marginally by 0.3% to Rs. 131919 million, sanctions under non project finance, constituting 49.25% of the total sanctions, grew by 19.9% to Rs. 141116 million. Sanctions of rupee loans under project finance declined by 1.1% to Rs. 81265 million, where as sanctions of foreign currency loans declined significantly by 52.3% to Rs. 15535 million. Under writing and direct subscription to equity / debt instruments increased by 96.6% to Rs. 11533 million during 2000 – 2001 from Rs. 5867 million in the previous year. The increase is attributable to investments made in electricity generation and telecom industry. Assistance by way of guarantees nearly doubled to Rs. 23586 million during 2000 – 01 from Rs. 11763 million sanctioned in 1999 – 2000.

Sector wise Assistance : Sector wise assistance sanctioned to private sector projects accounted for well over 3/4ths of the cumulative sanctions. During 2000 – 2001, private sector accounted for 67% of the total sanctions, followed by public sector (30.7%) and joint sector (1.9%). Sanctions to cooperative sector recorded manifold increase as compared to a decline of 99.1% in the previous year, followed by public sector (44.6%). While sanctions to private sector declined marginally by 0.1% as against a growth of 5.3% in 1999 – 2000, joint sector recorded a decline of 57.6% over a decline of 1.3% in the previous year.

The IDBI has been extending concessional assistance to new units set-up in specified backward districts / areas. The assistance to units in backward areas expanded rapidly during the last 20 years of IDBI's operations. The IDBI also extends assistance to the small-scale sector on priority basis comprising small scale industries and small road transport operators. Such assistance is granted mainly through the scheme of refinance of industrial loans and, to some extent, through the bills rediscounting scheme.

Under the Energy Conservation Scheme, the IDBI focuses on proposals which result in substantial energy savings requiring commensurate investment. IDBI took the lead in setting up of 'National Stock Exchange' (NSE) with equity participation by financial institutions and banks. It has also promoted investors services Ltd., (ISL), a company providing share registry services and acting as a transfer agent.

Table :: 12. 3

ASSISTANCE SANCTIONED & DISBURSED BY IDBI

(Rs. Million)

Year	Sanctions	Growth rate %	Disbursements	Growth Rate %
1964 – 65	3473.0	—	3015.4	—
1970 – 75	9170.2	—	6553.0	—
1975 – 80	41404.1	—	29196.7	—
1980 – 81	16915.6	—	12586.0	—
1981 – 82	17789.4	5.2	15043.1	19.5
1982 – 83	19259.6	8.3	15950.1	6.0
1983 – 84	23942.7	24.3	19763.1	23.9
1984 – 85	33712.0	40.8	21887.5	10.7
1985 – 86	36603.9	8.6	27978.6	27.8
1986 – 87	45875.5	25.3	32590.4	16.5
1987 – 88	53024.9	15.6	40043.4	22.9
1988 – 89	44084.1	-16.9	33824.0	-15.5
1989 – 90	73248.2	66.2	51241.9	51.5
1990 – 91	62778.5	-14.3	44985.4	-12.2
1991 – 92	65699.4	4.7	57796.2	28.5
1992 – 93	93451.7	42.2	67373.7	16.6
1993 – 94	122148.8	30.7	81140.6	20.4
1994 – 95	183945.3	50.6	106808.3	31.6
1995 – 96	159846.8	-13.1	107207.6	0.4
1996 – 97	139934.6	-12.5	114831.0	7.1
1997 – 98	220827.9	57.8	151699.3	32.1
1998 – 99	218289.3	-1.1	144700.7	-4.6
1999 – 2000	269664.5	23.5	170594.3	17.9
2000 – 01	287111.0	6.5	174983.1	2.6
Cumulative upto end - March 2001	**2231343.3**	—	**1523920.7**	—

12.7 State Industrial Development Corporations (Sidcs) Or State Industrial Investment Corporations (Siics)

12.7.1 Origin & Establishment :

Many states in the country have established State Industrial Development as well as State Industrial Investment Corporations during 1960's as in order to accelerate the tempo of industrial growth in various parts of the country. They were set up as wholly owned state government undertakings for promotion and development of medium and large industries. They came into being joint stock companies and autonomous corporations established under specific state acts. This arrangement brings a certain amount of operations flexibility to the corporations in conducting their affairs. At present, there are 28 SIDCs in the country. The SIDCs and SIDCs located in the Andaman & Nicobar, Arunachal Pradesh, Daman & Diu, Dadra and Nagar Haveli, Goa, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Pondichhery and Sikkim also act as SFCs to provide assistance to small and medium enterprises and act as promotional agencies for this sector.

12.7.2 Objectives of SIDCs :

The main objective of SIDCs is to act as catalytic agents for industrial development in their respective prates. SIDCs or SIICS provide financial assistance to industrial units by way of term loans, underwriting and direct subscriptions to shares / debentures and guarantees. They also undertake a variety of promotional activities like preparation of feasibility reports, industrial potential surveys, entrepreneurship development programmes and developing industrial esrates / areas. SIDCs are also engaged in setting up medium and large industrial projects in joint sector in collaboration with private entrepreneurs or as wholly owned subsidiaries. Some SIDCs also administer the incentive scheme of central and state governments and participate in risk capital.

Resources :

The main source of funds of SIDCs are SIICs has been the paid up capital and loans from the state governments, borrowings from the market by way of bonds and debentures and refinancing from the IDBI. With fast expansion of their financial commitments, the SIDCs have been increasingly relying on borrowings from the state governments, IDBI, banks and other financial institussons.

Management:

The SIDCs function under the overall guidance of the respective state governments. Except for the nominee of the IDBI, all other members of the Boards of Directors of SIDCs are nominated by the state governments. The Boards constitute special committees, whenever necessary to advise them in conducting the business. The Managing Director who acts as the chief executive of the SIDCs lacks after, the day to day management.

12.7.3 Functions:

There are some differences in the functions of different SIDCs. They differ depending mainly on the degree of industrialisation and the kind of institutional network developed in the state concerned. The functions of SIDCs cover.

- Industrial promotion activities such as project identification, preparation of feasibility reports, identifying the entrepreneurs and the offering of assistance to them in project implementation.
- The setting up of industrial projects in the medium and large sectors in partnership with private entrepreneurs (Joint Sector) or as sole owners (public sector).
- Provision of infrastructural facilities and market intelligence services and consultancy.
- The granting of financial assistance by way of term loan / bridging loans and under writing of or subscription to equity / preference shares.
- Implementing the governments schemes relating to various sectors and back ward areas.
- Underwriting as well as direct subscription of company shares.
- Acting as agent of the state / central government in respect of grant of subsidies, incentives etc, as also of IDBI for provision of seed capital assistance.

Promotional Activities:

Some SIDCs have on their own or in association with other state level agencies, been conducting techno economic surveys of industrially backward areas for ascertaining their industrial potential as also identification of potential entrepreneurs and specific project areas. In some states, the SIDCs have set up industrial escort divisions to provide guidance to industrial units. Some SIDCs also provide a variety if ancillary services like assistance in project identification supply of project profits etc., these services are made available to entrepreneurs at nominal cost and in some cases without any change.

12.7.4 Operation of SIDCs:

During 2000-2001, financial assistance sanctioned and disbursed by SIDCs increased by 29.9% and 3.1% to Rs. 20801 million and Rs. 16,644 million respectively as against a deline in sanctions and disbursements of 29.8% and 25.8% in 1999-2000, respectively. Upto end March 2001, aggregate sanctions and disbursements amounted to Rs 223309 million and Rs 176479 million respectively.

Table – 12. 4

ASSISTANCE SANCTIONED AND DISBURSED BY SIDCs

(Rs. million)

Year	Sanctions	Growth Rate(%)	Disbursements	Growth Rate(%)
1971-72	236.0	—	144.0	—
1972-73	235.0	-0.4	166.0	15.3
1973-74	279.0	1.7	2006.0	24.1
1974-75	335.0	20.1	267.0	29.6
1975-76	375.0	11.9	264.0	-1.1
1976-77	718.0	91.5	350.0	32.6
1977-78	879.0	22.4	44.0	28.0
1978-79	983.0	11.8	601.0	34.2

1979-80	1577.0	60.4	853.0	41.9
1980-81	2164.0	37.2	1246.0	46.1
1981-82	2996.0	3.4	1911.0	53.4
1982-83	2966.0	-1.0	2080.0	8.8
1983-84	3646.0	22.9	2365.0	13.7
1984-85	4779.0	31.1	2976.0	25.8
1985-86	5270.0	10.3	3640.0	22.3
1986-87	5703.0	8.2	4255.0	16.9
1987-88	6415.0	12.5	4486.0	5.4
1988-89	7221.0	12.6	4721.0	5.2
1989-90	6910.0	-4.3	5452.0	15.5
1990-91	8237.0	19.2	5983.0	9.7
1991-92	10090.0	22.5	6787.0	13.4
1992-93	9731.0	-3.6	6947.0	2.4
1993-94	9179.0	-5.7	7008.0	0.9
1994-95	15886.0	73.1	10510.0	50.0
1995-96	19512.0	22.8	11887.0	13.1
1996-97	18111.0	-7.2	15018.0	26.3
1997-98	17951.0	-0.9	14162.0	-5.7
1998-99	22805.6	27.0	21763.4	53.7
1999-2000	16014.2	-29.8	16147.1	-25.8
2000-01	20800.5	29.9	16643.7	3.1
Cumulative Upto end-March 2001	**223308.5**	--	**176478.6**	--

During 2000-2001 direct finance constituting 66.6% (83.1%) of over all sanctions increased by 4.1% to Rs 13849 million as against a decline of 41.6% in 199-2000 of the project finance, rupee loans declined by 2.3% over a decline of 49% in the previous year. Underwriting and direct subscriptions however, registered a growth of 315.4% (-92.5%). Non project finance constituting 15.7% of the total sanctions declined by 6.4% during 2000-2001. Disbursements under asset credit scheme / equipment finance / corporate loans and working capital / short term loans were lower by 17.6% and 25.9% respectively, during 2000 – 2001. disbursements under bills finance accounting for 38.4% of the total disbursements grew by 9.9%.

State Wide Operations:

Of the toal 28 SIDCs in the country 16 SIDCs have registered increase in sanctions during 2000 – 01. Of these, the SIDCs in West Bengal recorded the maximum increase (235.6%) followed by SIDCs in Maharastra (51.6%), Karnataka (45.3%), Haryana (17.5%), Gujarat (17.2%) and Rajasthan (6.8%). The other SIDCs that recorded increase included Tripura, Jammu and Kashmir, Uttar Pradesh, Andhra Pradesh, Sikkim, Arunachal Pradesh, Nagaland, Himachal Pradesh, Pondicherry and Orissa. States in which SIDCs recorded decline in sanctions in 2000 – 01 over growth in 1999 – 2000 were Goa (-63.7%), Mizoram (-35.3%), Kerala (-33.2%), and Meghalaya (-28.1%). In terms of absolute sanctions, SIDCs in Maharastra (52.2%) ranked first, followed by Karnataka (11.92%), West Bengal (7.9%), Haryana (6.1%), Rajasthan (4.8%) and Gujarat (4.3%).

The SIDCs have contributed significantly to the structural transformation in industry. In fact, three fifths of the total sanctions by the SiDCs were in respect of units in non traditional industries such as chemicals, basic metals and metal products, machinery including electrical machinery etc., The corporations assistance for the acceleration of industrial development in backward regions has been growing. The concept of 'Joint sector' was developed as a promotional tool to attract private sector investment and their managerial abilities for the promotion of projects in different states. The SIDCs have been able to promote a number of projects in the joint sector in association with private co promoters. About three fourths of the cumulative sanctions by the SIDCs were in favour of the projects in the private sector, the share of the joint sector being 11 – 9%.

Tasks and Challenges for the SIDCs :

Despite the organisational and operational limitations and limited resources, these corporations have been playing a significant role in the industrialisation process. The corporation's role in training new entrepreneurs and offering them assistance for launching new industrial ventures is well known. The role of SIDCs in promoting and financing industries, particularly in backward areas.has been widening. As State Government Promotional agencies, the SIDCs are able to act as an effective link between the industrial development planning efforts of the government and the activities of the entrepreneurs and industrialists.

12.8 State Financial Corporations (SFCs)

12.8.1 Genesis :

The Industrial Finance Corporation of India (IFCI) was established in 1948 to provide finance to large scale industrial undertakings. The small and medium size industries were excluded from its purview. Hence, the government felt the need for starting development banks on a regional basis in each state for financing the long term needs of the industries in their respective areas. Later, two of such institutions viz; the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) were established in each state.

