BAOU
Education for All

Dr. Babasaheb Ambedkar
Open University
(Established by Government of Gujarat)

NAAC ACCREDITED A++ GRADE 3.55/4

MBA
SEMESTER - 3
MBA03EF305
Management of Financial Services

Message for the Students

Dr. Babasaheb Ambedkar Open (University is the only state Open University, established by the Government of Gujarat by the Act No. 14 of 1994 passed by the Gujarat State Legislature; in the memory of the creator of Indian Constitution and Bharat Ratna Dr. Babasaheb Ambedkar. We Stand at the seventh position in terms of establishment of the Open Universities in the country. The University provides as many as 54 courses including various Certificate, Diploma, UG, PG as well as Doctoral to strengthen Higher Education across the state.

On the occasion of the birth anniversary of Babasaheb Ambedkar, the Gujarat government secured a quiet place with the latest convenience for University, and created a building with all the modern amenities named 'Jyotirmay' Parisar. The Board of Management of the University has greatly contributed to the making of the University and will continue to this by all the means.

Education is the perceived capital investment. Education can contribute more to improving the quality of the people. Here I remember the educational philosophy laid down by Shri Swami Vivekananda:

> ***"We want the education by which the character is formed, strength of mind is Increased, the intellect is expand and by which one can stand on one's own feet".***

In order to provide students with qualitative, skill and life oriented education at their threshold. Dr. Babaasaheb Ambedkar Open University is dedicated to this very manifestation of education. The university is incessantly working to provide higher education to the wider mass across the state of Gujarat and prepare them to face day to day challenges and lead their lives with all the capacity for the upliftment of the society in general and the nation in particular.

The university following the core motto 'स्वाध्यायः परमम् तपः' does believe in offering enriched curriculum to the student. The university has come up with lucid material for the better understanding of the students in their concerned subject. With this, the university has widened scope for those students who are not able to continue with their education in regular/conventional mode. In every subject a dedicated term for Self Learning Material comprising of Programme advisory committee members, content writers and content and language reviewers has been formed to cater the needs of the students.

Matching with the pace of the digital world, the university has its own digital platform Omkar-e to provide education through ICT. Very soon, the University going to offer new online Certificate and Diploma programme on various subjects like Yoga, Naturopathy, and Indian Classical Dance etc. would be available as elective also.

With all these efforts, Dr. Babasaheb Ambedkar Open University is in the process of being core centre of Knowledge and Education and we invite you to join hands to this pious *Yajna* and bring the dreams of Dr. Babasaheb Ambedkar of Harmonious Society come true.

Prof. Ami Upadhyay
Vice Chancellor,
Dr. Babasaheb Ambedkar Open University,
Ahmedabad.

MBA
SEMESTER-3 FINANCE
MANAGEMENT OF FINANCIAL SERVICES
BLOCK: 1

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MANAGEMENT OF FINANCIAL SERVICES (MFS)
MBA03EF305
SEMESTER-3

BLOCK-1

BLOCK-2

UNIT – 1 INTRODUCTION TO FINANCIAL SERVICES

1.1 Introduction

Since 1990, Indian financial services industry has transformed drastically. Previously commercial banks and other financial institutions dominated the Indian industry. It was liberalization due to which financial services got the prominent position in the economy. Today, it is one of the largest industries of the world.

Financial service sector is a strong driver of the economic growth. A strong financial service sector will lead the economy to grow, and if not, it may drag the economy down. Financial services channelize the free flow of capital and liquidity in the economy.

Financial services are an important part of financial system. Financial system is nothing but the complex system of financial institutions, financial instruments, financial markets and financial services. Financial Service as a part of financial system provides different types of finance through various credit instruments, financial products and services. Financial services provide financial solutions in the form of various credit instruments, financial products and even services.

1.2 Meaning of Financial Services

Financial services are the services provided by the finance industry. The services provided by banks, insurance companies, stock brokers, credit card companies, investment funds etc. are financial services. The financial services can be defined as," the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities."

Financial services can also be understood as mobilization and allocation of savings. The various activities that led transformation of savings into investments are called financial services.

According to the Finance and Development Department of the International Monetary Fund (IMF), "Financial services are the processes by which consumers or businesses acquire financial goods."

Cheques, bills, promissory notes, debt instruments, letter of credit, commercial papers etc. are financial instruments. On the other hand, mutual funds, various types of extended investment opportunities, credit cards, debit cards, insurance related products are the examples of financial products. Leasing, banking, hire purchase, factoring, financing, merchant banking, venture capital, banking, insurance are the financial services through which a prospective investor may avail the various types of assets ownership or on lease. Financial services are there to enable the user of financial services to obtain the asset of his choice on credit and that too with reasonable rate of interest.

1.3 Characteristics or nature of Financial Services

1. Intangibility
2. Customer orientation
3. Inseparability
4. Perishability
5. Labour intensive
6. Information based

Characteristics of Financial Services:

1. Intangibility: The very nature or characteristics of financial services are that they are intangible in nature. Though intangible in nature, it would be ultimately the image of the institution creating innovative financial solutions for the public. It will be again the goodwill of the company that plays an important factor for the marketing of financial services.

2. Customer Orientation: There are different investment objectives and financial needs of customers. The institutions create innovative financial solutions on the basis of needs of the customers. On the basis of studies conducted by them to understand the customer's needs better, they try to come out with reliable, innovative financial products.

3. Inseparability: The functions of production and supply of financial services have to be carried out simultaneously. This requires a project understanding between the financial services firms and their clients.

4. Perishability: It is compulsory on the part of financial service providers to match the needs of their customers. The solutions need to be provided instantaneously. Financial Services providers have to be instant in both, the creation of financial services and delivery of the same to the target customers.

5. Labour intensive: Financial service industry is completely a people intensive industry. One can perform better in the financial service marketing as successful personnel only when he would be in a position to satisfy the varied investment objectives and needs of different individual investors. The solutions should be customized for each investor in the economy. One can be successful in the marketing of financial products only when he will perform better on the basis of his knowledge, efficiency and effectiveness of his training. Hence the industry is labour intensive.

6. Information based: The information like disposable income, standard of living, educational changes related to various classes of customers is very important in the financial services sector. The performance of the market depends upon the varied needs and wants of the market. The perfect information will always lead to good business. The institutions providing financial services will always look after the market needs in advance. While evolving new services, it will always be good to have proactive approach.

1.4 Functions of Financial Services

1. Fund Raising: The financial requirement of various groups like investors, individuals, institutions, corporate houses can be fulfilled with the help of financial services. Financial services become instrumental in providing assistance in fund raising activity. Financial instruments of variety of attributes are useful to raise funds from the market.

2. Funds Deployment: The financial services like bill discounting, factoring of debtors, parking of short-term funds in the money market, credit rating, e-commerce, and securitization of debts are provided by banking financial services firms in order to ensure efficient management of funds. It helps players to ensure the efficient deployment of funds resulting into profitable ventures.

3. Specialized Services: The finance sector has become a multidimensional sector with variety of specialized services. The financial services sector provides specialized services such as credit rating, venture capital financing, lease financing, factoring, mutual funds, merchant banking, stock lending, depository, credit cards, housing finance, book building, etc. besides banking and insurance institutions and agencies such as stock exchanges, specialized and general financial institutions, non-banking finance companies, subsidiaries of financial institutions, banks and insurance companies also provide these services.

4. Regulation: Monitoring and regulating the financial institutions and the activities related to financial services is essential to expect an ideal financial system. The objective of the regulatory bodies should be to ensure an orderly functioning of financial institutions. There are agencies that are involved in the regulation of the financial services activities. In India, agencies such as the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI) and the Department of Banking and Insurance, Government of India, through a plethora of legislative measures, regulate the functioning of the financial service institutions.

5. Economic Growth: Financial services have a major role to play in the economic development of a nation. It contributes, in good measure, to speeding up the process of economic growth and development. This takes place through the mobilization of the savings of a cross section of people, for the purpose of channeling them into productive investments would be the ultimate of objective of financial services. The benefit of economic growth is reflected on the people in the form of economic prosperity where in the individual enjoys higher standard of living.

1.5 Importance of Financial Services

1. Endorsing Investment: Financial services leads to the creation of more demand for product and services. Increase demand leads to increase volume of production leading to ballooned requirement of funds or investments. Here the financial services play a pivotal role. Merchant bankers through the new issue market, enable the producer to raise capital. The stock market helps in mobilizing more funds by the investor. Investment from abroad is attracted. Factoring and leasing companies, both domestic and foreign, enable the producer not only to sell the products but also to acquire modern machinery / technology for further production.