The State Financial Corporations are the state level development banks set up under the SFC Act – 1951 for the development of small and medium scale industries in various states. The act authorised each state to set up an SFC. SFCs aim at bringing about balanced regional development by wider dispersal of industries, catalysing greater investment and generating larger employment opportunities. The Punjab Government took the led in organising a financial corporation under the above act in 1953 when the Punjab Financial Corporation was setup. Gradually, financial corporations were established in different states. Now, there are 18 SFCs functioning in different states of the country. These institutions are closely modelled on the lines of the IFCI, but differ in the scope of their activities. While the IFCI Limits its financial help to larger industrial concerns, the SFCs are intended to extend financial assistance to small enterprises. With a view to reaching the small scale units spread out in their respective areas of operationas, the SFCs have opened a number of regional / branch offices.

12.8.2 Objectives of SFCs :

The principal objective of SFCs is to provide medium and long term financial assistance to small and medium industries particularly when normal banking accommodation is not available. They provide financial assistance to industries by way of term loans, direct subscriptions to equity / debentures discounting of bills of exchange and guarantees. Most of the IDBI's schemes for assistance to small and medium sectors are operated through SFCs. These include : composite loan scheme, schemes for women entrepreneurs, modernisation scheme, equipment finance scheme, schemes for hospitals and nursing homes, schemes for ex-servicemen, single window scheme etc., The SFCs collectively sub serve the broad national objective of economic growth with accent on promotion of small enterprises, balanced regional growth and widening of the entrepreneurial base through encouragement of new entrepreneurs.

Scope of Business :

The SFCs have been established to help entrepreneurs to setup new industries and undertake programmes of modernisation, renovation, expansion and diversification. According to section 2(C) of the SFC Act 1951 (as amended up to 1962), the SFCs can assist an industrial concern engaged or to be engaged in any of the following activities.

(a) Manufacture, preservation or processing of goods.

(b) Mining

(c) Hotel Industry

(d) Road Transport

(e) Generation and distribution of electricity or any other form of power.

(f) Development of any area of kind as an industrial estate.

(g) Providing Special or technical knowledge or other services for the promotion of industrial growth.

The processing of goods includes any art or process for producing, preparing or making an article by subjecting any material to a manual, mechanical, chemical, electric or any other operation. The amendments to SFCs Act have significantly enlarged the scope of business of SFCs to provide for discounting of bills of exchange and direct subscription to equity / debentures of industrial concerns. The SFCs (amended in 2000). Act provides greater flexibility to SFCs to cope with the challenges posed by the deregulated financial system.

Forms of Assistance :

The SFCs are permitted to provide financial assistance to industries by :

(a) Granting loans or advances or subscribing to the debentures of industries, loans repayable within 20 years.

(b) Guaranteeing deferred payments of any industrial concern which purchases capital goods with in India.

(c) Guaranteeing the loans raised by industries on such terms and conditions as may be mutually agreed upon, but they should be repayable with in 20 years.

(d) Underwriting the issue of stocks, bonds or debtentures of industrial concerns. subject to their being disposed of in the market with in 7 years.

(e) Providing foreign exchange loans under the World Bank scheme.

(f) Participating in the equity capital of the small scale industrial units coming up in backward areas and

(g) Providing for discounting of bills of exchange.

Further, the SFCs act as agents of the central government, state government, to the IFCI or any other financial institution for the grant of loans or advances to, or subscribing t the debentures of an industrial unit. The SFCs cannot grant assistance to a concern whose paid up capital and free reserves together do not exceed Rs. 1 crore.

12.8.3 Operational Policies of SFCs

The SFCs Act lays down general rules for the operations of the corporations. They have been adopted by the respective state governments in their own way for the corporations. The board features of the operational policies of SFCs in India are discussed hereunder.

(a) Policy on Forms of Assistance : The SFCs are empowered to provide financial assistance by way of granting and guaranteeing loans directly subscribing to securities, underwriting issues and by discounting of bills of exchange.

(b) Policy on Duration of Assistance : The SFCs are authorised to lend up to a period of 20 years and underwrite shares and debentures, subject to their disposal in the market with in 7 years. However, they have made it a policy to provide loans for periods up to 12 years with suitable initial grace periods.

(c) Policy on Industrial Projects to be assisted : The SFCs provide assistance mainly to small scale units which are mostly organised as partnership or proprietary concerns. The projects organised as private and public limited companies and registered cooperative societies are also provided assistance. SFCs give greater emphasis to Agro based industrial units, chemicals and machine making units.

(d) Policy on Security and Margin : The SFCs generally provide secured loans which are normally secured by way of legal mortgage of fixed assets. A mortgage executed in favour of the corporation includes plant and machinery installed over and above the assets already acquired as on the date of the execution of the deed, 40% margin is generally maintained on the loans. The SFCs show considerable flexibility in operating this norm.

(e) Policy on Assistance to Technician Entrepreneurs : In pursuance of the government policy to encourage self employment, the SFCs have from 1970, introduced special schemes in which provision for concessional financing to technician entrepreneurs is made. The assistance under the scheme ranges between Rs. 1 lakhs and Rs. 3 lakhs, and is given, on very liberal terms in so far as the margin requirements, the rate of interest and the moratorium on repayment are concerned. Generally, graduates or dipolma holders and certified technicians or those having adequate experience in the line are eligible for financial assistance under the scheme.

12.8.4 Working Operations of the SFCs :

During fifties and sixties, the SFCs operation was only moderate. During seventies, however, there was a rapid increase in their activities mainly duue to the emphasis laid down by the government on the promotion of small scale industries, new entrepreneurs and development of backward areas. As seen in the Table – 7 during 1965 – 66, the SFCs sanctioned and disbursed Rs. 253 million and Rs. 180 million respectively. The sanctions and disbursements of SFCs were Rs. 2638 million and Rs. 1848 millions respectively up to 1979 – 80. Later, the operations of SFCs increased rapidly by 2000 – 2001 and they were able to sanction Rs. 27899.7 million and disburse Rs. 20050.6 million. The cumulative sanctions up to March 2001 were Rs. 358886.7 million and disburse Rs. 20050.6 million. The cumulative sanctions up to March 2001 were Rs. 35886.7 million and the disbursements to the tune of Rs. 29242.5 million.

The most disconcerting tendency is the continuance of the gap between sanctions and disbursals, sometimes rising and sometimes declining. The gap between the sanctioning and disbursement of loans reduces the value of the assistance because of the applicant may not be able to get the help at the right time. The gap may be attributed to the following reasons.

(1) Stringent financial conditions

(2) Limited availability of bridge finance from banks

(3) Conditions to be fulfilled for obtaining refinance

(4) Delay in complying with the conditions on the part of the applicants before any disbursements can be made

(5) Uncertainty about the availability of base inputs like cement, steel, plants etc., resulting in delays in the Completion of projects.

SFCs have rendered assistance to diverse groups of industries, ranging from artisan's industries to units engaged in sophisticated lines of manufacture. However, there has been concentration of SFCs assistance which industries as chemicals, services, food products, metal products and textiles. These five groups of industries claimed over 53.2% of the total assistance of the SFCs.

Table - 12.5

Assistance Sanctioned and Disbursed by SFCs

(Rs. million)

Year	Sanctions	Growth Rate(%)	Disbursements	Growth Rate(%)
1965 - 66	253.0	--	180.0	--
1970 - 71	496.0	--	335.0	--
1971 - 72	641.0	29.2	396.0	18.2
1972 - 73	787 0	22.8	447.0	12.9
1973 - 74	1031.0	31.0	546.01	22.1
1974 - 75	1418.0	37.5	796.0	45.8
1975 - 76	1555.0	9.7	988.0	24.1

1976 - 77	1633.0	5.0	1052.0	6.5
1977 - 78	1661.0	1.7	1074.0	2.1
1978 - 79	2007.0	20.8	1350.0	25.7
1979 - 80	2638.0	31.4	1848.0	36.9
1980 - 81	3705.0	40.4	2480.0	34.2
1981 - 82	5096.0	37.5	3177.0	28.1
1982 - 83	6116.0	20.0	4040.0	27.2
1983 - 84	6449.0	5.4	4355.0	7.8
1984 - 85	7431.0	15.2	4977.0	14.3
1985 - 86	10091.0	35.8	6085.0	22.3
1986 - 87	12108.0	20.0	7919.0	30.1
1987 - 88	13050.0	7.8	9425.0	19.0
1988 - 89	13911.0	6.6	10552.0	12.0
1989 - 90	15142.0	8.8	11565.0	9.6
1990 - 91	18639.0	23.1	12708.0	9.9
1991 - 92	21903.0	17.5	15368.0	20.9
1992 - 93	20153.0	-8.0	15574.0	1.3
1993 - 94	19088.0	-5.3	15634.0	0.4
1994 - 95	27024.0	41.6	1809.0	20.3
1995 - 96	41885.0	55.0	29611.0	57.4
1996 - 97	35448.0	-15.4	27827.0	-6.0
1997 - 98	26261.0	-25.9	21102.0	-24.2
1998 - 99	1641.8	-29.0	16246.5	-23.0
1999 - 2000	22377.8	20.0	18250.9	12.3
200 - 2001	27899.7	24.7	20050.6	9.9
Cumulative upto end March 2001	**358886.7**	--	**29242.5**	--

Assistance to Backward Areas :

In line with the government policy of fostering industrial growth in backward areas, the SFCs have provided since 1970, an increasing share of their financial assistance to such units as are located in areas identified by the government as industrially backward areas and districts and thus assitance has been on concessional terms and conditions. Bulk of the sanctions to backward areas was from the SFCs in Karnataka (16.6%), Andhra Pradesh (12.5%), Rajasthan (11.5%), Tamilnadu (9.3%) and Uttar Pradesh (8.7%). This is the result of the liberal policy pursued by SFCs with respect to assistance to units located in backward areas.

Special Capital Scheme :

The objective of the special capital scheme of the SFCs, inroudced in 1976 was to provide equity type of assistance on soft terms to such entrepreneurs, as possessed the necessary skills or practical experience but lacked financial resources to setup projects in small, tiny and decentralised sectors covered under the credit guarantee scheme.

Problems :

The SFCs have been playing an important role in meeting the financial needs of small and medium scale concerns. They have been helping their respective states in their industrial development. However, the SFCs at present are facing certain limitations and difficulties. They include : (a) non recovery of loans, (b) procedural problems in the recovery of loans, (c) increasing sickness among industrial units, (d) dominance of the personal factor in small business units and (e) lack of adequate resources for the corporations.

Gupta Committee :

The government of India has set up a committee headed by Sri GP Gupta, the then chairman and Managing Director of IDBI in the year 2000 for looking into the functioning of SFCs and for making recommendations for their restructuring and revitalisation. The Committee submitted its report in Jan 2001 to the government and it indicated that the further business convas of SFCs is likely to affect by stiff competition of emerging in the financial system. In the awake of WTO provisions becoming effective, SSI sector would face new challenges. The Committee also felt that there would be a new role for financial institutions specialising in and dedicated to financing and development of SSI sector. The SFCs, therefore, would continue to be significant players particularly in financing of SSI sector in India. The recommendations of the committee are being implemented by the government.

12.9 Summary :

This unit attempted to survey the origin and growth of Development Banking in India. Over the years, there had been wide structural changes on the development banking. The charter of development banking is slowly eroding and they are converting themselves into commercial banks. ICICI is the best example. It became ICICI Bank recently similarly IDBI is also merging into IDBI bank. In addition, discussion is made & the state level development banks in this unit.

12.10 Self Assessment Questions :

1. Trace out the evolution & Development Banks in India.
2. Explain the role and functions of Development Banks.
3. Examine the working of IFCI.
4. Critically evaluate the working of SIDCs and SIICs.
5. What is the significance of SFCs in promoting small industry ?

12.11 Further Readings :

1. IDBI Annual Report on Development Banking in India, 2002 - 03.
2. Saxana, RM, Development Banking in India, Bombay, Vora & Co., 1981
3. Srivastava, RM Management & Indian Financial Institutions, Mumbai, Himalaya 1990.

UNIT - 13

SPECIAL FINANCIAL AND PROMOTIONAL INSTITUTIONS – I

Objectives

The objectives of this unit are :

To know the origin and establishment of ICICI Venture Fund, IFCI Venture Fund and EDI

To understand the functions and various schemes of assistance

To make an operational Review on the working of the above three institutions

Structure

In order to promote industrial development in a speedy manner some specialised financial institutions have been setup in the country. The functions and working operations of these specialised financial institutions are discussed in this and the next unit. This unit covers the discussion on the following SFPIs.

1. ICICI Venture Funds Management Co. Ltd.
2. IFCI Venture Capital Fund Ltd.
3. Entrepreneurship Development Institute of India

13.1 ICICI Venture Funds Management Company Ltd., (Formerly known as Technology Development and Information Company of India Ltd (TDICL).