2. Promotion of Savings habits: Financial Services like mutual funds with ample opportunities provides variety of investment options to the investors. Understanding the varied investment preferences of salaried people, business community, pensioners, aged people even the investment avenues have been thought of with assured reasonable return without much risk.

3. Minimalizing the risks: The existence of insurance companies helps the economy to safeguard from various types of risk. Both financial and operating risk can be minimized by the presence of insurance companies. Various types of risks are covered which not only offer protection from the fluctuating business conditions but also from risks caused by natural calamities. Insurance is not only a source of finance but also a source of a savings, besides minimizing the risks.

4. Take full advantage of the returns: Limited risk with ample investment opportunities through various types of financial services enables businessmen to maximize their returns. The availability of credit at reasonable rate, various types of credit facilities to acquire capital assets, financial services like leasing, factoring enables the corporate houses to increase their profitability.

5. Ensures greater yield: Yield means return. The financial services will help the producers to earn more profits and to maximize their wealth. Financial Services enhance their goodwill and induce them to go in for diversification. The stock market and the different types of derivative market provide ample opportunities to get a higher yield for the investor.

6. Economic growth: Financial services has the major role to play in the economic development of a nation. It contributes, in good measure, to speeding up the process of economic growth and development. This takes place through the mobilization of the savings of a cross section of people, for the purpose of channeling them into productive investments would be the ultimate of objective of financial services.

7. Economic development: Creating disposable income can even be one of the objectives of financial services. Financial Services enable the consumers to obtain different types of products and services by which they can improve their standard of living. Purchase of car, house and other essential as well as luxurious items are made possible through hire purchase, leasing and housing finance companies.

8. Benefit to Government: Raising of both short term and long-term funds can be possible for the government because of an existence of financial services. Through financial services, the funds can be raised by issue of Treasury bills commercial papers, government securities while foreign exchange requirements of the government can be met in the foreign exchange market.

9. Expands activities of financial institutions: The presence of financial services enables financial institutions to not only raise finance but also get an opportunity to disburse their funds in the most profitable manner. Mutual funds, factoring, credit cards, hire purchase finance are some of the services which get financed by financial institutions.

10. Promotion of Domestic and Foreign Trade: The presence of factoring and forfeiting companies ensures increasing sale of goods in the domestic market and export of goods in the foreign market. Financial Services ensure promotion of domestic as well as foreign trade. Banking and insurance services further contribute to step up such promotional activities.

1.6 Types of Financial Services

1. Leasing: A lease is a contract outlining the terms under which one party agrees to rent an asset—in this case, property—owned by another party. It guarantees the lessee, also known as the tenant, use of the property and guarantees the lessor (the property owner or landlord) regular payments for a specified period in exchange. Leasing is nothing more than a method of paying for the use of an asset over a specified period of time. There are two types of lease agreement. They are as follows:

Types of lease agreement

a) Financial Lease
b) Operating Lease

a) Financial Lease: A financial lease is a commercial lease. In this case the finance company is a legal owner of the asset. A financial lease is a contract involved payment over a fixed period of a specific amount for the use of a specific asset or project.

b) Operating Lease: An operating lease is a contract that allows for an asset's use but does not convey ownership rights of the asset. These leases allow businesses to use the asset without incurring the high expenses involved in purchasing it.

2. Hire Purchase Finance: The word "Hire Purchase" is widely used in the United Kingdom specifically and it is also known as Installment Plan in United States. It is an arrangement for buying expensive goods, where the buyer makes the downpayment and pays the balance plus interest through installments. Such agreements are made while buying expensive goods. In this arrangement, the consumer by making downpayment purchases the asset and the rest of balance along with interest will be charged from him in monthly installments.

3. Merchant Banking: Merchant banks are non-depository financial institutions. These institutions are specialized in providing financial services to private corporations or specialty clients. A merchant bank is a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high-net-worth individuals. Merchant bankers understands the requirements of business houses and makes an arrangement with the help of financial institutions, stock exchanges, and banks.

4. Credit Card: A credit card is a physical payment card that allows the holder to get credit from a financial institution. A credit card is a type of credit facility, provided by banks that allow customers to borrow funds within a pre-approved credit limit. It enables customers to make purchase transactions on goods and services. A credit card is a financial tool with a pre-loaded amount that allows the cardholder to make purchases and pay for them later. Those who are with stable income are provided with this facility.

5. Mutual Funds: A mutual fund is a pool of money managed by a professional fund manager. It is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities. A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates. The risk in the mutual funds investments is lower as compared to capital market. The advantage of professional guidance will be available for the investors.

6. Factoring: Factoring is a type of finance in which a business would sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs. Under the transaction between both parties, the factor would pay the amount due on the invoices minus its commission or fees. A factor is an intermediary agent that provides cash or financing to companies by purchasing their accounts receivables. A factor is essentially a funding source that agrees to pay the company the value of an invoice less a discount for commission and fees. Factoring can help companies improve their short-term cash needs by selling their receivables in return for an injection of cash from the factoring company. The practice is also known as factoring, factoring finance, and accounts receivable financing.

7. Housing Finance: Housing Finance has not only become popular, but the procedure for obtaining loan has been simplified and housing loans for dwelling houses are made easily available. This is due to the change is the housing policy of both the central and state governments. Commercial banks have entered housing finance. In fact, State Bank of India has setup a separate subsidiary for housing finance. World Bank is providing soft loan repay in 25 to 40 years for the purpose.

8. Forfeiting: The provision of medium-term financial support for the import and export of capital goods is known as forfeiting. Forfeiting is a method of trade finance that allows exporters to obtain cash by selling their medium and long-term foreign accounts receivable at a discount to a forfeiter, a specialized finance firm or a department in a bank. Forfeiting can help exporters improve cash flow, particularly when pursuing sales to foreign buyers who depend on longer financing terms which can stretch for months or years. It is an understanding between the exporter bank, forfeiting bank and the importer bank. Due to this, the exporters are able to get finance immediately after export and the risk of bad debts is eliminated.

9. Book Building: A process used by companies raising capital through Public Offerings- both Initial Public Offers (IPOs) or Follow-on Public Offers (FPOs) to aid price and demand discovery is known as book building. Book Building is the process by which an underwriter determines the price at which the shares must be sold in an Initial Public Offer. The process of price discovery requires the underwriter to call forth bids from various institutional investors such as fund managers, merchant bankers and others. An underwriter, normally an investment bank, builds a book by inviting institutional investors (such as fund managers and others) to submit bids for the number of shares and the price(s) they would be willing to pay for them.

10. Asset Liability Management (ALM): It is a fact that well managed assets and liabilities increases the profitability of businesses. Asset Liability Management is the practice of managing the use of assets and cashflows to reduce the risk of loss arising out of nonpayment of liabilities on time. The function of Asset Liability Management is to mitigate the financial risk, financial planning, strategic allocation of assets, on time payment of liabilities etc.

11. Underwriting: Underwriting is the process through which an individual or institution takes on financial risk for a fee. This risk most typically involves loans, insurance, or investments. The term underwriter originated from the practice of having each risk-taker write their name under the total amount of risk they were willing to accept for a specified premium. According to the companies act, when a person agrees to take up shares specified in the underwriting agreement, when the public (or) others failed to subscribe for them, it is called underwriting agreement.

12. Portfolio Finance: A portfolio's meaning can be defined as a collection of financial assets and investment tools that are held by an individual, a financial institution or an investment firm. To develop a profitable portfolio, it is essential to become familiar with its fundamentals and the factors that influence it. Portfolio finance deals with the Management of Portfolio Investment. A company involved in portfolio management undertakes to manage the investment of an individual (or) company is such a manner that a better return on investment is ensured, keeping in that the safety of investment. Thus, in portfolio finance the finance in various shares (or) securities is managed by persons with special knowledge of the market and different securities. The mutual fund companies and investment trust companies are very good example of portfolio finance. They help individuals, commercial banks and other finance companies is distributing their investment in different portfolios. Portfolio management consists of investment in shares debentures, government securities, commercial paper, bonds, global deposit receipt and other investment securities such as Unit Trust of India, infrastructure bonds etc.

13. Credit Rating: It is a method of judging the credit worthiness of a borrower (or) of a company in which investments are made the credit rating of a borrowing company is done on the basis of its performance of the company is previous years, liquidity position, market share of the company repayment of deposits, profits earned, interest offered on deposits & assets portfolio etc.

1.7 Conclusion

Financial services are very important for the smooth functioning of an economy. Financial sector plays a major role in the country's economy. The financial services are essential element of our economy. Financial services play as a motivational force to boost up with savings habits among investors. Financial system with the help of financial services is responsible for the management of funds efficiently between the investors and corporates fulfilling the need of both prospects.

❖ **Exercise**

Fill in the blanks.

1. ______________ are the services those are provided by the finance industry. (**Financial services**)
2. ___________________ are the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities. (**Financial services**)
3. ________________ are the processes by which consumers or businesses acquire financial goods.” (**Financial services**)
4. ________________ become instrumental in providing assistance in fund raising activity. (**Financial services)**
5. A _____________ is a contract outlining the terms under which one party agrees to rent an asset. (**lease**)
6. _______________ In this case the finance company is a legal owner of the asset. **(Financial lease)**
7. A ________________ is a contract involved payment over a fixed period of a specific amount for the use of a specific asset or project. (**Financial lease**)
8. An ______________ is a contract that allows for an asset's use but does not convey ownership rights of the asset. (**Operating lease**)
9. A ___________ is a pool of money managed by a professional fund manager. (**Mutual Fund**)
10. ________________ is a type of finance in which a business would sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs. (**Factoring**)
11. A ______________ is a type of credit facility, provided by banks that allow customers to borrow funds within a pre-approved credit limit. (**credit card**)

Answer the following questions.

1. What is Financial Service? Explain its characteristics in detail
2. Explain the features of financial services
3. Write down the functions of financial services
4. Explain the importance of financial services.
5. Explain the various types of financial services.
6. What is Lease? Explain the types of leases.

Write the full form of the following:

1. IPO
2. FPO
3. ALM

UNIT – 2 FINANCIAL SYSTEM AND MARKET

2.1 Introduction

When Elon Musk started Tesla, he was in need of finance to start with the production of electric vehicles. Elon Musk had to approach bank to take a loan. As the individuals like us deposit our money with banks, the same money is used to lend money to people like Elon Musk to fulfill his objective of producing electric vehicles. Can it be said that we all have helped Elon Musk? Or the financial system helped him?

Financial systems are crucial for economies as they promote economic growth. They enable individuals and institutions to save, invest, manage risks, and conduct transactions efficiently. Financial systems also play a role in price discovery, ensuring fair prices for assets and commodities. They contribute to economic stability, support monetary policy, and help regulate financial activities. Overall, financial systems are vital for the functioning and development of economies. It refers to the network of institutions, such as banks, insurance companies, markets, and stock exchanges. The main function of the financial system is to distribute savings from individuals and businesses and organizations to productive investments, allocate capital efficiently, and manage risks. They permit exchange of funds.

Financial system is a set of financial markets, institutions, services, intermediaries those enables flow of funds from the lenders to the group of borrowers. Financial system is made up of four important components:

1. Financial markets
2. Financial instruments
3. Financial institutions
4. Financial services

2.2 Components of Financial System:

1. **Financial markets** - the market place where buyers and sellers interact with each other and participate in the trading of bonds, shares and other assets are called financial markets.
2. **Financial instruments** - the products which are traded in the financial markets are called financial instruments.
3. **Financial institutions** - financial institutions are acting as a mediator between the investors and borrowers. It is also termed as financial intermediaries because they act as middlemen between the savers and borrowers.
4. **Financial services** – the services provided by assets management and liabilities management companies. They help to get the required funds and also make sure that they are efficiently invested. For e.g. banking services, insurance services and investment services

2.3 Features of Financial System

- It plays a vital role in the economic development of the country as it encourages both savings and investment.
- It helps in mobilizing and allocating one's savings.
- It facilitates the expansion of financial institutions and markets.
- Plays a key role in capital formation.
- It helps form a link between the investor and the one saving.
- It is also concerned with the Provision of funds.

2.4 Functions of Financial System

1. Intermediation

Financial systems act as intermediaries between savers and borrowers, channeling funds from those who have excess funds (savers) to those who need funds (borrowers). This intermediation process facilitates the efficient allocation of capital and promotes economic growth.

2. Mobilization of savings

Financial systems provide a mechanism for individuals and businesses to save money and earn a return on their savings. Through banks, investment funds, and other financial institutions, savings are pooled together and made available for productive investments.

3. Facilitation of investments

Financial systems enable individuals, businesses, and governments to access the capital needed for investment in productive activities. They provide various investment options such as stocks, bonds, and venture capital, allowing entities to raise funds to expand operations, launch new projects, or develop infrastructure.

4. Risk management

Financial systems offer a range of risk management tools and instruments, such as insurance, derivatives, and hedging strategies. These mechanisms help individuals and businesses mitigate risks associated with fluctuations in interest rates, exchange rates, commodity prices, and other market uncertainties.

5. Price discovery

Financial markets provide a platform for trading financial instruments, allowing buyers and sellers to determine fair prices based on supply and demand dynamics. This price discovery process ensures transparency and efficiency in the valuation of assets and facilitates the efficient allocation of resources.

6. Facilitation of payments

Financial systems enable the smooth and secure transfer of funds between individuals, businesses, and institutions. They provide payment systems, such as electronic funds transfer, credit cards, and digital wallets, which facilitate the settlement of transactions and support economic activities.

7. Capital Formation

Financial systems play a crucial role in capital accumulation within an economy. By mobilizing savings, facilitating investments, and promoting efficient allocation of capital, they contribute to capital stock growth, which is essential for long-term economic development.

8. Monetary policy implementation

Central banks implement monetary policy as part of the financial system by controlling the economy's money supply, interest rates, and liquidity. They regulate and stabilize the financial system, ensuring price stability and fostering macroeconomic stability.

9. Financial inclusion

Financial systems aim to promote financial inclusion by providing access to financial services for individuals and businesses, including those in underserved or marginalized communities. This fosters economic participation, poverty reduction, and social development.

10. Safeguarding financial stability

The financial system maintains stability and mitigates systemic risks. Regulatory authorities monitor and supervise financial institutions, set prudential standards, and establish risk management frameworks to safeguard the system's stability and protect consumers.

2.5 Financial Market

A financial market is a word that describes a marketplace where bonds, equity, securities, currencies are traded. Few financial markets do a security business of trillions of dollars daily, and some are small-scale with less activity. These are markets where businesses grow their cash, companies decrease risks, and investors make more cash.

2.6 Meaning of Financial Market

A Financial Market is referred to space, where selling and buying of financial assets and securities take place. It allocates limited resources in the nation's economy. It serves as an agent between the investors and collector by mobilizing capital between them.
In a financial market, the stock market allows investors to purchase and trade publicly companies share. The issue of new stocks is first offered in the primary stock market, and stock securities trading happens in the *secondary market*.

2.7 Objectives of Financial Market

Financial market plays a dynamic role in promoting the effective functioning of capitalist economies by distributing resources and creating liquidity for business and the markets made it simple for buyers and sellers to deal with financial holdings. Financial market distributes competently flow of investments as well as savings and also clear the way towards growth of funds. The perfect mixture of financial market and financial product will help us to grow the investor's demand and overall countries economy

- **Capital Allocation:** By integrating investors, or investors with borrowers, or companies, or governments, financial markets encourage the optimal allocation of capital. Investors had the capacity to distribute their capital to companies which required it, thereby supporting economic endeavors like corporate growth, research and development, and infrastructure initiatives.

- **Price Discovery:** The prices of financial instruments are largely set by the financial markets. Prices for stocks, bonds, currencies, and other assets are set by the laws of supply and demand. Participants in this price discovery process are better able to make educated decisions about the purchase or sale of assets.

- **Liquidity Provision:** Participants may purchase or sell assets rapidly and for comparatively little money thanks for the liquidity offered by financial markets. Markets are unable to operate properly without liquidity, which allows investors to enter and exit positions without significantly impacting prices.

- **Risk management:** To manage and mitigate risks, players in the financial markets employ a variety of tools, including derivatives. For instance, investors can use options to shield their portfolios from adverse market movements, and companies can use futures contracts to hedge against changes in commodity prices.

- **Facilitating Investment**: A platform for saving and building up assets is offered by financial markets to both individual and institutional investors. According to their time horizon, investment objectives, and risk tolerance, investors might choose from a broad range of assets.

Building Economic Growth: Sound and effective financial systems encourage the growing size of the economy as a whole. Access to capital, handling risk skills, and efficient capital allocation all improve company productivity and promote innovation.