13.1.1 Origin and Establishment :

The guidelines on venture capital issued by the Reserve Bank of India towards the end of 1988 were a recognition of their role in the Indian market conditions. The Technology Development and Information Company of India Limited (TDICL), presently known as ICICI venture, Funds management Company Limited (ICICI VFMCL) was set up as a subsidiary by ICICI and UTI and as the country's first venture capital finance company in July 1988. Venture capital is thought of as a creative capital which is expected to perform economic functions different from other investment institutions which primarily serve as expansion capital.

Venture capital is equity support to fund new concepts that involve a high risk and at the same time have high growth and profit potential. Venture capital encompasses a whole gamut of activities – from providing seed capital, and supplying funds for product development and marketing expenditure to extending bridge finance prior to an initial public offering(IPO).

13.1.2 Functions :

ICICI Venture Funds Management Company Ltd is a technology venture finance company that grants project finance to new technology ventures. It primarily provides assistance to small and medium industries conceived by technocrats. Entrepreneurs in the form of project loans, direct subscription to equity and a quasi-equity instrument called conditional loan spread across knowledge based sectors like information technology, health care and services.

The objective of venture capital is to help professionals, small and medium entrepreneurs to launch enterprises with a specific promise. Venture capital is thus closely linked with innovation, high growth and profit. It provides the necessary dimension to convert the business idea of entrepreneur into a commercial venture.

13.1.3 Schemes of Assistance :

ICICI venture funds offer a package of assistance to entrepreneurs to enable them to translate their project idea into a raising operation. This package may be broadly classified into developmental and financial services. It also implements a scheme of incentives to motivate and encourage entrepreneurs to setup potential revenue earning enterprises.

13.1.4 Forms of package of Assistance :

The following are the different forms of assistance :

- Equity participation in Joint Ventures.
- Equity participation in private and public limited companies to the extent of short fall in promoters contributions.
- Essential loans to private and public limited companies for promotion of the industry.
- Setting up units in the public sector for optimum utilisation of the outer resources where private capital is non-existent – a pace sector for future private investment.
- Project identification / technical consultancy for new projects - guidance, investigation, feasibility and other studies.
- Plant location, guidance on incentives, raw materials etc., specialised help for NRIs.
- Equipment financing, Equipment leasing
- Seed capital for technocrats
- Term lending, etc.,

13.1.5 Schemes of Institutional Finance :

The following schemes are designed to serve diverge purposes :

1) **Technical Scheme :** Technically qualified or experienced professionals – up to Rs. 7.50 lakhs.
2) **Special Capital Scheme :** Assistance towards equity on soft terms up to Rs. 15 lakhs along with term loans for technically qualified or experienced persons.
3) **Composite Loan Scheme :** Both equipment finance and working capital up to Rs. 50,000 for artisans and normal industries.
4) **Disabled Entrepreneurs :** 100% finance up to Rs. 50,000 to disabled entrepreneurs.
5) **Modernisation :** For replacement / renovation of equipment for successful units which are in existence since 5 years - assistance up to Rs. 90 lakhs.
6) **Electro Medical Equipment :** for qualified doctors/ private nursing homes – up to Rs. 90 lakhs.
7) **Equipment Finance :** For procurement of new machinery / equipment by existing industrial units - up to Rs. 90 lakhs.
8) **Quality Control Equipment :** 100 % assistance for setting up quality control facility by existing and new SSI units – up to Rs. 7.50 lakhs.

9) **Single Window Scheme :** Provision of term loan and working capital together to upcoming small scale industrial units up to Rs. 7.50 lakhs towards term loan and up to Rs. 3.75 lakhs towards working capital.

10) **Mahila Udyam Nidhi Scheme :** To setup new industrial Projects in SSI sector by women entrepreneurs.

13.1.6 Operational Review of ICICI Venture Fund :

Up to the end of March 1998, TDICI has sanctioned an amount of Rs. 299.70 Crores and disbursed about Rs. 278.10 Crores towards venture capital assistance to the industries. During 2000-2001, assistance sanctioned and disbursed by ICICI ventures increased to Rs. 2036 million from Rs. 1262 million in 1999-2000. The disbursed by ICICI ventures increased to Rs. 2036 million from Rs. 1262 million in 1999-2000. The disbursements have increased from Rs. 953 million in 1999-2000 to Rs. 1849 million during 2000-2001, up to the end of March 2001, sanctions and disbursements aggregated to Rs. 6380 million and Rs. 5814 million respectively. Bulk of assistance sanctioned and disbursed during the year 2000-2001 was by way of under writing and direct subsection which increased nearly two fold, where as sanctions under rupee loans declined considerably.

13.2 IFCI Venture Capital Fund Ltd., (Formerly known as Risk Capital and Technology Finance Corporation Ltd (RCTC))

13.2.1 Establishment :

The Risk Capital and Technology Finance Corporation Ltd., now being called as IFCI Venture capital Funds Ltd., was set up in the year 1988 by Industrial Finance Corporation of India with the assistance of Unit Trust of India. It has been set up to assist potentially highly profitable ventures involving innovative products / technologies / services aimed at futuristic or new markets and having characteristics of high risk and high return.

13.2.2 Functions :

The IFCI Venture Capital Fund Ltd., provides both risk capital and technology finance under one roof to innovative entrepreneurs and technocrats for their technology oriented ventures.

Fund of the ICFI Ventures : The Fund has been enlarged through 5:1 rights issue which was subscribed to in full, to the extent of Rs. 500 million each by UTI and IFCI raising total corpus of Rs. 1200 million. IFCI ventures receive venture capital fund management fee and is entitled to commission on surplus generated on termination of the fund.

13.2.3 Operational Appraisal of IFCI Ventures :

During 2000-2001, the sanctions and disbursements of IFCI Venture Capital Fund (IVCF) have declined by 53.7% and 72.5% to Rs 38 million and Rs. 33 million, respectively. (Table – I) up to the end of the March 2001, IVCF's Sanctions and disbursements aggregated Rs. 1533 million and Rs. 1507 million respectively.

Table – 13.1
Assistance Sanctioned and Disbursed by IVCF

(Rs. In Millions)

Year	Sanctions	Growth Rate (%)	Disburse-ments	Growth Rate(%)
1989 – 90	61.0	—	51.0	—
1990 – 91	98.0	60.7	73.0	43.1
1991 – 92	106.0	8.2	84.0	15.1
1992 – 93	92.0	-13.2	102.0	21.4
1993 – 94	74.0	-19.6	94.0	-7.8
1994 – 95	133.0	79.7	133.0	41.5
1995 – 96	273.0	105.3	154.0	15.8
1996 – 97	227.8	-16.6	207.2	34.5
1997 – 98	72.7	-68.1	182.4	-12.0
1998 – 99	106.7	46.8	103.5	-43.5
1999 – 2000	81.0	-24.1	119.2	15.2
2000 – 2001	37.5	-53.7	32.8	-72.5
Cumulative up to March 2001	1532.9		1507.1	

Industry wise Assistance :

Chemicals & Chemical products, electronic equipments, telecommunications and other industries received assistance during 2000 – 2001. Disbursements were more wide spread covering iron and steel and non-ferrous metals, etc.

State wide Assistance :

Delhi accounted for the bulk of assistance sanctioned, during 2000-2001 (42.7%), West Bengal, Uttar Pradesh, Haryana, Karnataka, and Andrha Pradesh were other states which received considerable assistance during 2000 – 2001.

13.2.4 Financial performance :

It can be seen from Table 13.2 that the total assets of IVCF have declined from Rs. 309.0 million in March 2000 to Rs. 196.8 million as at the end of March 2001. All the major components of

Table – 13.2

Liabilities and Assets of IVCF (Rs. in Millions)

A. Liabilities	**March 2000**	**March 2001**
1. Paid up Capital	78.5	78.5
2. Reserves and Funds	79.2	7.7
3. Borrowings from IFCI	149.6	109.6
4. Others	1.7	1.0
Total	**309.0**	**196.8**
B. Assets		
1. Cash and Bank Balance	81.8	73.7
2. Investments	202.1	102.6
3. Loans and advances	11.8	7.0
4. Others	13.3	13.5
Total	**309.0**	**196.8**

its portfolio i.e., investments, loans and advances and cash & bank balances contributed to the decline in total assets. Total income of IVCF declined from Rs. 53 million during 1999-2000 to Rs. 34 million during 2000-2001. Interest on loans fell marginally from Rs. 6.8 million to Rs. 4.1 million, while income on investments declined sharply from Rs. 25.4 million to Rs. 3.8 million (Table–13.3). Other income, however, increased from Rs. 207. million to Rs. 25.9 million in 2000 and 2001 respectively. Profit after tax declined from Rs. 6.3 million during 1999-2000 to Rs. 0.4 million during 2000 – 01.

Table –13.3

Income and Expenditure Account (Rs. in Millions)

A. Expenditure	**March 2000**	**March 2001**
1. Payment of Interest	—	—
2. Other Expenditure	45.8	32.8
3. Provision for taxation	0.8	0.6
4. Profit after Tax	6.3	0.4
Total	**52.9**	**33.8**

B. Income		
1. Interest on loans	6.8	4.1
2. Income from Investments	25.4	3.8
3. Others	20.7	25.9
Total	**52.9**	**33.8**

13.3 Entrepreneurship Development Institute of India (EDII)

13.3.1 Origin and Establishment :

Small enterprise development has been accepted as viable strategy for hastening the pace of industrial growth in particular and economic development in general. In order to facilitate the same, planned intervention in terms of policy support as also training involving identification of latent entrepreneurial talent and nurturing the same through systematic result oriented entrepreneurship development programmes (EDPs) have been resorted to. Since 1950s, a substantial volume of study has gone into different facets of entrepreneurial development in India to accelerate the process of industrialisation. The study showed that entrepreneurs are born and can also be made and their skills sharpened, quality of an enterprise improved and generated in a good number. The Entrepreneurial Development programmes (EDPs) have become a new concept for harnessing the vast untapped human resources. The EDPs are presently one of the most talked about social development activities which many organisations have taken up in the right earnest. They indeed strike a welcome role in respect of change in perception and recognition of the critical role. The entrepreneurs would play in industrial development by creating potential revenues for self development.

The EDP was first initiated in Ahmedabad in Gujarat in 1970 under the sponsorship of the Gujarat Industrial and Investment Corporation (GIIC). The basic elements and characteristics of this innovative programme was crystallised, through repeated experiments by the year 1978, when the Gujarat financial institutions and industrial promotion agencies of the State sponsored the centre for Entrepreneurship Development (CED). The success of this CED approach convinced all India financial institutions. Accordingly, Entrepreneurship Development Institute of India (EDII) was set up at Ahmedabad in the year 1983 at the initiative of Industrial Development Bank of India (IDBI) with the support from Industrial Credit and Investment corporation of India (ICICI), Industrial Finance Corporation of India (IFCI), State Bank of India (SBI) as also the government of Gujarat as a resource organisation at the national level. The central government also established in the same year i.e. 1983, the National Institute for Entrepreneurship and small Business Development (NIESBD) at New Delhi, with the objective of coordinating activities related to entrepreneurship and small business development. Both these organisations are working hard in hand for giving a fillip to the entrepreneurship development movement.

13.3.2 Objectives and Functions :

Entrepreneurship Development Institute of India (EDII) was set up basically to under take research, consultancy and training in the area of entrepreneurship and thus assist the State level agencies in carrying out such programmes. The EDII, the principal agency with special responsibility for entrepreneurship development in the country, has been focussing attention on developing programmes for entrepreneurship development and innovative training techniques for trainers. Following are the function of EDII.

- To select potential entrepreneurs or individuals with certain entrepreneurial traits.
- To organise and conduct training programmes for each specific target group of individuals.
- To identify and assist potential entrepreneurs amongst technical and non-technical personnel in setting up self employment ventures in small industries involving service industries.
- To conduct workshops, seminars, and conferences etc. for promotion of and development of entrepreneurship in small / medium scale industries.
- To publish literature through pamphlets and brochures for furtherance of entrepreneurship and small business development.
- To interact with other institutions engaged in conducting entrepreneurship development programmes in the country.
- To conduct research and consultancy on various aspects of entrepreneurship.

13.3.3 Operational Activities :

The programmes then by EDII are said to be the oldest, most comprehensive and best organised. The training activity is tailored to the specific requirements of each target group and tools and techniques vary according to the characteristics of the target group.

Training :

There are three main categories of training inputs. They are (i) Achievement motivation, (ii) Business opportunity guidance, and (iii) Management achievement motivation training (AMT) is a crucial dose of behavioural psychological inputs devised on the basis of research and practice in this field in India and abroad. These motivation inputs are aimed at enhancing (a) achievement orientation, (b) ability to define goals realistically and work towards their fulfilment, (c) self awareness and confidence. The training culminates in the completion of a project report by each trainee.

The training programme is mainly for conducting market surveys and prepare a project plan for oneself and also to expose the participants to the thought process and field experience necessary for the rational choice of business, product line and market mix etc., It also constitutes an instrument for raising finance for the project and thereby links up completion or training with the support of financial institutions for implementation of the project.