- **Promoting Savings and Investment:** By offering returns on capital invested, securities markets encourage people to save and invest. This promotes saving for future needs like college, retirement, and other expenses, which helps to maintain long-term economic stability.

• **Encouraging Transparency:** By forcing businesses to give investors access to pertinent financial information, financial markets encourage transparency. Investment decisions can be made with greater knowledge thanks to this transparency, which also boosts investor confidence.

• **International Capital Flows:** Financial markets allow cross-border capital flows, permitting trade and investment. The worldwide reach of financial markets serves an important part in fostering economic interdependence and enhancing resource distribution worldwide.

2.8 Functions of Financial Market

The significance of financial markets to the health and prosperity of an economy cannot be overemphasized. The financial markets play the following four dynamic roles:

• **Reduces transaction costs:** A wide range of securities-related information can be obtained in the financial markets without requiring any kind of fee.

• **Makes better use of savings:** Savings money shouldn't just be tucked away in a vault. Because of this, banks and other financial markets make it available to people and businesses who require a business, student, or home loan.

• **Financial asset liquidity:** Enables trading between buyers and sellers at any time, thereby increasing the liquidity of financial assets. Through the financial markets, they can sell their securities and engage in any kind of investment.

• **Sets the price of securities:** Investors aim to optimize their profits from their investments. Unlike how the law of supply and demand determines the price of goods and services, the financial market sets the price of securities.

2.9 Types of Financial Market

Financial markets can be classified on the basis of various factors like, type of financial instrument, functions of it, key components of the type of financial market, etc. The financial markets are classified as under.

1. The Stock Market
2. Foreign Exchange Market
3. Derivatives Market
4. Money Market
5. Cryptocurrency Market
6. Options Market
7. Bond Market (Debt Market)

The Stock Market (Equity Market):

The equity market, commonly referred to as the stock market, is a crucial component of the financial system in which ownership of companies can be purchased or sold. It offers investors a platform to trade stocks, commonly referred to as shares or equities, which are issued by publicly traded companies. This market allows it to be simpler to purchase and sell stocks, or shares, that indicate a company's ownership. Two examples of these platforms are the New York Stock Exchange (NYSE) and the Nasdaq.

Following are some of the important details of Stock Market:

- **Primary Market -** This is the first market for the issuance of new securities which involved bonds and stocks. In an initial public offering (IPO), companies issue new shares to raise capital. These newly issued shares are purchased directly from the company by investors.
- **Secondary Market -** This is where existing shareholders can sell their shares to other investors. The most well-known secondary market is the stock exchange.
- **Stock Exchanges:** A stock exchange is an online marketplace that links buyers and sellers. The Bombay Stock Exchange and The National Stock Exchange in Mumbai, The London Stock Exchange (LSE) in the United Kingdom, the Tokyo Stock Exchange (TSE) in Japan, and the New York Stock Exchange (NYSE) and Nasdaq in the United States are a few examples. The infrastructure and regulations for trading are provided by exchanges. They facilitate the buying and selling of securities, list company stocks, and guarantee the fairness and transparency of the trading process.
- **Listed Stocks:** Companies whose shares are traded on a stock exchange are said to be "listed." Listing requirements vary by exchange and typically include financial disclosure, minimum market capitalization, and corporate governance standards.
- **Unlisted Stocks:** Some companies choose not to list on a stock exchange. Their shares may be traded over-the-counter (OTC), which involves direct transactions between buyers and sellers without a centralized exchange.

Foreign Exchange Market:

The Foreign Exchange Market, also referred to as the Forex market or FX market, is the world's largest and most liquid over-the-counter (OTC) marketplace for trading currencies. The participants in the market buy and sell currencies, and the Forex market arranges for the exchange of one currency for another at determined exchange rates.

Important details of Foreign Exchange Market:

• **Decentralized nature:** The forex market runs without a centralized exchange which comprise of network of financial institutions, banks, government, individual traders etc. who perform electronic currency trading.

• **Currencies pairs:** At the time of trading, the one currency is traded for another in pairs. A trader can sell a currency pair at the bid price, that is the price which has been quoted, while they can buy a currency pair at the ask price. For example, currencies of pair consist USD/EUR or JPY/USD etc.

24-hour market: Since the major financial centres are located in different time zones and trading of currencies is different activity, the forex market operates 24 hours a day and five days a week.

Functions of Foreign Exchange Market:

- **Currency Conversion**: The Forex market's primary function is to facilitate it easier to change one currency into another. For foreign investment and trade, this is crucial.
- **Price Determination:** Exchange rates, or the relative values of different currencies, are set by the Forex market. Market forces impacting supply and demand had an impact on exchange rates.
- **Hedging:** To protect themselves against currency risk, players in the Forex market, including corporations and institutional investors, use the market. This entails opening positions to offset possible losses brought on by unfavorable currency fluctuations.
- **Arbitrage:** Trading arbitrage is the practice of taking advantage of price discrepancies between spot and futures markets, as well as between various currency markets. This supports the market's continued price efficiency.

Derivatives Market:
The financial market where financial instruments known as derivatives are traded is called the derivatives market. An underlying asset, index, or reference rate is where derivatives get their value. These tools can be employed in investment, speculative, or risk management scenarios. Futures contracts, options, swaps, and forwards are the most popular forms of derivatives.

Types of Derivatives market:

- **Futures Contracts:** Futures contracts are contracts that commit parties to the purchase or sale of an asset at a fixed price at a future date.
- **Options:** Options give the holder the choice—but not the obligation—to purchase (call) or sell (put) an underlying asset before or on the expiration date at a fixed price.
- **Swaps:** Agreements to swap cash flows or other financial instruments over a predetermined time period are known as swaps. Currency swaps and interest rate swaps are common varieties.
- **Forwards:** Forward contracts are contracts that commit parties to buying or selling an asset at a predetermined price at a later time. Forwards are not standardized, unlike futures, and are frequently tailored to the specifics of each transaction.

Money Market:
The financial market's money market is the area where short-term lending and borrowing occurs. It works with low-risk, highly liquid instruments that usually have maturities of one day to one year. Financial institutions, governments, corporations, and other large

entities are the main players in the money market. The money market is essential for managing liquidity, facilitating the implementation of monetary policy, and supplying short-term funding.

Key elements of the money market are as follows:

- **Treasury Bills (T-Bills):** To raise money, governments (like the US Treasury) issue short-term debt securities. With maturities ranging from a few days to a year, T-Bills are regarded as extremely low-risk investments.
- **Commercial Paper (CP):** Commercial Paper (CP) is unsecured short-term debt that businesses issue to cover their immediate financial needs. The typical maturity of commercial paper is one to two hundred and seventy-seven days.
- **Certificates of Deposit (CDs):** Banks offer time deposits known as certificates of deposit (or CDs) with set terms and interest rates. Banks can obtain short-term funding through the secondary market trading of CDs.
- **Repurchase Agreements (Repos):** Repurchase agreements, or repos, are contracts for short-term borrowing and lending that frequently involve securities issued by governments. One party sells securities to another in a repo transaction with the understanding that the other party will buy the securities back at a later date for a higher price.
- **Banker's Acceptances (BAs**): Bank-guaranteed short-term drafts or bills of exchange. To make the purchase of goods easier, they are frequently utilized in international trade finance.
- **Money Market Mutual Funds (MMMFs):** MMMFs are investment funds that combine investor capital to purchase a variety of money market instruments. A means for individual investors to get involved in the money market is through MMMFs

Functions of money market:

- **Short-Term Lending and Borrowing:** In the money market, participants can lend or borrow money for a short period of time using a variety of instruments. This includes companies looking for short-term financing and banks borrowing to meet reserve requirements.
- **Liquidity Management**: To effectively manage their liquidity needs, corporations and financial institutions turn to the money market. When necessary, they can raise shortterm capital or invest surplus funds.
- **Implementation of monetary policy**: Monetary policy is carried out by central banks through open market operations, which include purchasing and selling government securities in the money market. This allows them to adjust interest rates and carry out monetary policy.
- **Risk management**: Since money market instruments are typically regarded as low-risk, they offer investors looking to preserve their capital a safe haven. In particular, Treasury bills are frequently utilized as benchmarks free of risk.

Crypto-currency Market:

The market for cryptocurrencies is the collection of websites and exchanges where different cryptocurrencies are bought, sold, and traded. Users are able to transact with digital currencies on this decentralized, round-the-clock market. As cryptocurrencies like Bitcoin, Ethereum, and many more have grown in popularity, the cryptocurrency market has attracted a lot of attention.

Important details of the cryptocurrency market:

- **Market Participants:** The cryptocurrency market is made up of traders, businesses, institutional investors, and individuals. Institutional investors may use over-the-counter (OTC) platforms, but retail investors typically interact through exchanges.
- **Cryptocurrencies:** Cryptocurrencies are digital or virtual money that run on decentralized blockchain-based networks and employ cryptography for security. Litecoin, Ethereum, Bitcoin, and Ripple (XRP) are a few well-known cryptocurrency examples.
- **Wallets:** Online resources that let users send, receive, and store cryptocurrency are known as cryptocurrency wallets. Wallets can be hardware-based (physical devices) or software-based (online, desktop, or mobile applications).
- **Exchanges:** Online marketplaces for cryptocurrencies allow users to purchase, sell, and trade them. Coinbase, Binance, Kraken, and Bitfinex are a few examples. Exchanges are essential for promoting cryptocurrency liquidity and price discovery.
- **Token sales and initial coin offerings (ICOs):** ICOs are events that raise money where new cryptocurrency projects sell tokens to potential investors. In a blockchain-based project, token sales can stand in for utility or ownership.
- **Decentralized Finance (DeFi):** A collection of blockchain-based financial services and apps is referred to as DeFi. Lending, borrowing, decentralized trade, and other financial operations without the use of conventional middlemen are all included.
- **Market Capitalization:** The total value of all cryptocurrencies in circulation is known as the market capitalization, or market cap. It is computed by multiplying each cryptocurrency's market value by the total number of units in circulation.

Options Market:

Options contracts are bought and sold on the options market, which is a financial market. Financial derivatives known as options give the buyer the right, but not the responsibility, to purchase (call) or sell (put) an underlying asset at a predefined price within a given time frame or on a particular future date. Stocks, indexes, commodities, or other financial instruments can all be considered the underlying asset.

<u>Important details of the options market:</u>

- **Option contracts:** Standardized agreements between a buyer (holder) and a seller (writer) are known as options contracts. A certain percentage of the underlying asset is represented by each contract.
- **Call Options**: Before or on the expiration date, a call option buyer has the option to purchase the underlying asset at a predefined price, known as the strike price. Bullish strategies that anticipate an increase in the value of the underlying asset frequently employ call options.
- **Put Options:** Before or on the expiration date, a put option buyer has the option to sell the underlying asset at a predefined price. Bearish strategies frequently employ put options, anticipating that the price of the underlying asset will drop.
- **Strike Price:** In the case of call options, the strike price is the amount at which the option holder may purchase the underlying asset, and in the case of put options, sell it. In figuring out how profitable the option is, it is a crucial component.
- **Expiration Date:** Options have a set duration, and on a designated date known as the expiration date, their validity ends. Weekly or monthly options are also available, as well as longer-term (quarterly or annual) options.
- **Premium:** The cost of the rights granted by the option that the option buyer pays to the option seller is known as the premium. The cost of the option is determined by various factors, including the underlying asset's volatility and the remaining time until expiration.
- **Option Buyer and Seller:** The option buyer, also known as the holder, is the one who pays the premium and is entitled to use the option. If the buyer chooses to exercise the option, the option seller (writer) will receive the premium and will be responsible for fulfilling the terms of the agreement.
- **European versus American options:** European options can only be exercised at the expiration date, whereas American options can be exercised at any point prior to or on the date of expiration. In the US, American-style stock options are the most commonly traded.

Bond Market (Debt Market):

The bond market is a financial marketplace where participants purchase and sell debt securities. It is also referred to as the debt market or the fixed-income market. Bonds are interest-bearing securities that symbolize a loan from an investor to a borrower, usually a business or government. An essential part of the larger financial system is the bond market, which gives investors the opportunity to earn interest income and allows entities to raise capital.

<u>Important details of the bond market:</u>

- **Fixed-Income Securities:** Bonds are classified as fixed-income securities because they give investors a predefined, fixed stream of income in the form of recurring interest payments (coupon payments).

- **Debt Instruments:** One type of debt or borrowing is represented by bonds. By buying bonds, investors are effectively lending the issuer money in return for the assurance that interest will be paid on a regular basis and that the principal will be repaid at maturity.
- **Bond Issuers and Borrowers:** Governments, corporations, and municipalities are among the entities that can issue bonds. (municipal bonds). Every category of issuer has distinct functions and differing credit attributes.
- **Coupon Payments**: The majority of bonds provide bondholders with periodic interest payments, or coupons. The amount of interest paid on a bond is determined by the coupon rate, which is a fixed percentage of the bond's face value.
- **Face Value and Maturity:** The face value of a bond is its expected value at maturity. It is also referred to as principal or par value. The repayment date of the principal is referred to as maturity. Bonds can mature in the short, medium, or long term.
- **Yield:** The bondholder's effective interest rate is represented by the yield. It considers the coupon rate, time to maturity, and price of the bond. Bondholders' return on investment is reflected in yield.
- **Credit Ratings:** To represent the issuer's creditworthiness, rating agencies (like Moody's, S&P, and Fitch) assign credit ratings to bonds. Bonds with higher ratings are thought to be less risky than those with lower ratings, which may have higher yields but greater risk.
- **Instruments of Government Monetary Policy:** The bond market is one of the instruments that central banks use to carry out monetary policy. In order to affect interest rates, open market operations entail the purchase or sale of government bonds.

❖ **Exercise**

Answer the following questions in brief.

1. What is financial market?
2. What is financial system?
3. List out the types of financial market.
4. Explain types of derivatives of market.
5. Explain the objectives of financial market.
6. Explain the functions of financial market.

Write down the answers of following questions in detail.

1. Explain the types of financial market in detail.
2. What is stock market? Explain the important components of stock market.
3. Explain the functions and components of foreign exchange market.
4. Explain the components of financial system.
5. Explain the features of financial system
6. Explain the money market in detail.
7. Explain the cryptocurrency in detail
8. Explain the option market in detail.

9. What is bond market and explain the important components of bond market
10. Define Financial system and functions of financial system

Fill in the blanks.

1. _________________ is a set of financial markets, institutions, services, intermediaries those enables flow of funds from the lenders to the group of borrowers. (Financial system)
2. ________________ is made up of four important components. (Financial system)
3. The market place where buyers and sellers interact with each other and participate in the trading of bonds, shares and other assets are called______________. (financial markets)
4. The products which are traded in the financial markets are called_____________ . (financial instruments)
5. A ______________is a word that describes a marketplace where bonds, equity, securities, currencies are traded. (financial market)
6. A ______________is referred to space, where selling and buying of financial assets and securities take place. (Financial Market)
7. _________________ serves as an agent between the investors and collector by mobilizing capital between them. (Financial Market)
8. ________________ is where existing shareholders can sell their shares to other investors. (Secondary Market)
9. A ______________ is an online marketplace that links buyers and sellers. (stock exchange)
10. Companies whose shares are traded on a stock exchange are said to be "_________." (listed)
11. __________________is the practice of taking advantage of price discrepancies between spot and futures markets, as well as between various currency markets. (Trading arbitrage)
12. ____________ are contracts that commit parties to buying or selling an asset at a predetermined price at a later time. (Forward contracts)

Write the full form of the following.

1. OTC
2. CP
3. IPO
4. T-Bills
5. CD
6. Repos
7. MMMF
8. ICO
9. DeFi

UNIT – 3 INSURANCE

3.1 Introduction

Imagine having a safety net that catches you when unexpected challenges come your way. That's what insurance is all about. It's like a promise from a company that says, "If something goes wrong, we've got your back." Insurance is a fundamental and integral part of our modern-day lives and plays a critical role in managing risks and uncertainties. In today's interconnected world, it provides individuals, businesses, and societies with a safety net against unexpected financial losses and helps secure peace of mind.

The concept of insurance revolves around the principle of spreading and sharing risks. It involves a contractual arrangement between an individual or entity (the policyholder) and an insurance company. You agree to pay them some money regularly, called premiums, and in return, they promise to help you out if something bad happens. This could be a car accident, a sudden illness, or even damage to your house.