Faculty :

Normally, no full time faculty is used for the training programme except the trainer – motivator supported by an expert in project formulation. Most of the business inputs are given by management / professional practitioners, business and industry executives, experts from state industrial promotion agencies, financial institutions and technical consultancy organisations and small scale entrepreneurs.

The EDII would assist various organisations in various states in conducting about 30 EDPs per year. The trainers trained in EDII will also conduct demonstration programmes for potential entrepreneurs in various states of India.

Promotion of EDPs by EDII :

Emergence of the Entrepreneurship Development Institute of India in early 1983 has accelerated the spread of EDP efforts in the country and improved the effectiveness and performance of the programmes conducted. Acting as a national resource of expertise and know how, the EDPs have been taken by EDII to less developed States, where there is need to identify indigenous entrepreneurship. Since the performance experiences have not been uniformly satisfactory in various parts of the country, EDII is geared to improve the qualitative aspects of selection and training, strengthening local organisational capabilities, developing trainer-motivators and institutional involvement for sustained effort.

The EDII has developed an experimental EDP for women, keeping in view of their special needs and the first such EDP was organised in September 1988. The EDII over the years has carried out experiments n rural entrepreneurship development in a cluster of villages in Uttar Pradesh and Orissa in collaboration with a voluntary organisation. The institute was also prepared a video cassette on the "focussed behaviour event interview technique" for assessing entrepreneurial potential in the country. The EDII has been offering its services to Srilanka, Nepal, Kenya, Ghana and other African common wealth countries in the entrepreneurship development. In the Nehru centenary year, the EDII brought out a book entitled "self made impact making entrepreneurs" based on a study undertaken by it.

13.4 Summary :

The institutional assistance provided by ICICI ventures has helped in catalysing substantial production capacities in many industries and in the establishment new industries – not merely in the traditional sector such as textiles and food processing but also in modern industries such as chemicals, fertilisers, cement, industrial machinery, transport, equipment, food products and services etc.,

As a national resource agency, Entrepreneurship Development Institute of India (EDII) has been significantly contributing in the field of entrepreneurship development by way of identifying and developing Entrepreneur-trainer-motivators (ETMs) – The backbone of an EDP. In order to develop a network of such ETMs who form a part of the increasing number of EDP conducting agencies spread throughout the country, EDII has compiled a comprehensive national directory of ETMs. With the setting up of EDII, entrepreneurship development in India through organised training has assumed added significance particularly for training the educated technical unemployed youth for taking up various self employment business ventures.

13.5 Self Assessment Questions

1. Trace the origin and establishment of TDICL
2. Explain the functions and forms of package of Assistance of ICICI ventures.
3. Briefly write on the working of ICICI ventures.
4. Explain the establishment and functions of IFCI ventures.
5. Discuss the operational appraisal of IFCI ventures.
6. Discuss the origin and Establishment of Entrepreneurship Development Institute of India (EDII)
7. Examine the functions and operations of EDII

UNIT - 14 SPECIAL FINANCIAL AND PROMOTIONAL INSTITUTIONS – II

Objectives :

Objectives of this lesson are

- to understand the origin and objectives of LIC of India and UTI
- to discuss the operational policies of LIC and UTI
- to understand the Investment Policy of LIC and UTI
- to know about the LIC Mutual Fund
- to make the performance review of LIC and UTI

Structure :

14.1.1 Life Insurance Corporation of India :

14.1.1 Purpose and Origin :

The emergence of Life Insurance Corporation of India (LIC) as the largest single channel of individual savings and the biggest investing institution is a significant event in the socio-economic development of the country. It took over the assets and liabilities of 245 private insurers engaged in the transaction of Life Insurance business in India. The need of a corporation amalgamating all insurance companies operating in India arose largely as corollary of the industrial policy resolutions of 1948 and 1956, which brought in their wake a wave of nationalisation and the participative role of the government in economic development.

Prior to nationalisation of Life Insurance business, the private institutions were found to be serving the vested interests of a few big business houses at the expense of national economic growth. It was felt that if these institutions were merged and operated to encourage nation-building activities, they would prove to be a valuable asset for the nation. The integrated strength of these insurance companies would mobilise in an organised manner the vast savings of the people in different parts of the country and make them available for the industrial development programmes envisaged in the country's second five year plan. The need to cater to the increased financial requirements of five-year plans and to Shun Vagaries of private enterprises led to the nationalisation of the insurance industry in India. The Life Insurance Corporation of India came into existence in October 1956, following the enactment of the LIC Act, 1956.

14.1.2 Objectives of LIC :

Following are the objectives of Life Insurance Corporation of India.

(a) To spread Life Insurance widely and in particular to the rural areas and to the socially and economically backward classes with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost.

(b) To maximise mobilisation of people's savings by making insurance linked savings adequately attractive.

(c) To act as trustees of the insured public in their individual and collective capacities.

(d) To meet the various Life Insurance needs of the community that would arise in the changing social and economic environment.

(e) To conduct business with utmost economy and with the full realisation that the moneys belong to the policy holders and

(f) To involve all people working in the corporation to the best of their capability in furthering the interests of the insured public by providing efficient service with courtesy.

14 1 3 Life Insurance Features and Functions :

Life Insurance provides a superior form of savings to the people. The assured's dependent family is protected as the sum assured is payable on the death of the assured. In ordinary savings, only sum saved is payable to dependents. Life Insurance is inculcating the habit of thrift in the people. Proceeds of a policy can be protected against the claims of creditors of the life assured through a valid assessment. Loans can be raised against the policy, thus providing liquidity. Tax relief is available to the assured on the premier paid on policies taken on a person's life. Life Insurance fund is invested in highly social oriented activities. Thus, social purpose is served by Life Insurance.

The Principal function of LIC is providing Life Insurance cover to people of the country for a premium. Life Insurance eliminates risk, substitutes, certainty for uncertainty and comes to the timely aid of the family in the unfortunate death of the bread winner. LIC is dedicating itself to the noble task of standing by the side of the dependent on the death of the breadwinner.

14.1.4 Management and Organisation :

The LIC of India is managed by a Board of Directors of not more than 15 headed by a Chairman. LIC has two Managing Directors and about 11 Executive Directors to manage the affairs of the corporation. LIC with its central office in Mumbai and seven zonal offices at Mumbai; Calcutta, Delhi, Chennai, Hyderabad, Kanpur and Bhopal operates through 100 divisional offices in important cities with branch offices numbering 2046 all over India. With 5.70 lakh agents it has the largest field organisation in the country for advising on different matters the LIC has set up two committees. I.e. Executive Committee and Investment Committee.

14.1.5 Types of Policies :

Following are various kindly LIC policies which are in operation – Whole Life, Endowment Assurance, Jeevan Mitra, Bhima Sandesh, Bhima Kiran, Jeevan Aadharsh, Jeevan Viswas, Jeevan Griha, Mortgage Redemption, Bhavishya Jeevan, New Jana Raksha, Double Endowment, Money Back Plan, Jeevan Surabhi, Jeevan Sathi, Jeevan Chaya, Jeevan Sree, Asha Deep, Jeevan Sanchay, Jeevan Sneha, Bhima Nivesh, Jeevan Asha, Pension Plan, Joint Life Endowments, Jan Raksha, Anticipated Whole Life, Progressive protection, Children's Anticipated Marriage Redemption, Jeevan Dhara etc., are the diverse types of policies available.

Besides, Group insurance schemes for land less Agri-labour, Life Insurance cover for IRDP beneficiaries, Group savings linked insurance, Group Scheme for weaker sections of the society, Group Gratuity Scheme, Group Superannuation Scheme, Group Term Insurance etc., are available for specific categories of persons. LIC has been conceiving every insurable interest possibility and comes with a policy to insure the interest. Its innovation has protected many families, even after the main source of light of the families is no more there.

14.1.6 Operational Policies :

LIC is essentially an investment institution. Its investment policy has been designed after or thoughtful consideration of the cardinal principles of the safety of the principal, the diversification of investments interms of types of securities, the number and types of enterprises to be assisted maturities of securities and the development of backward regions. The corporation acts on business principles and its investment policy is guided by considerations of the interests of its policyholders and the larger interests of the country. The investment policy of the LIC is subject to regulation under the provisions of the LIC Act 1956, enjoining on it the duty of carrying units business to the best advantage of community, always bearing in mind its primary obligation to the policy holders whole money it holds and its management should be characterised by dynamism and imbued with a spirit of trusteeship.

14.1.7 Investment policy of LIC :

According to the investment policy of LIC, out of the accretion to its controlled fund, not less than 50% has to be invested in central and state government securities including government guaranteed marketable securities in the form of shares, bonds, and debentures, 35% in approved investments and the remaining 15% in unapproved investments as decided by the corporation's investment committee.

The amended section of the insurance act in 1975 stipulates that accretion to the controlled fund, all funds of the corporation pertaining to its life insurance business of the LIC shall be invested as under :

(i) In central government marketable securities - not less than 25%

(ii) In central government, state government securities, including government guaranteed marketable securities in (i) above – not less than 50%

(iii) In socially oriented sector, including the public sector, cooperatives, houses built by policy holders, OYH schemes, plus (ii) above - not less than 75%.

In respect of the balance 25% of the accretion to the controlled fund, the government has indicated that :

(a) About 8% would be required for loans against policies within the surrender values.

(b) About 2% may be invested in immovable properties.

(c) and about 10% may be invested in the private corporate sector.

While investing its funds in the socially oriented sector or in the private sector, or in landed properties, the stipulation about scheduled investment should be satisfied subject to some tenets of its investment policy as given below :

(a) The keynote of the corporation's investment policy is the fact that it should invest its funds in such a manner as to safeguard and promote to the maximum extent possible, the interest of the policy holders.

(b) Investments should be dispersed over different classes of securities, industries and regions. The corporation's policy has been not to acquire more than 30% of the outstanding equity shares of a company.

(c) The corporation should act purely as an investor and not assume the role of an operator or speculator in order to take advantage of temporary fluctuations in the market prices.

(d) The corporation should underwrite security issues after a careful investigation of the project from financial, economic, technical, managerial and social angles. By underwriting, LIC purchases a large block of sound securities for its investment portfolio. The approach of the LIC to underwriting should be that of an investor and not one of a catalytic agent to generate public subscription.

(e) The corporation should not acquire control or participate in management of any concern in which it has an interest as an investor, unless exceptional circumstances warrant such participation.

As regards its assistance policy, the corporation assists public sector undertakings and public limited companies and abstains from assisting private limited companies. It assists industrial enterprises directly by underwriting their capital issues, subscribing to shares and bonds of special industrial financing institutions, such as IDBI, IFCI and SFG etc., In sanctioning loans, the corporation accords priority to production and generation of electricity, housing schemes and water supply and drainage schemes, transport development etc.,

LIC Investments :

The Table – 14.1 explains the details of investments of LIC during the period from 1976 – 77 to 2001 – 2002.

Table – 14.1

LIC INVESTMENTS

Types of Investment	1976 – 77	1986 – 87	1996 – 97	2001 – 2002
1. Central Govt. Securities	981	4,675	37,330	1,09,938
2. State Govt. and Other Govt. guaranteed marketable securities	715	1,683	8,906	21,463
3. Electricity (SEBs)	733	2,603	8,214	13,447.
4. Housing	618	1,872	10,967	19,054
5. Water Supply & Sewerage	203	718	2,028	4,000
6. State Road Transport Corporation	—	180	540	893
7. Loans to Industrial Estates	9	37	45	45
8. Loans to Sugar Cooperatives	22	37	37	37
9. Development Authority	—	1	1	1
10. Roadways, Railways	—	—	—	681
11. Power generation (Private sector)	—	—	—	3,797
12. Municipalities	—	—	—	4
Total	**3,281**	**11,806**	**80,945**	**1,73,370**

LIC over the years, has been investing a major part of its funds primarily in the socially oriented sectors. As at 31st March 2002, 87.24 percent of its total investments were in the public sector, 1.03 percent were in the cooperative sector and 11.73 percent in the private sector. While investing the money of the corporation it keeps in view the national priorities and obligations of reasonable returns. The life funds, so invested for the benefit of the community at large has accumulated to Rs. 2,27,008.98 crores as at 31st March 2002, after meeting the liabilities towards the claims, management and other expenses registering an increase of Rs. 44,486-41 crores during the year 2001-2002. The total investments made by LIC in the socially oriented sector including investment in central / state government securities and government guaranteed marketable securities up to 31st March 2002 amounted to Rs. 1,73,370 crores. The corporations assistance to State Electricity Board was Rs. 13,447 crores up to March 2002. for Housing sector, LIC has provided financial assistance to the tune of Rs. 19,054 crores up to March 2002 as against Rs. 618 crores in 1976 – 77. There has been an around increase of LIC investments in all sectors of the economy during the last 25 years.