Why is this important? Well, life is full of surprises, and not all of them are pleasant. Insurance helps us manage these surprises. It's like having an umbrella on a rainy day or a life jacket when you're in rough waters. It's there to keep us safe and dry when things get stormy. Insurance isn't just one-size-fits-all. There are different kinds of insurance for different situations. It's like having a toolbox with various tools for different jobs. Sometimes, the government helps out with insurance, like when they provide healthcare for everyone. That's public insurance. But most of the time, it's private companies that offer insurance. They compete to provide you with the best protection. Banks aren't just about saving money and getting loans. They also team up with insurance companies to offer you insurance options. Insurance companies are helping out by making sure you're covered if you face other climate-related problems. Developing countries have their own unique challenges when it comes to insurance.

So, as we dive into this chapter, we'll learn more about how insurance works, the different types available, how banks and insurance go hand-in-hand, and even how insurance is adapting to a changing world. By the end, you'll have a clear picture of how insurance can be your safety net in life's unpredictable journey.

3.2 Definition, Meaning and Importance

- **Definition:**
  Experts provide different explanations of insurance. These explanations can be sorted into two main groups: functional and contractual. Here's what they mean:
- **Functional Definition:** This definition looks at what insurance does. It's like saying insurance helps you when something unexpected happens.
- **Ghosh and Agrawal:** Insurance is a cooperative form of distributing a certain risk over a group of persons who are exposed to it.
- **Contractual Definition:** This definition focuses on the legal agreement part of insurance. It's like saying insurance is a deal you make with a company to protect you from certain risks.
- **E. W. Patterson:** Insurance is a contract by which one party, for a consideration called premium assumes particular risk of the other party and promises to pay him or his nominee a certain or ascertainable sum of money on specified contingency.

  So, experts have different ways to describe what insurance is all about.

- **Meaning:**
  "Insurance is a means of compensating for possible losses arising from any irregular and uncertain events by paying a certain premium. Insurance is an agreement between two parties, where one party is the insurer and the other is the insured. An insurance contract is a legal document that shows the risk covered by insurance. In this contract, the insurance company demonstrates its responsibility to compensate the insured against unexpected events, which are referred to as accidents. In exchange for this commitment, the insured pays a premium to the insurance company."

  Importance of Insurance:
  Insurance is a critical component of modern financial systems, serving various essential purposes in both individual and societal contexts.

- **Risk Mitigation:** Insurance helps individuals and businesses mitigate financial risks. It provides a safety net that safeguards against unexpected events, such as accidents, illnesses, or property damage. This risk mitigation is vital for financial security and stability.
- **Financial Security:** Insurance offers a sense of financial security and peace of mind. Knowing that insurance can cover unforeseen losses or expenses provides individuals and businesses with confidence in their financial well-being.
- **Wealth Protection:** Insurance protects accumulated wealth and assets. Policies like property insurance safeguard valuable possessions like homes and vehicles. This protection ensures that hard-earned assets remain intact even in the face of unexpected events.
- **Legal and Regulatory Compliance:** In many instances, insurance is a legal requirement. For example, auto insurance is typically mandatory in most countries to ensure that

drivers can cover potential accident-related costs. Compliance with these regulations is crucial for legal and financial protection.

- **Business Continuity:** Businesses rely on insurance to ensure continuity in the face of unexpected disruptions. Commercial insurance, including business interruption coverage, helps companies recover from disasters, maintain operations, and fulfill their commitments to employees and customers.
- **Investment Opportunities:** Some insurance products, such as whole life insurance and annuities, serve as investment tools. They offer opportunities for individuals to accumulate savings and plan for retirement while simultaneously providing insurance coverage.
- **Risk Management:** Insurance is a fundamental component of risk management. It allows individuals and businesses to transfer, mitigate, or share risks. This strategic approach to risk contributes to financial stability and long-term planning.
- **Social Welfare:** Insurance has broader societal implications. It helps individuals and communities cope with large-scale disasters and emergencies, contributing to overall social welfare and resilience.
- **Economic Stability:** The insurance industry plays a role in economic stability by providing financial resources to cover losses. This, in turn, helps maintain the overall stability of the economy.

In Summary insurance is like a guardian that helps us when unexpected things happen. It has many important jobs, such as keeping our money safe, following the law, and helping everyone in society. This is really important in today's complicated financial world.

3.3 Type of Insurance

There are two main types of insurance: Life insurance and General insurance. Their explanations are given below:

1. Life Insurance:

Life insurance is a type of insurance that provides financial protection to the policyholder's beneficiaries upon the policyholder's death. It is designed to offer support to the insured person's family or dependents in the event of their passing.

Subtypes of Life Insurance:

- **Term Life Insurance:** This type of insurance provides coverage for a specific period, typically 10, 20, or 30 years. If the policyholder passes away during the term, the beneficiaries receive a death benefit. It's often more affordable than other types of life insurance.
- **Whole Life Insurance:** Whole life insurance offers lifelong coverage. It includes a savings component known as cash value, which grows over time and can be withdrawn or borrowed against. Premiums are typically higher than term life insurance.

- **Universal Life Insurance:** Universal life insurance is flexible, allowing policyholders to adjust their premiums and death benefits. It also includes a cash value component that earns interest.
- **Variable Life Insurance:** In variable life insurance, policyholders can invest their cash value in various investment options, such as stocks and bonds. The death benefit and cash value can fluctuate based on the performance of these investments.
- **Final Expense Insurance:** This type of insurance covers the costs associated with a person's funeral and burial. It is often purchased by seniors to relieve their loved ones of these expenses.

Following policies are included in life insurance:

1. Endowment Insurance Policy: An endowment insurance policy is a type of life insurance that combines protection and savings components. Here's how it works:

- **Death Benefit:** If the policyholder passes away during the policy term, the policy pays out a predetermined sum assured to the beneficiary.
- **Survival Benefit:** If the policyholder survives the policy term, they receive the sum assured along with any accumulated bonuses or profits. This maturity amount can be used for various purposes, such as retirement planning or funding major expenses.
- **Savings Component:** Endowment policies build a savings corpus over time through regular premium payments. A portion of the premium is invested, and the policyholder receives the benefits of these investments.
- Endowment policies offer financial security to beneficiaries in case of the policyholder's demise and provide a lump sum payout upon maturity, making them a popular choice for both protection and long-term savings.

2. Money-Back Policy: A money-back policy is a type of life insurance that offers periodic payouts during the policy term, providing liquidity at various intervals. Here's how it works:

- **Periodic Payouts:** Money-back policies provide policyholders with a percentage of the sum assured at regular intervals (usually every few years). These payouts are referred to as survival benefits.
- **Maturity Benefit:** If the policyholder survives the entire policy term, they receive the remaining sum assured along with any accrued bonuses.
- **Death Benefit:** In the event of the policyholder's death during the policy term, the full sum assured is paid to the beneficiary.

Money-back policies offer a combination of life insurance coverage and a source of periodic income, making them suitable for meeting specific financial goals or addressing liquidity needs at different life stages.

3. Unit-Linked Insurance Plans (ULIPs): Unit-linked insurance plans (ULIPs) are a type of life insurance that combines insurance coverage with investment opportunities. Here's how they work:

- **Investment Component:** A portion of the premium paid towards a ULIP is invested in various funds, allowing policyholders to participate in the financial markets.
- **Fund Options:** ULIPs offer a range of fund options, such as equity, debt, or balanced funds. Policyholders can choose the funds that align with their risk tolerance and financial goals.
- **Flexibility**: ULIPs provide flexibility for policyholders to switch between funds and adjust their investment strategy as needed.
- **Insurance Coverage:** ULIPs also offer life insurance coverage, ensuring financial protection for the policyholder's beneficiaries in case of the insured's demise.

ULIPs offer the potential for wealth creation and investment growth while providing life insurance coverage. Policyholders have the flexibility to tailor their investments based on their risk appetite and financial objectives.

4. Pension Plan Policy: A pension plan policy, also known as a retirement or annuity plan, is designed to provide financial security during retirement. Here's how it works:

- **Accumulation Phase:** During the accumulation phase, individuals make regular contributions or a lump sum payment to the pension plan.
- **Investment and Growth:** The contributions are invested, and the plan's value grows over time. Policyholders can choose from various investment options.
- **Deferred Annuity:** Upon reaching retirement age, the pension plan can be converted into a deferred annuity. This annuity provides regular income payments to the policyholder, ensuring financial support during retirement.

Pension plan policies are essential for individuals looking to secure their financial future after retirement. They provide a reliable source of income in later years when regular employment income ceases.

5. Child Insurance Policy: A child insurance policy is designed to provide financial security and support for a child's future needs, such as education and other milestones. Here's how it works:

- **Protection**: Child insurance policies offer life insurance coverage for the parent or guardian. In the event of the parent's demise, the policy provides financial support for the child's needs.
- **Savings Component:** These policies often include a savings or investment component to accumulate funds for the child's future expenses.
- **Maturity Benefit:** Upon maturity, the policy pays out a lump sum amount that can be used for the child's education, career, or other financial goals. Child insurance policies help parents ensure that their children have a secure financial foundation and can pursue their aspirations without financial constraints

These various insurance policies cater to different financial needs and goals, providing individuals and families with protection, savings, and income security in various life situations.

2. General Insurance:

General insurance, also known as non-life insurance, covers a wide range of risks and losses that are not related to human life. It provides financial protection against events like accidents, damage to property, and liability claims.

Subtypes of General Insurance:

1. Health Insurance: Health insurance covers medical expenses, including doctor visits, hospitalization, and medications. It helps individuals and families manage healthcare costs. Health insurance is a policy that covers medical expenses, ensuring individuals and families can access necessary healthcare services without facing significant financial burdens.

Individual Health Insurance: These policies provide coverage to individuals and families, typically through private insurance companies. They may include various levels of coverage, such as basic, comprehensive, or specialized plans.

Group Health Insurance: Employers often offer group health insurance to their employees, providing access to healthcare benefits as part of their compensation packages.

2. Marine Insurance: Marine insurance covers risks associated with shipping and transportation of goods. It includes cargo insurance and hull insurance for ships.

These are the main types of life insurance and general insurance, each offering protection against different risks and uncertainties in our lives.

3. House Insurance:

House insurance, also known as homeowners' insurance or property insurance, covers residential properties against damage, theft, and liability claims.

Structural Coverage: This part of house insurance protects the physical structure of the home, including the building itself, attached structures (garages), and sometimes detached structures (like sheds).

Contents Coverage: Contents coverage includes protection for personal belongings within the home, such as furniture, appliances, and electronics.

Liability Coverage: This component safeguards homeowners from legal claims arising from injuries or property damage that occur on their property. These are some of the key types of insurance, each tailored to address specific risks and provide financial protection to individuals, families, and businesses in various situations.

4. Motor Insurance: Motor insurance, also known as auto insurance or car insurance, provides coverage for vehicles and drivers against accidents, theft, and liability claims.

Comprehensive Insurance: This type of motor insurance covers damage to the insured vehicle caused by accidents, theft, vandalism, and natural disasters. It may also include liability coverage.

Third-Party Liability Insurance: This insurance covers damages and injuries caused to third parties in accidents involving the insured vehicle. It is often a legal requirement in many countries.

5. Rural Insurance: Rural insurance is designed to address the unique needs of individuals living in rural and agricultural areas. It provides coverage for risks commonly faced by rural communities.

Farmers' Insurance: This type of rural insurance is tailored for farmers. It covers crops, livestock, farm equipment, and farm structures. It helps protect farmers from financial losses due to crop failure, animal diseases, or property damage.

Livestock Insurance: Livestock insurance specifically covers animals like cattle, poultry, and sheep. It provides compensation in case of livestock deaths due to accidents, diseases, or natural disasters.

Crop Insurance: Crop insurance safeguards farmers against crop losses caused by factors like adverse weather conditions, pests, and diseases. It helps maintain farmers' financial stability during challenging agricultural seasons.

6. Social Insurance: Social insurance is a government-sponsored program that provides financial assistance and protection to individuals and families facing specific life events or challenges.

Unemployment Insurance: This type of social insurance offers financial support to individuals who lose their jobs through no fault of their own. It helps cover living expenses while job seekers look for new employment.

Social Security: Social security programs provide financial benefits to retirees, disabled individuals, and survivors of deceased workers. They offer a safety net to ensure financial security during retirement or in the event of disability or death.

Medicare and Medicaid: These programs provide healthcare coverage to specific groups, with Medicare primarily for seniors and Medicaid assisting low-income individuals and families with medical expenses.

7. Fire Insurance: Fire insurance is a type of property insurance that protects against damage or destruction caused by fires. It covers not only the cost of repairs but also potential loss of income or additional living expenses if the property becomes uninhabitable.

Fire and Allied Perils Insurance: In addition to fire, this type of insurance extends coverage to other perils like lightning, explosion, earthquake, and riot damage.

8. Crop Insurance:

Crop insurance offers protection to farmers and agricultural producers against financial losses resulting from crop failures, adverse weather conditions, pests, and other risks.

Multi-Peril Crop Insurance (MPCI): MPCI policies provide comprehensive coverage for a range of perils affecting crops, such as drought, hail, and disease.

Revenue-Based Crop Insurance: This type of crop insurance guarantees a certain level of revenue for farmers, even if their crop yields or prices fluctuate.

9. Travel Insurance: Travel insurance offers protection while traveling, including coverage for trip cancellations, medical emergencies abroad, and lost luggage.

10. Business Insurance: Business insurance includes various types of coverage for businesses, such as commercial property insurance, liability insurance, and workers' compensation insurance.

3.4 Private and Public Insurance

Insurance can be categorized into two broad sectors: private insurance and public insurance. These sectors differ in terms of ownership, regulation, and the types of coverage they provide. In this section, we will delve into the details of private and public insurance:

1. Private Insurance:

- **Ownership and Operation:** Private insurance companies are owned and operated by private entities, including corporations, shareholders, or individuals. These companies operate for-profit and are motivated by generating revenue and profit for their shareholders.
- **Types of Coverage:** Private insurance offers a wide range of coverage options, including life insurance, health insurance, property insurance (e.g., home and auto insurance), and specialty insurance (e.g., travel insurance, pet insurance).Private insurers often tailor their policies to meet specific customer needs, allowing policyholders to choose coverage levels, deductibles, and policy terms.
- **Pricing and Competition:** Pricing for private insurance policies is competitive, and individuals can obtain quotes from multiple private insurers to compare rates and coverage. Competition among private insurers can lead to innovation in insurance products and pricing strategies.
- **Regulation**: Private insurance companies are subject to regulatory oversight by government agencies at the state or national level. Regulations vary by jurisdiction and may include solvency requirements, consumer protection laws, and financial reporting standards.
- **Customer Service:** Private insurers focus on providing efficient customer service and claim processing to maintain customer satisfaction. Policyholders can typically interact with private insurers through agents, brokers, or online platforms.
- **Profit Motive:** Private insurance companies aim to generate profits for their shareholders while providing insurance coverage to policyholders. Profitability is achieved through premium collection, investment income, and effective risk management.

2. Public Insurance:

- **Ownership and Operation:**
- Public insurance is government-owned and operated. It is often managed by government agencies or entities created for this purpose. Public insurance programs are typically non-profit and operate in the public interest.
- **Types of Coverage:** Public insurance programs are designed to provide essential coverage to a broad population. Common examples include social security, unemployment insurance, and government-sponsored healthcare programs. Public insurance may cover risks that private insurers find challenging or unprofitable to underwrite, such as catastrophic events or healthcare for low-income individuals.
- **Funding**: Public insurance programs are funded through various mechanisms, including payroll taxes, government appropriations, or contributions from both employers and employees. The goal is to ensure widespread access to coverage, even for individuals with limited financial means.
- **Regulation:** Public insurance programs are subject to government regulation and oversight to ensure they fulfill their intended purposes. Regulations may include eligibility criteria, benefit levels, and financial accountability.
- **Universal Coverage:** Public insurance often aims to achieve universal coverage, providing protection to all eligible individuals within a society. It serves as a safety net to support those who may not have access to private insurance.
- **Social Objectives:** Public insurance programs often align with social objectives, such as reducing income inequality, ensuring access to healthcare, and providing financial stability during retirement.
- **Non-Exclusionary:** Public insurance programs are typically non-exclusionary, meaning they accept individuals regardless of pre-existing conditions or risk profiles.

In summary, private insurance is provided by for-profit companies and offers a wide range of coverage options, while public insurance is government-owned and focuses on fulfilling social objectives and providing essential coverage to a broad population. Each has its role in a well-functioning insurance ecosystem, with private insurers catering to diverse needs and public insurers addressing broader societal goals.

3.5 Impact and the Role of Banking Industry

The interaction between the banking and insurance sectors, often referred to as "bancassurance," has evolved significantly over the years. This integration has had a profound impact on both industries and has created new opportunities and challenges. Let's explore the impact and role of the banking industry in the insurance sector in detail:

1. Distribution Channel:

Role of Banking: Banks serve as a crucial distribution channel for insurance products. They leverage their extensive branch networks and customer relationships to offer insurance policies.