Boosting Industrial Growth :

The LIC helps boost the industrial growth in the country. It helps small scale and medium scale industries by granting loans for setting up cooperative industrial estates. The corporations assistance to state level finance corporations, IDBI, IFCI, ICICI etc., by way of subscription to bonds / debentures issued by such institutions, also indirectly helps development of small scale and medium scale industries. The corporation's investments in the corporate sector by way of loans up to March 2002 were Rs. 3021 crores and by way subscription to shares debentures were Rs. 46,476 crores up to March 2002. All these make a distinct contribution towards growth in industrialisation and generation of skilled and unskilled employment opportunities in the country. Table II presents the progress of LIC at a glance up to 2002-2003.

TABLE - 14.2
PROGRESS AT A GLANCE

Particulars	1956 – 57	1974 – 75	1998 – 99	2001 – 2002	2002 – 2003
Total New Business					
Individual (Rs. in crores)	336.37	1772.61	75606.26	192572.31	179811.17
Group (Rs. in crores)	—	1339.82	69558.14	99446.11	164574.44
Business in force					
Individual (Rs. in crores)	1476.52	11852.25	459201.04	811011.00	956675.20
Group (Rs. in crores)	5.29	1457.00	77918.65	100597.64	124312.99
No. of policies (Rs. in lakhs)	56.86	188.20	917.26	1258.76	1411.63

Life Fund (Rs. in crores)	410.40	3033.79	127389.06	227008.98	281664.33
Claims settled					
No (in lakhs)	—	4.68	59.84	87.67	96.91
Amount (Rs. in crores)	25.00	145.17	7583.18	14519.25	17035.81

4.1.8 LIC Mutual Fund :

The LIC Mutual Fund was launched by LIC in 1989 with the basic objective of mobilising savings from the investors spread across the country, having no easy access to the capital market, with a view to providing them a vehicle for investment of their funds thereby ensuring safety, security, easy liquidity and reasonably good returns. LIC mutual fund was setup as a separate trust and LIC made an initial contribution of Rs. 2 crores towards the Trust Fund and appointed a Board of Trustees to supervise the activities of the fund. The board of trustees have entrusted the work of management of the fund to Jeevan Bhima Sahayog Asset Management Company Ltd., (JBSAMC Ltd.,), which is a company promoted by the LIC with an authorised capital of Rs. 25 crores. The day to day operations of JBSAMC Ltd., are looked after by senior officers on deputation from LIC, which has the experience of handling and investing large funds for more than 40 years.

LIC Mutual Fund has mobilised more than Rs. 4000 crores up to March 2002 from over 17 lakh investors during the last 13 years of its existence since 1989, by successfully launching 35 schemes of various types. On the wake of liberalisation, it has the distinction of being the only mutual fund to launch the largest number and variety of schemes. It has the highest investor base of over 4 lakhs since inception, one of the largest among mutual funds. Currently, LIC Mutual Fund has redeemed 20 of the close ended schemes and has the record of being the only mutual fund to redeem an equity linked tax saving scheme with in 4 years giving the highest annualised returns of 27% for its Dhan 80 CC redeemed in 1995. The BS-IMRB serves of December 2001 rated LIC Mutual Fund in the top 5 funds based on investor satisfaction in key parameters like service, performance and Brand Strength, LIC Mutual Fund has valued the trust of its investors and applied it to a conservative approach to investment to ensure a consistent performance. It has withstood the test of time by remaining active in all good and bad phases of the market and the economy. The tremendous result that could be achieved by the corporation during the short period of time was due to introduction of need based products and vast and effective marketing network.

14.1.9 Performance Review :

LIC no doubt, has achieved a major breakthrough in mobilising the savings of the people and building up a big reservoir for financing socio-economic schemes of national importance and the needs of the public and private sector undertakings. The bulk of the corporation's investment is in government securities and loans to socially oriented schemes and projects, only a small proportion has gone to the financing of joint stock companies. Obviously, the public sector has claimed more than ¾ of the corporation's assistance. The balance ¼ of the total assistance was shared by other sectors.

Overall Sanctions and Disbursements :

Assistance sanctioned and disbursed by LIC to corporate sector during 2000 – 2001 increased by 59.2% and 26% to Rs. 108672 million and Rs. 70950 million respectively, as against the growth rates in sanctions and disbursements of 40.9% and 16.4% in 1999-2000 up to end March 2001, LIC's sanctions and disbursements aggregated Rs. 439017 million and Rs. 368343 million (Table – III) during 2000 – 2001, project finance forming 33.8% of total sanctions, grew by 328.1% as compared to 62.2% in 1999 – 2000. The entire assistance under project finance was by way of rupee loans. Assistance sanctioned under non-project finance was by way of rupee loans. Assistance sanctioned under non project finance grew by 20.6% as compared to 38.3% in the previous year. Disbursements under project finance declined by 1.2% over a decline of 18.8% in 1999 – 2001, where as the disbursements under non project finance grew by 27.5% in 2000 – 2001.

Industry wise - State wise Assurance :

During 2000 – 01, LIC's sanctions witnessed growth in respect of industries such as refineries and oil exploration, paper & paper products, infrastructure, machinery, cement, services and chemicals and chemical products. Industries accounting for a substantial portion of LIC's sanctions during the year included infrastructure (33.1%), services (23.1%), refineries & oil exploration (7.3%) chemicals and chemical products (5.2%) and transport equipment (3.3%).

States that witnessed manifold rise in sanctions were Haryana, Punjab, and U.P. followed by Andhra Pradesh (67.6%), Maharashtra (27.4%), Karnataka (25.4%) and Gujarat(15.7%). States that recorded decline in sanctions in 2000-2001 over growth in 1999-2000 included Assam, Delhi, M.P., Goa and West Bengal.

Sector wise – Purpose wise Assistance :

Public sector (73.2%) accounted for the bulk of LIC's sanctions, followed by private sector (25.5%). Also, sanctions to public sector at Rs. 79477 million grew at 75.3% in 2000 – 2001 as compared to a growth rate of 32.7% in 1999 – 2000. sanctions to private sector grew at much lower rate of 21.4% as compared to 62.4% growth in the previous year.

While the share of others (comprising loans to insurers policies, investments in foreign countries, special deposits and contribution to initial capital of UTI, LIC housing finance, LIC International and LIC Mutual Fund) in LIC's sanctions to corporate sector declined to 59.5% in 2000 – 2001 from 86.6% in 1999 – 2000, the share of new projects and expansion / diversification increased from 7.1% and 6.3% in 1999 – 2000 to 15.6% and 24.9% respectively in 2000 – 2001. New projects and expansion / diversification projects recorded growth in sanctions in 2000 – 2001.

TABLE - 14.3

ASSISTANCE SANCTIONED AND DISBURSED TO CORPORATE SECTOR BY LIC

(Rs. million)

Year	Sanctions	Growth rate%	Disbursements	Growth rate%
1970 – 71	180.0	—	80.0	—
1971 – 72	230.0	27.8	50.0	-37.5
1972 – 73	200.0	-13.0	140.0	180.0
1973 – 74	260.0	30.0	200.0	42.9
1974 – 75	440.0	69.2	540.0	170.0
1975 – 76	610.0	38.6	280.0	-48.1
1976 – 77	570.0	-6.6	390.0	39.3
1977 – 78	530.0	-7.0	430.0	10.3
1978 – 79	660.0	24.5	320.0	-25.6
1979 – 80	800.0	21.2	710.0	121.9
1980 – 81	700.0	-12.5	660.0	-7.0
1981 – 82	1660.0	137.1	1360.0	106.1
1982 – 83	1370.0	-17.5	870.0	-36.0
1983 – 84	1670.0	21.9	1410.0	62.1
1984 – 85	2200.0	31.7	1620.0	14.9
1985 – 86	3840.0	74.5	2620.0	61.7
1986 – 87	3640.0	-5.2	3900.0	48.9
1987 – 88	3630.0	-0.3	3420.0	-12.3
1988 – 89	6600.0	81.8	4420.0	29.2
1989 – 90	5780.0	-12.4	4550.0	2.9
1990 – 91	6880.0	19.0	4270.0	-6.2
1991 – 92	15150.0	120.2	10220.0	139.3
1992 – 93	17400.0	14.9	13950.0	36.5
1993 – 94	16640.0	-4.4	7940.0	-43.1
1994 – 95	17899.5	7.6	13433.4	69.2
1995 – 96	23419.0	30.8	25296.7	88.3
1996 – 97	28208.2	20.5	29606.2	17.0
1997 – 98	35631.0	26.3	39714.4	34.1
1998 – 99	48456.0	36.0	48369.5	21.8
1999 – 00	68255.3	40.9	56294.4	16.4
2000 – 01	108672.3	59.2	70950.1	26.0
Cumulative Up to end - March-2001	439017.4	—	368343.4	—

Role in the capital market :

The corporation has been playing a pivotal role in the capital market since its formation. Although only a small share of the funds is used for financing the needs of private sector enterprises, the magnitude of the corporation's resources is such that even this small proportion constitutes one of the largest single sources of industrial finance in the country. The financial assistance to industries has taken the form of direct purchase of securities, under writing of capital issues, loans to corporations. Among these, underwriting of and direct subscription to corporate securities comprises the most significant form of assistance. Industry wise, the assistance by LIC has been provided largely to new industries, such as chemicals, machine making and electricity generating undertakings. State wise, an overwhelming portion of the corporation's assistance has been received by industrially advanced states. The share of the relatively less developed states is woefully low. There has been a high degree of concentration of the LIC's investment in big business houses, which have claimed almost half of its total investment.

Although the LIC has played a significant role in mobilising savings, it might have been a more effective mobiliser of savings, if its policyholders had been offered attractive rates of return in the form of bonus and if life insurance had been made cheaper by reducing the premium rates.

Although the corporation covers the risk factor, the importance of adequate yield to policy holders cannot be over emphasised. The present rate of return on the insurance policy is much lower than the rate of return on equity investment and difference is much higher than is legitimately warranted by the risk coverage. Therefore, if the LIC has to become a more attractive saving medium for the savers in this country, and if it has to compete with other savings media, including the UTI and the national savings scheme certificates, it must offer a cheaper insurance policy to the people and assure a higher return, together with the risk cover. The corporation should not find any problem in this respect if its investment policy is modified to allow the management more discretion to invest its funds in the vest interests of the policy holders, and it will facilitate the evolution of a flexible and active investment policy to secure the maximum return with the safety of capital.

As regards the role of LIC in the capital market, it is obvious that the corporation can play a very useful role in satisfying the whopping capital needs of up and coming enterprises. This can be done in many ways. In the first place, the corporation should employ larger funds for investment in corporate securities. To ensure adequate safety of investments and steady return on them, it is necessary that it should diversify the investment portfolio in terms of units, industries and regions. Unfortunately, there has not been any significant diversification of the corporation's portfolio among the different industries and regions. Second, the LIC should invest more in the securities of special financing corporations. This would provide adequate funds to the financial institutions which in turn, would be able to satisfy the growing requirements of industrial enterprises and this minimises the gaps in the capital market. Such investment is very safe and profitable and may prove to be a better alternative to government securities.

14.1.10 Criticism on the Investment Policy :

The investment policy of LIC has been the subject of controversy. Its investment policy has to satisfy both yield and safety considerations of the shareholders. The procedure followed by the LIC is not very helpful because the corporation invests on the basis of offers from brokers. The brokers will market investment to suit their interests. To remove this defect, the corporation in 1960 had set up an investment research section in the investment Department to analyse systematically the balance sheets of all the companies, whose shares were quoted on the stock exchanges. This research bureau is responsible for the continuous evaluation of the share and the performance of the joint stock companies and also is required to provide the necessary data to the investment committee on the basis of which assistance can be given to any industry.

It is criticised that LIC's contribution to the new industrial ventures is very limited. The funds at the disposal of the corporation are the hard earned savings of the common man. So, the corporation is not in a position to take the risk of investing its funds in new industrial ventures. But the LIC can help them by forming underwriting consortiums with other credit institutions and by purchasing liberally the securities, shares and debentures of other financial institutions. It is also pointed out that LIC has not played any significant role in social development projects like housing, drainage, water supply and other basic amenities. The corporation might have been slow in the initial years in discharging its social responsibilities, but had stepped up in recent years. Several measures have been taken by LIC to streamline its organisation and to improve its functioning.

14.2 Unit Trust of India :

14.2.1 Evolution of UTI :

The need for the establishment of Unit Trust type of investing institution was felt as early as 1931, when the Indian central Banking enquiry committee submitted its report. The importance for setting up these trusts was stressed once again by the Shroff Committee in 1954 in order to increase the capital available for industries, small savings have to be drawn into the investment market. The committee therefore, suggested that both the public and private sectors should setup such institutions. However, the Government of India did not take cognizance of these recommendations, with the result that Unit Trusts could not be established although these institutions had acquired a tremendous popularity and gained immense success in the USA and Japan by that time. They are quite popular in the West as they possess certain advantages over other forms of intermediation. They are Diversified portfolio or pooling of risks, professional management and high degree of liquidity. A small investor on his own cannot avert risk if he directly makes investment in the shares and debentures of companies. With small resources to invest he cannot have diversified portfolio. However, by making investment in the shares of Unit Trusts, risk is averted due to their investment policy. The unit trusts as a policy do not make concentrated investments in a few companies whatever be their financial position.

In 1963, when the whole stock market was in a state of despondency following the Chinese aggression, and when uncertainty engulfed the entire economy, joint stock companies found it difficult to raise capital from the market owing to the diffidence of investors, with the result that industrial development in the country came to a grinding halt. The government therefore, undertook aggressive programmes to mobilise the long term savings of the people and direct them into productive channels with a view to fostering industrial growth in the country. The emergence of Unit Trust of India in 1964 was part of these efforts. The Trust was established in 1964 under the certain of the Unit Trust, as of similar trusts in other countries, to afford the small savers a means of acquiring a share in the widening prosperity based on a steady industrial growth of the country through facilities for investment, combining the benefits of wide diversification, a reasonable return and expert services of management talent. The trust commenced its operations from July 1, 1964. The Unit Trust mobilises funds through selling units, which, like shares and bonds have specific face value. But unlike shares or bonds, the units are continually sold and repurchased by the trust, Thus, liquidity, safety and return are guarantees.

14.2.2 Objectives of UTI :

Until recently the Unit Trust of India was the only organisation of its kind in this country. It was monolithic public sector organisation which has the following objectives.

1. It mobilises the savings of the community and channelises them into productive investment, by promising savers the triple benefits of safety, liquidity and profitability of their investments, the Trust encourages individuals to save.
2. It gives everyone a chance to indirectly own shares and securities in a large number of select companies and enables the investors to share in the widening prosperity consequent on industrial growth.
3. It offers customer oriented innovative products by leveraging technology to provide superior returns, achieve the highest service standards and attain sustained growth levels through principle human resources striving in or focussed, transparent ethical member to exceed investor expectations.
4. It serves the unit holders by spreading throughout the length and breadth of the country.

The UTI sees to provide to the savers the above benefits by means of diversification and expertise in management.

Management :

The UTI is managed by a Board of Trustees consisting of 11 persons, including some of the most distinguished men in finance and business. The chairman of the Board is appointed by the central government in consultation with the IDBI. The executive trustee and 4 other members are appointed by the IDBI. The remaining members are appointed by the RBI, LIC, commercial banks and other institutions.

UTI Network :

The UTI has a track record of managing a variety of schemes catering to the needs of every class of citizens over a period of 39 years. It has a nationwide network consisting of 54 branches, 3 UTI financial centres and representative offices in Dubai and London. With a view to reach to common investors at the district level, 18 satellite offices have also been opened in select towns and districts. It has 2400 committed employees and over 1000 active agents and 266 chief representatives to sue and service its schemes. It has well qualified, professional fund management team, who have been highly empowered to manage funds with greater efficiency and accountability in the sole interest of unit holders. The funds managers are also ably supported with a strong in house equity research department. To ensure better management of funds, a risk management department is also in operation.

The UTI has reset and upgraded transparency standards for the mutual funds industry. All the branches, UTI financial centres and registrar offices are connected on a robust 17 network to ensure cost effective quick and efficient service. All these have evolved UTI to a position as a dynamic, responsive, restructured, efficient, transparent organisation.

Resources of UTI :

The UTI came into existence with two tier capital structure – initial capital and unit capital. While 50% of the initial capital of Rs. 50 million was provided by the RBI, the other 50% was provided by State Bank of India and its subsidiaries, LIC and other banks and financial institutions. Simultaneously with the delinking of IDBI from RBI in February 1976, the initial capital of UTI held by the RBI and also various powers exercised by the RBI under the UTI Act stood transferred to IDBI, making it an associate institution of IDBI. The unit capital has been raised over the years by selling units to the public.

Operational policies of UTI :

In its endeavors to accomplish the principal objective of mapping up the savings of relatively moderate income groups and channelling them into industrial outlets with a view of promoting the growth and diversification of the country's economy, the UTI has formulated suitable policies in different directions. Broadly speaking, these policies may be categorised into two groups, viz; policy on mobilisation of savings and policy on investment of funds. We shall now discuss each of these policies.

(a) Policy on Mobilisation of Savings : The UTI's policy on the mobilisation of savings has its accent on the small and medium income groups of savers. The Trust seeks to garner savings by way of sale of units to the public, each of which confers on buyer an equal right in the beneficial ownership of the assets of the Trust, which are mainly composed of shares and debentures. The units provide a medium through which a number of small investors combine to secure the benefits of the spread of risk, convenience and professional management. From the very beginning, the management decided to evolve innovative schemes, suiting the various requirements of different groups of savers. The UTI has introduced a myriad of savings schemes, which have come into existence from time to time, depending on the particular situations then prevailing in the country.

In the light of the emerging environment of economic liberalisation, competition and globalisation of corporate policy, UTI has envisaged introduction of innovative skills of the agency force, rationalisation of product distribution arrangements, continuous R&D for improved product handling and phased shift from scheme-oriented investor service to 'single window' personalised client oriented service. To achieve the goal of single point service to each investor, a captive subsidiary UTI Investors Services Ltd has been formed. The first scheme launched by the UTI was the unit scheme –1964 which was followed by several open as will as close ended schemes. The UTI added a new dimension to its activities in July 1986, when it launched its first offshore fund, namely 'India Fund' in association with Merrill Lynchy the reputed investment firm of the USA.

The UTI asset management company presently manages 42 NAV based domestic SEBI compliant schemes and 4 offshore funds having a corpus fund of Rs. 15,243 crores from about 10 million investor accounts.

(b) Policy on Investment Funds : The investment policy of the Trust is guided by three main criteria namely,

1) to earn a reasonable return on its investments so as to pay steady and growing dividends to unit holders.
2) to ensure the safety of investments and
3) to provide liquidity so as to meet the obligation of the investment commitments, dividend liability and the repurchase liability under various schemes.

Apart from the above basic criteria, the investment policy also endeavours to give or reasonable capital appreciation to the unit holders over a period of few years. The aspect of capital appreciation has to be viewed from the angle of large volume of growing fund vis-à-vis the opportunities of investment avenues available to the Trust, particularly in the sphere of equity market.

Under the provisions of the Act, UTI can invest either in industrial securities i.e. equity shares, preference shares, debentures / bonds or invest its funds as deposits with scheduled banks or other approved institutions like RBI and other corporations. From the year 1970 onwards, UTI also became a member of consortium of All India Financial Institutions and started participating along with other institutions in the project finance proposals by way of subscription to the privately placed debentures, as granting loans is not permitted under the UTI Act. UTI has been placing its surplus funds as short term unsecured deposits with corporate sector for shorter periods of 3/6 months or 1 year based on the criteria laid down by the Board for such assistance. The debenture portfolio and the deposit portfolio of the Trust has shown substantial increase in recent years due to higher rate of return available on these investment holdings.

The core of the investment policy of UTI is the management of its portfolio assets consisting primarily of industrial securities. It requires constant vigilance over the trends emerging in the stock and capital markets under the influence of variety of factors, real and monetary and the governments economic and financial policies. The board aim of the investment strategy should, therefore, be to maximise income on the portfolio as a whole, given the conditions in the capital and stock markets. In its endeavour to ensure the security of capital and a reasonable return there on, the management has adopted the principle of diversification as the basic tenet of the investment policy. Accordingly, it diffuses its investible resources over different type of securities of numerous units belonging to different industry groups. It has been clearly stipulated that :

(i) The investment by the UTI in any one company should not exceed 5% of the value of the total invested funds of the UTI or 10% of the value of the securities issued and outstanding of such company, whichever is less.

(ii) Not more than 5% of the investible funds should be invested in the initial issues of the securities of new industrial undertakings.

By the amendment to the UTI's general regulations, 1964 the ceiling of 10% in (i) above has been revised upward to 15% from the year 1969-70.

Another characteristic feature of the investment policy of the Trust in its flexible policy which allows it to make appropriate adjustments there in to suit the changing situations. One of the important functions performed by the UTI is the under working of the security issues of corporate enterprises. The UTI Act was amended in 1986 to broad base scope of business of the Trust. Thus, the trust was empowered to enter into business of leasing, housing, granting of direct loans, portfolio management services to perform resident outside the country, merchant banking, bills rediscounting and all other matters incidental there to.

14.2.3 Working performance of the Trust :

During 2000 – 2001, sanctions and disbursements by UTI declined by 12.7% and 10.9% to Rs. 59723 million and Rs. 45999 million, respectively as compared to the growth of 71.5% and 47.6% in 1999 – 2000, up to end March 2001, sanctions and disbursements by UTI aggregated Rs. 683623 million and Rs. 522698 million, respectively.

Sanctions under project finance declined by 11.5% to Rs. 59643 million as against a growth of 72.8% in 1999 – 2000. Direct subscription declined by 48% to Rs. 35051 million in 2000 – 01, while deferred payment guarantees, having nil sanctions during 1999 – 2000, stood at Rs. 24592 million. Non project finance, comprising unsecured / secured term notes and special deposits with industrial concerns and constituting only 0% of total sanctions, declined by 92.6%. Disbursements under project and non-project finance declined by 9.4% and 91.3% to Rs. 45919 million and Rs. 80 million, respectively, as against a growth of 47.6% and 48% during 1999 – 2000.

Financial Assistance to Corporate Industry :

By serving as an effective conduct between saving and investment, UTI has achieved spectacular success in rendering financial support to programmes of rapid indust realisation in the country. Because of the sizable resources garnered by the Trust, it has been possible for it to pump substantial amount of assistance into the corporate sector undertakings. The trust has granted financial assistance to the corporate sector by investment in privately placed debentures and loans, under writing and direct subscription and by way of special deposits. It is to be noted that bout 50% of assistance of the Trust was in the form of underwriting and direct subscription. About 1/3rd of the trusts assistance was by way of privately placed debentures and loans.

Sale, Repurchase and Outstanding of Units :

During 2000 – 01, the aggregate sales (face value) of units under various schemes declined sharply by 41.2% to Rs. 79097 million from Rs. 134584 million during 1999 – 2000. US 64 accounted for the largest share in sales (24.5%) followed by money market fund – 97 (12.3%), monthly income plan 2001(8.2%), monthly income plan – 2000 III (8.1%), UTI Bond fund – 98 (7.9%) and children's college & career fund unit plan – 93(CCCF) (5.7%). Aggregate repurchases at Rs. 104912 million(face value) grew by 24.1% as against a decline of 28.7% in 1999 – 2000. As at the end of June 2001, outstanding unit capital under various schemes stood at Rs. 581308 million.

Advantages for the Unit Holders :

Following are advantages of investment in the UTI units

- Money invested in the units is quite safe. This is because the funds are invested over a wide range of securities.
- of the net total income on unit capital of the UTI, at least 90% is distributed among the unit holders. This means that the unit holders are assured of a steady and reasonable rate of return on their investment.
- Income arising from units is eligible for exemption under the income tax and wealth tax acts. Thus, income from units together with that from other specified investments are exempted from wealth Tax up to the limit of Rs. 1.5 lakhs.
- The units are easily saleable and easily convertible into cash. The units can be sold back to the Trust at the prices fixed by it. These can also be transferred to third parties.

Criticisms :

Though the UTI has shown remarkable progress in a few years of its existence, it suffers from several drawback which are give below

(i) **Urban Bias :** It is pointed out that the UTI is concentrating its activities in Urban areas so that people living in rural areas are denied the advantages accruing from the holding of the units. More than 60% of the units have been sold only in a few big cities.

(ii) **Centralised Control :** As it is, the centralised set up of the Trust makes it difficult to formulate an efficient and effective policy as regards investment decisions.

(iii) **Conservation :** The Trust follows a conservative policy in deciding investment matters. More than half of its investments are in fixed income bearing securities which offer little scope for capital appreciation.

(iv) **High Cost of Maintenance :** The trust spends a great deal to maintain itself. The expenditure is well over 10% of its income. Assuming that the Trust distributes 90% of its income among unit holders, there is only a little amount left for investment or for adding to its financial soundness.

14.2.4 Recent Developments :

In May 2001, there was a scam unearthed in the UTI. The same resulted in the debacle of UTI as a Mutual Fund. There was considerable depreciation in the Net present value of the units of several schemes. The government of India has interfered in the matter but could not set right the things. A committee was appointed to enquire into the scam and make recommendations for its revival. The committee suggested bifurcation of UTI into UTI – I and UTI – II. The government announced its decision of separation in December, 2002.

UTI mutual fund has recently opened out yet another investor friendly vista for its investors on the internet i.e. 'My UTI' whereby an investor can transact through the Internet. With this the investors need not visit UTI offices, or write letters for non monetary changes, not involving any document submission for transactions viz., change of address, bank particulars mandate (mode of payment), update income tax details and view, download and print the latest statement of account (SOA).

By January 2003, almost all schemes funds have outperformed, the respective benchmark indices over various periods. These schemes have distributed income/ bonuses consistently. Over and above, the faith reposed by the investor community on UTI has also been reflected by fresh sales mobilisation over Rs. 5200 crores in the last 7 months, commencing 1st January 2002. US 95 has been awarded with CNBC Mutual Fund Award for the year for the best performance in the open end balance fund category under the three year segment. UTI Mutual Fund is poised to meet the challenges of the future with its dedicated human resources, vast reservoir of funds and 39 year track record. Quality, speed and transparency are the edifice on which the UTI desires to stride a head for the benefit of its investors.

14.3 Summary :

The LIC occupies a unique position among the various financial institutions that constitute the Indian Capital Market. Because it handles huge funds, the decisions of LIC exercise a decisive influence on the capital market, whether they relate to government bonds, industrial securities or real estate. LIC has been actively involving itself in the promotion of new development financial institutions in collaborations in the other institutions by subscribing to their initial and subsequent offers of shares and debentures. It has subscribed to shares and bonds of IDBI, IFCI, ICICI, IRBI, SIDBI, Exim Bank, NHB and REC etc.

The insurance industry in our country is on the threshold of a new era of rapid expansion. A more competitive environment is expected to emerge with new private participants being allowed to enter the insurance industry. The need for private sector participation in this sector is justified on the basis of enhancing the efficiency of operations, achieving a greater density and penetration of life insurance in the country and for a greater mobilisation of long term savings for long gestation infrastructure projects. In the wake of emerging competition, LIC with its more than 47 years of experience and wide reach, is equipped to face the challenges emanating from the entry of new players.

The UTI has commendable job in the mobilisation of the savings of the community in the last 39 years of its operations. This was because of the intensive efforts put in by the Trust, the introduction of novel and innovative deposit schemes and the provisions of a reasonable dividend rate and capital appreciation. The bulk of the savings pooled by the Trust has come from individuals. There was also a predominance of corporate securities in the investment portfolio of the Trust. The Trust has rendered a sizeable amount of financial assistance to the corporate sector. such assistance has been given in the form of under writing of securities, subscription to shares and debentures and subscription to privately placed debentures. A major portion of the Trusts assistance has been provided for the expansion and diversification of existing undertakings and for other purposes.

In the face of highly competitive environment following globalisation of Indian economy and economic liberalisation, the UTI has adopted the strategy of building a well diversified financial conglomerate providing complete range of financial services to common investors and industrial clients. Different enterprises for fund management, commercial banking, financial product marketing, investor services, financial information service, credit rating, investment banking and securities trading, as parts of UTI family, reflect a common services culture, dedicated to bettering tomorrow of common man.

14.4 Self Assessment Questions :

1. Explain in detail the origin and objectives of LIC of India.
2. What are the features and functions of LIC of India.
3. Examine the operational and investment policy of LIC of India.
4. Write on LIC mutual fund.
5. Discuss the working performance of LIC of India.
6. Explain the role of LIC in the capital market.
7. Explain the Evolution and objectives of UTI
9. Discuss the operational policies of UTI
10. Critically assets the working performance of UTI
11. What are the recent developments with regard to UTI

UNIT - 15 CREDIT RATING

Objective :

Financial markets have grown increasingly complex and global and borrowers base has become highly diversified, in the wake of recent financial sector reforms. Investors and financiers have turned their attention to agencies, which are engaged in assessment of financial strength of an organisation and its instruments, in deciding whether their investment is likely to be safe. So the birth of credit rating agencies and diversification of their services. This lesson aims at providing an understanding of the concept of credit rating, benefits of credit rating to investors and companies, as also the origin and growth of credit rating agencies with special reference to India.

Structure :

15.1 Concept of Credit Rating :

Credit Rating is a codified rating assigned to an issue/credit instrument by authorized credit rating agencies, by estimating or assessing the solvency that if the ability of the borrower to repay debt and expressing that through pre determined symbols. It is an assessment of the credit quality or investment quality of a particular issue/credit instrument issued by a company. In other words credit rating is a rating or ranking arrived at a systemic analysis of the strengths and weaknesses of a company and debt instrument issued by the company, based on financial statements, project analysis, credit worthless of factors and future projects of the project and the company appraised at a point of time.

The following are a few definitions credit rating.

"Credit rating is designed exclusively of the purpose of grading bonds according to their investment quality."

"Corporate or municipal debt rating is a current assessment of the credit worthiness of the obligator with respect to a specific obligation."

"A corporate credit rating provides with a simple system of grading by which the relative capacities of companies to make timely repayment of interest and principle on a particular type of debt can be noted. The higher the rating the greater the likely hood that the borrower will fulfil his Obligations towards creditors".

"Security rating is a process by which a statistical service prepares various ratings identified by symbols which are indicators of the investment quality of the securities rated."

Credit rating in India is mandatory for the issuance of debt instruments: debentures with conversion/redemption period; commercial paper issued by corporate; and public deposits of all non banking financial institutions with net owned funds above Rs. 50 lakhs. Rating is not mandatory for public issue of shares. However the companies at their own volition can get themselves rated for their public issues. Rating is usually expressed in alphabetical or alphanumerical symbols like A A A : A1 A2 A3.

All companies can issue investment grade securities through an issue of more than Rs. 100 crores to the public with out listing equity. In this case the company must obtain investment grade rating from two rating agencies. In addition the promoter will have to bring in 20 percent of the equity requirements of the project for which the debts are raised.

15.2 Nature of Ratings :

Credit rating is not a recommendation to purchase or sell or hold security. It is not a general-purpose evolution of the company. It does not create a fiduciary relationship between the credit rating agency and the rating users. It is not a one-time evolution of risk which remains valid for the entire life of the security.

Credit rating is done by specialized expert, reputed, accredited institutions. Though the whole organisation is not graded, it does reflect the issuer's strength, soundness of operations, quality of management, organisational behaviour and composite performance.

Credit rating may differ for different instruments issued by the same organisation because of the different nature of obligations each instrument has. While assigning ratings the factors such as industry risk, market position, operating efficiency, track record planning and controlling systems accounting quality, financial flexibility, profitability, liquidity and assigned quality of the borrower are taken in to account. The rating is based not only on information provided by the borrower but also the one obtained by the agency independently. After they are assigned, ratings are continuously monitored by the agency and they can be changed, suspended and with drawn by it at any time as a result of new information or other circumstances.

Credit ratings guide the investors, but they may also serve to mis-guide them, which depends on both the expertise and honesty of credit rating agencies. Credit is a science as well as an art. However it will never be a precise science as there are too many variables relating to business conditions to be judged, at times on value system. There is no magic formula for arriving credit rating; it involves matter of judgement, not merely an analysis of statistics.

15.3 Determinants of Ratings :

A rating agency assigns quality ratings that measure the default or bankruptcy risk of a security and sells the rating to their subscribers. The default risk is primarily determined the amount of funds available to the issuer relative to the amount of funds to be paid to the security holders. The ability to pay is evaluated by financial ratios. Ratio analysis is used to analyse the present and future earning power of the company issuing the security. Security rating appraises the default risk, which is a combination of business risk and financial risk.

Rating thus is not based on a predetermined formula, which specifies the relevant variables as well as weights attached to each one of them. Further, the emphasis on different aspects varies from agency. Broadly, the rating agency assures itself there is good congruence between the assets and liabilities of a company downgrade the rating if the qualities of assets depreciate. The rating agencies employ qualifies professions to ensure consistency and reliability. The agency also ensures the integrity of rating by insulating rating from conflicts of interest.

15.4 Advantages of Credit Rating :

To Investors :

Primarily several benefits accrue to investors through rated instruments.

1. Investor gets an idea about the degree of financial strength of the issuer company which enables him to decide whether to invest or not in that instrument. Highly rated instrument of a company gives an assurance to the investors of safety of instrument an minimum risk of bankruptcy.
2. Symbols are easily recognisable indicators of the degree of risk involved in investment. By looking at the symbol an investor can understand the risk involved or the expected advantages from the investment. He can make a quick decision on knowing the symbol.
3. Rating gives clue to the credibility of the issuer company. It is a rating by third party agency and is therefore reliable for an investor.
4. Ratings saves time and energy for the investor in bothering a lot about knowing the unknown – little known company position and the risks associated with offered instrument. It provides low cost information to the investor.
5. An investor can make a choice of highly safe instrument from among several alternative credit rating instruments available in the market at a point of time.
6. An investor get the benefit of the credit rating agency's on going monitoring of the Rating and he can act as he choose knowing the revision of rating, if any.

To Company :

Their rated credit instruments also benefit companies.

A highly rated credit instrument easily attracts investors who prefer no or less risk on their investment, though yielding marginally low rate of return. This situation reduce the cost of borrowing from public for a company by quoting lesser rate of interest.

The company approach the investors in different strata of the society extensively for resource mobilisation using the media, using as a powerful incentive and effective marketing tool.

The overall image of the company issuing high rated instruments also improves there by pushing up company's sales, and making borrowings from banks and other financial institutions easy.

Brokers also find it easy to convince their clients to select an investment proposal with a good rating this saves their time energy and costs.

Disadvantages :

1. In the absence of impartial, genuine rating by a professions agency, credit rating become a curse rather than a boom.
2. There is a possibility of different credit agencies rating a company instruments differently. Human bias, value judgement, varied levels of expertise and honestly makes it possible.
3. Prediction of company's health true rating is momentary and any thing can happen after assignment of rating symbols to the company. Economic, Political, Government policies may change since rating, making rating less dependable.
4. Rating is specific to instrument but does not reflect the soundness of the company. Independent analysis therefore, may have to be made by the investor. Credit instruments rating cannot be consideration for purchase of shares in accompany.
5. Rating is time specific. If once the earlier rating is down graded subsequently, it severely adversely effect the image of the company.

Credit rating is a science as well as an art. It has been rightly pointed out that rating is not and never will be a precise science; there are simply too many variables or a tremendous variety and a combination of business conditions to be judged. There fore there is no magic formula for arriving at credit rating; it involves matter of judgement, not merely an analysis of statistics. Subject to this the useful ness of credit rating depends up of the quality of the credit rating agency, its dependence from industrial concerns, absence of its vested interest in or linkages with the issuer of securities, its objectivity, the quality of its staff and so on.

15.5 Credit Rating Agencies :

The origin of credit rating can be trace back to 1840 with Louis Tappan established the first Mercantile Credit agency in New York in 1841. This agency rated the ability of merchants to pay their financial obligations. Further expansion of credit rating activity took place in 1920's with the entry of three more firms into the field. Since then in the 1970's the number of credit rating agencies commenced their operations all over the world. Selected major credit rating agencies include the following....

SL. No.	Name of the Agency	Home Country	Owner ship	Principal Rating Areas
1.	Moody's Investors Service	U.S.A	Dun and Bradstreet	Full Service
2.	Fitch Investors Service	U.S.A	Independent	Full Service
3.	Standard and Poor	U.S.A Corporation	McGraw Hill	Full Service
4.	Japan Bond Rating Service	Canada	Independent	Full Service (Canada)
5.	Japan Bond Rating Institute	Japan	Japan Economic Journal	Full Service (Japan)
6.	Duff and Phelps Credit Rating	U.S.A	Duff and Phelps Corpn	Full Service
7.	Japanese Credit Rating	Japan Agency	Financial Institutions	Full Service (Japan)
8.	IBCA Ltd.	United Kingdom	Independent	Financial Institutions

Source: Indian Financial System – P.N. Varshney & D.K. Mittal. Page : 1.215.

There are credit rating agencies in operation in many other countries such as Malaysia, Philippines, Mexico, Indonesia, Pakistan Cyprus, Coria, Thailand and Australia.

Credit Rating industry in Indian was ushered in 1987 with the setting up of Credit Rating and Information Service of India, followed by three more set up during the Nineties.

Credit Rating Agencies in India :

1. Credit Rating and Information Services of India (CRISIL) 1987
2. Investment Information and Credit Rating Agency of India (ICRA) 1991.
3. Credit Analysis and Research Limited (CAR) 1993.
4. Duff and Phelps Credit Rating of India (P) Ltd.

15.6 Credit Rating and Information Services of India (CRISIL) :

Established in 1987, CRISIL in India's Premier Credit Rating Agency and Ranks amongst the top five in the world. It has been promoted by ICICI, UTI, LIC,GIC and Asian Development Bank and is a Public Limited Company with headquarters at Mumbai. The main objective of CRISIL has been to rate debt obligation of Indian Companies. Its rating provides a guide to the investors as to the risk of timely payment of interest and principal on a particular debt instrument. Its rating creates awareness of the concept of credit rating amongst corporations that facilitates the debt rating. It has also envisaged to cover under debt rating all securities viz. Fixed deposits, commercial papers, equity and preference shares and real estate project.

Over the fifteen years the rating agency has successfully established the concept of credit rating among the major market participants. CRISIL has innovated and institutionalised a viable and making system of credit rating in India and has thus facilitated greater investments in debt instruments.

CRISIL is the market leader in India and as a full servicing rating agency, it has the most comprehensive range of rating services. Combining its understanding of risk and the science of building risk frameworks, with its strong contextual understanding of business. CRISIL ratings provide the most reliable opinions on risk.

Since 1996 CRISIL has had a strategic tie up with Standard & Poor's USA (S&P) the world's top agency, the tie up which was initially in the nature of a technical tie up culminated with S and P equity stake of 9.68% in CRISIL in 1966. This affiliation gives CRISIL access to the latest rating methodology as well as enables to leverage on S and P' s global rating experience.

In the short span of 15 years, CRISIL has succeeded in gaining international recognition, provided technical assistance and training to new rating agencies in Malaysia and Israel and only rating agency out side the United States to provide technical know how overseas. CRISIL credibility has helped it to tie-up with some of the largest information vending companies in the world.

CRISIL currently employs over 150 professional analysis and has an extensive data-base spanning industries and companies, which assists in the rating exercise. In addition, CRISIL has dedicated the form of Centres of Excellence for Manufacturing. Finance and infrastructure with a view to provide qualitative focus to existing as well as proposed rating methodologies, as well as in-depth understanding of various industry proposed.

Range of Services :

CRISIL rates all rupee denominated debt obligations. These include long term instruments such as debentures/bonds preference shares, structured obligation (including asset based securities) and short term instruments such as commercial paper programmes and short term deposits. It has also undertaken credit assessments of various State Governments including Maharastra, Gujarat and Andhra Pradesh.

CRISIL has pioneered the rating of subsidiaries and joint ventures of multi nations in India has already rated several multi national entities. Over the years CRISIL has also developed ratings for several structured obligations. The rating agency has also developed the methodology for enchantment of corporate borrowing programmes through the use of partial guarantees. In essence it is uniquely placed in its experience in understanding the extent of credit enhancement of arising out of structures.

CRISIL has developed performance methodologies for the credit rating of real estate developed projects in association with National Real Estate Development Council and for the credit rating of marketers of liquidified petroleum gas.

A part from the rating assignments for clients, CRISIL has undertaken several assignments of a developmental nature for credit risk analysis. The rating agency is currently involved in the evaluation of intrastate projects of national importance, particularly those related energy, railroad, irrigation and Tele Communications.

Credit Rating Process :

- The process of rating starts with the issue of a rating request by the issuer/signing of the rating agreement Fig 15.1 depicts the flow chart.

Credit Rating are arrived at based on information obtained in the rating process. In addition to management meetings and information provided by rated entities, the rated entity's audited accounts, regulatory filings, and information provided by trustees from an important source of information. CRISIL does not verify and validate all the information that it uses for its ratings. However, reasonable due diligence is carried out on all information used to the extent feasible to ensure that a meaningful and accurate rating exercise is done (for instance, financial accounts are extensively adjusted to ensure that they present a relevant picture of the financial position of an entity from a debt servicing perspective, to the extent feasible).

In evaluating and monitoring ratings, CRISIL employ qualitative and quantitative criteria in accordance with the industry practice. The rating method is an analysis of the past performance of the company and an assessment of its future prospects. Ratings criteria is developed for each important industry in all important sectors viz., corporate finance, infra-structure, structured finance, health care and governance.

Limitations of CRISIL'S Credit Ratings :

A credit rating is an assessment of carried out from the limited standpoint of credit risk evaluation. A credit rating from CRISIL therefore constitutes a current opinion on the credit quality of a specific issue of debt, in terms of the issuer's ability and willingness to meet principal and interest payments on rated debt instruments in a timely manner.

A Credit Rating from CRISIL is NOT :

1. A general-purpose credit or performance evaluation of the rated entity: CRISIL Credit Ratings are always issue-specific.
2. A recommendation to invest in, or not to invest in any shares, debentures or other Instruments issued by the rated entity, or derivatives thereof.
3. An opinion associate, affiliate or group companies of the rated entities, or on promoters directors or officers of the rated entity.
4. A statutory or non-statutory audit of the rated entity.
5. An indication of compliance or otherwise with legal or statutory requirements.

CRISIL Rating Symbols:

As has already been noted CRISIL has developed different criteria for different debt instruments, as also different symbols for each. Let us note down the rating symbols of widely issued instruments viz., debentures and fixed deposits.

For Debentures				For Fixed Deposits
	Symbol		Indication	Symbol
1.	AAA	-	Highest Safety	FAAA
2.	AA	-	High Safety	FAA
3.	A	-	Adequate Safety	FA
4.	BB	-	Inadequate Safety	FB
5.	B	-	High Risk	FB
6	C	-	Substantial Risk	FC
7.	D	-	Default	FD

CRISIL Fixed Deposit Rating Symbols :

Investment Grades:

FAAA (F-Triple A)	:	Highest Safety
FAA (F- Double A)	:	High Safety
FA	:	Adequate Safety

Speculative Grades :

FB	:	Inadequate Safety
FC	:	High Risk
FD	:	Default

Note:

(1) CRISIL may apply '+' (plus) or '-' (Minus) sign for ratings from FAAA to FC to indicate the relative position within the rating category.

(2) The contents within parenthesis are a guide to the pronunciation of the rating symbols.

Credit Rating for Short Term Instruments :

Rating Symbol	Indication
	(Each rating indicates that the degree of safety regarding timely payment on the is instrument shown against the symbol).
	Very Strong

P_{-2}	Strong
P_{-3}	Adequate
P_{-4}	Minimal
P_{-5}	Expected to be in default on maturity in Default

Note: CRISIL may apply "+" signs for ratings from PO-1 to P-3 reflect a comparatively higher standing with in the category.

15.7 Investment Information and Credit Rating Agency (ICRA)

ICRA (formerly Investment Information and Credit Rating Agency of India Limited) has been promoted by Industrial Financial Corporation of India, the chief promoter, with its head quarters at New Delhi. It is public limited company.

ICRA rates rupee denominated debt instruments issued by manufacturing companies, commercial banks, non banking finance companies, financial institutions, public sector undertakings and municipalities among the others. The rated instruments includes bonds, debentures, fixed deposits, commercial papers and certificate of deposits. ICRA also rates structured obligations and sector specific debt obligations. Since 1995 it has been doing equity grading also to a certain extent.

The information Services Group focuses on providing authenticated data and value added products used by intermediaries, financial institutions, banks asset managers, institutional and individual investors and others.

Advisory Services Group offers wide ranging management advisory services which include strategic concealing, restructuring solutions and client specific need based studies.

The Rating scales of ICRA are as Follows:

ICRA RATING SCALE:

Long Term including Debentures Bonds and Preference Shares		**Medium term including Deposits Fixed**	
LAAA	: Highest Safety	MAAA	: Highest Safety
LAA	: High Safety	MAA	: High Safety
LA	: Adequate Safety	MA	: Adequate Safety
LBBB	: Moderate Safety	MB	: Inadequate Safety
LB	: Risk Prone	MC	: Risk Prone
LC	: Substantial Risk	MD	: Default
LD	: Speculative		

Short Term Including Commercial Paper

A-1 Highest Safety
A-2 High Safety
A-3 Adequate Safety
A-4 Risk Prone
A-5 Default

Notes:

(i) The rating symbols group together similar (but not necessarily identical) concerns in terms of their relative capability of timely servicing of debts/obligations, as per terms of contracts, i.e. the relative degree of safety/risk

(ii) The Sign (+) or (-) may be used after the rating symbol to indicate the comparative position of the company with in the group covered by the symbol.

(iii) The letter 'P' in parenthesis after the rating symbol indicates that the debt instrument is being used to raise resources by a new company for financing a new project and the rating assumes successful completion of the project.

(iv) The rating symbols for different instruments of the same company need not necessarily be the same.

ICRA FIXED DEPOSIT RATING SYMBOLS		ICRA CREDIT ASSESSMENT SYMBOLS	
MAAA	Highest Safety	1.	Very Strong Capacity
MAA +		2.	
MAA	High Safety	3.	Strong Capacity
MAA-		4.	
MA+		5.	
MA	Adequate Safety	6.	Adequate Capacity
MA-		7.	
MB+		8.	
MB	Inadequate Safety	9.	Inadequate Capacity
MB-		10.	
MC+	High Risk	11.	Poor Capacity
MC		12.	
MC-		13.	
MD	Default	14.	Default

15.7.1 Credit Analysis and Research Limited (CARE) :

It is promoted by IDBI jointly with investment institutions, banks and finance companies. Its services include credit rating of debt instruments, information services, equity research and performance rating. Rating symbols of CARE are also similar to choose of other rating agencies.

They look as given below:

SL No	Investment Grade	CARE
	For Long term debt instruments	
1	Highest Safety	CARE AAA
2	High Safety	CARE AA
3	Adequate Safety	CARE A
4	Inadequate Safety	CARE BB
5	High Risk	CARE B
	For Medium term debt instruments	
1	Highest Safety	CARE AAA
2	High Safety	CARE AA
3	Adequate Safety	CARE A
4	Inadequate Safety	CARE BB
5	High Risk	CARE C
	For Short term debt instruments	
1	Highest Safety	PR1
2	High Safety	PR2
3	Adequate Safety	PR3
4	Inadequate Safety	PR4
5	High Risk	

15.7.2 SEBI Guidelines:

The following are the important guidelines pronounced by the SEBI in 1999 in respect of Credit Rating Agencies.

1. No credit rating agencies shall rate a security issued by its promoters.
2. It has barred rating agencies from rating securities issued by any borrower, subsidiary or associate of the promoter if it has a chairman, director, employee of any such firm.
3. Dual rating is compulsory for public and rights issue of debt instruments of Rs. 100 core or more.
4. SEBI has decided to incorporate a clause in the listing agreement of stock exchanges requiring companies to cooperate with agencies by providing correct information. Refusal to do so may lead to breach of contract between rating agencies and client.
5. The issues would be required to incorporate an undertaking in their offer documents promising necessary cooperation with the rating agency in providing factual information.
6. It is also suggested that a penal clause be introduced in the listing agreement of th information provided is proved to be incorrect at a later stage, to protect investor's interest.

7. The net worth of rating agencies has been fixed at Rs. 5 crore.
8. Rating agencies can choose their methodology of operation but self regulatory mechanism will give a better maturity status for agencies.
9. No chairman, director or employee of the promoters shall be a chairman, director or employee of the CRA or its rating committee. Promoter of a CRA is a person who holds more than 107 of holdings of the CRA
10. Period of validity of registration shall be 3 years.

15.8 Problem in Credit Rating :

The following are some crucial problems felled by the rating agencies.

1. The absence of widespread branch network of the rating agency may limit its skills in rating.
2. Inexperienced, unskilled or overloaded staff may not do justice to their job and the resulting ratings may not be perfect.
3. Since rating exercise involves a number of factors, a rigid mathematical formula cannot be applied to finalise rating and some element of subjectivity creeps in, there by giving scope for bias.
4. The time factor greatly affects rating and gives misleading conclusions. A company which experiences adverse conditions temporarily will be given a low rating judged on the basis of temporary phenomenon.
5. Since the rating agencies receive a sizable fee from the companies for awarding ratings, a tendency to inflate the ratings may develop.
6. The rating is not permanent but subject to changes and more over the agencies can not give any guarantee for the investors.
7. Investments which have the same rating may not have identical investment quality because the number of rating categories is limited and hence can not reflect small but meaningful differences in the degree of risk.
8. Borrowing entities give misleading advertisements about the rating symbols of their instruments. For example, 'X' Co. Ltd. Which has got AAX for its debenture may mobilise fixed deposits instead of revealing the low rating for fixed deposits. Such kind of window dressing should be curtailed.

15.9 Self-Assessment Questions :

1. Define the concept of Credit Rating. What are the advantages and disadvantages of credit rating?
2. Examine the need for credit rating, the nature and determinants of credit rating.

3. Discuss the role of credit rating agencies in promoting marketing of debt instruments.

4. Critically examine the functioning of CRISIL.

5. Write short notes on

    1. ICRA
    2. CARE
    3. RATING SYMBOLS

15.10 Further Readings:

1. Management of financial services - V.K. Bhalla- Anmol Publications- New Delhi 2002
2. Indian Financial System - P.N. Vashmey and D.K. Mital – S. Chand & Sons New Delhi 2002
3. Financial Institutions and Markets - L.M. Bhole – Tata Mc Grawhill New Delhi 1999.
4. Indian Financial System - M.Y. khan – Tata Mc Grawhill New Delhi 1996.