Impact: This partnership allows insurance companies to reach a broader customer base without the need for an extensive physical presence. For banks, it diversifies their product offerings, potentially increasing revenue streams.

2. Cross-Selling and Upselling:

Role of Banking: Banks can cross-sell insurance products to their existing customers, as they already have insights into their financial needs and risk profiles.

Impact: This cross-selling strategy benefits both industries. Banks can earn commissions on insurance sales, while insurers gain access to a pool of potential customers. Customers benefit from a convenient one-stop shop for financial services.

3. Regulatory Framework:

Role of Banking: Regulatory authorities often play a crucial role in shaping the integration of banking and insurance. They establish guidelines and oversight to ensure consumer protection and financial stability.

Impact: Regulations can impact the extent of collaboration between banks and insurers. Compliance requirements can influence the types of insurance products banks can offer and the transparency of these offerings.

4. Product Innovation:

Role of Banking: Banks and insurance companies collaborate to create innovative financial products that combine banking and insurance features. These may include investment-linked insurance plans, retirement products, and savings plans.

Impact: Customers benefit from more diverse and flexible financial products that meet various needs, such as wealth accumulation, protection, and retirement planning.

5. Risk Management:

Role of Banking: Banks use insurance as a risk management tool to protect their assets and manage various risks, including credit, operational, and natural disaster risks.

Impact: Insurance helps banks safeguard their financial stability, which ultimately benefits their customers. It provides reassurance to depositors and investors that their funds are protected.

6. Financial Inclusion:

Role of Banking: Banking institutions, especially in emerging markets, use insurance products to promote financial inclusion. They offer micro insurance and affordable coverage to underserved populations.

Impact: This approach enhances the accessibility of insurance to previously excluded segments of society, fostering economic resilience among low-income individuals and small business owners.

7. Investment Opportunities:

Role of Banking: Banks often invest in insurance companies or participate in underwriting activities. They may hold significant stakes in insurance firms, contributing to their capitalization.

Impact: Investment by banks strengthens the financial position of insurance companies, allowing them to meet policyholder obligations more effectively. This stability reassures policyholders and regulators.

8. Regulatory Challenges:

Role of Banking: Banks and insurers face regulatory challenges when offering insurance products. Compliance with insurance regulations can be complex, requiring collaboration and coordination.

Impact: Regulatory challenges can create operational complexities, but they also ensure consumer protection and the integrity of financial markets.

In conclusion, the banking industry plays a significant role in the insurance sector, offering distribution channels, cross-selling opportunities, and innovative products. This collaboration benefits customers by providing a wider array of financial services and products. However, regulatory oversight is crucial to maintaining transparency, consumer protection, and the overall stability of the financial system.

3.6 Climate Change Impact

Climate change has emerged as a critical global issue with far-reaching implications, including its impact on the insurance industry. The insurance sector is particularly vulnerable to climate change due to the increased frequency and severity of extreme weather events. Here, we delve into the details of how climate change is affecting the insurance industry:

1. Increased Frequency and Severity of Natural Disasters: Climate change is contributing to the rise in natural disasters, such as hurricanes, floods, wildfires, and droughts. These events result in higher insurance claims and payouts. Insurance companies face increased financial strain due to the surge in catastrophic events.

2. Rising Costs of Claims: As the frequency and severity of climate-related disasters increase, insurance companies experience higher claims costs. Insurers must factor in these rising costs when setting premiums, potentially leading to increased insurance rates for policyholders.

3. Underwriting Challenges: Climate change presents underwriting challenges for insurers. Predicting and assessing the risks associated with climate-related events becomes more complex. Traditional underwriting models may need to be adjusted to account for changing climate patterns.

4. Reinsurance Market Pressure: Reinsurance companies, which provide insurance to insurance companies, also face increased exposure to climate risks. This may lead to higher reinsurance costs, which are then passed on to primary insurers and policyholders.

5. Property and Asset Exposure: Climate change poses a significant threat to property and infrastructure, leading to potential losses for property insurers. As the value of insured assets at risk increases due to climate change, insurance companies must reevaluate their risk exposure.

6. Regulatory and Reporting Requirements: Regulatory bodies are increasingly requiring insurance companies to disclose their climate risk exposure and strategies for managing such risks. Insurers must adapt to these reporting requirements and invest in climate risk assessment and mitigation measures.

7. Product Innovation: Insurers are developing new products and services to address climate-related risks. These products include parametric insurance policies that pay out based on predefined climate-related triggers, such as wind speeds or rainfall levels.

8. Risk Mitigation and Adaptation: Insurance companies are actively involved in risk mitigation and adaptation efforts. They collaborate with governments, businesses, and communities to promote climate-resilient practices and reduce the impact of climate-related disasters.

9. Impact on Insurability: Climate change may lead to certain risks becoming uninsurable, particularly in high-risk areas prone to extreme weather events. This could result in insurance gaps and challenges for individuals and businesses in vulnerable regions.

10. Long-Term Investment Strategies: Insurers are adjusting their investment portfolios to consider climate-related risks and opportunities. They may divest from fossil fuels and invest in sustainable and environmentally responsible assets.

11. Public Awareness and Engagement: The insurance industry plays a role in raising public awareness about climate change risks. It educates policyholders about the importance of resilience and disaster preparedness.

12. Collaboration and Research: Insurance companies collaborate with climate scientists, researchers, and government agencies to better understand climate change impacts. This research informs risk assessment and pricing models.

In conclusion, climate change significantly affects the insurance industry, leading to increased costs, challenges in underwriting, and the need for innovative solutions. As climate-related risks continue to evolve, insurance companies must adapt, invest in resilience, and collaborate with stakeholders to address this critical issue. Climate change mitigation and adaptation efforts are essential to ensure the long-term sustainability of the insurance sector

3.7 Special Issues in Developing Countries

Developing countries face unique challenges and considerations when it comes to the insurance industry. While insurance is essential for economic stability and risk mitigation, several special issues need to be addressed in these regions:

1. Low Insurance Penetration:

Issue: Insurance penetration (the percentage of the population with insurance coverage) is often low in developing countries. Many individuals and businesses do not have access to insurance products.

Impact: This lack of coverage leaves people vulnerable to financial losses caused by various risks, including natural disasters, health emergencies, and property damage.

2. Affordability:

Issue: The cost of insurance premiums relative to income levels can be high in developing countries. Many people find it challenging to afford insurance.

Impact: Affordability issues limit the ability of individuals and small businesses to protect themselves against risks. It also hinders the growth of the insurance market in these regions.

3. Lack of Awareness and Education:

Issue: Many people in developing countries lack awareness and understanding of insurance products and their benefits.

Impact: This lack of awareness results in underutilization of insurance, as people may not recognize the value of coverage until they experience a loss.

4. Informal Insurance Practices:

Issue: In some developing countries, informal insurance practices, such as community-based risk-sharing arrangements, are more common than formal insurance policies.

Impact: While these informal practices offer some protection, they may not provide comprehensive coverage and can be limited in scope. Transitioning to formal insurance can be challenging.

5. Regulatory Challenges:

Issue: Developing countries may lack robust regulatory frameworks and supervisory authorities for the insurance industry. This can lead to issues related to consumer protection, solvency, and market stability.

Impact: Weak regulatory oversight can result in unethical practices, lack of trust in insurance companies, and potential financial instability.

6. Infrastructure and Technology Gaps: Issue: Insurers in developing countries may face challenges related to outdated technology and inadequate infrastructure for data management and policy administration.

Impact: These limitations can hinder the efficient delivery of insurance products, claims processing, and customer service.

7. Catastrophe Risk Exposure: Issue: Many developing countries are highly vulnerable to natural disasters and climate-related risks.

Impact: The insurance industry in these regions must grapple with the increased frequency and severity of catastrophes, leading to higher claims costs and potential solvency issues.

8. Micro insurance Development: Issue: Micro insurance, designed for low-income individuals, is crucial in developing countries. However, creating viable microinsurance products and distribution channels can be challenging.

Impact: Developing micro insurance solutions can help bridge the insurance gap for vulnerable populations, but it requires innovation and collaboration with local communities.

9. Government Role: Issue: In many developing countries, governments play a significant role in insurance through state-owned or state-sponsored insurance companies.

Impact: Government intervention can influence market dynamics, competition, and access to insurance. Striking the right balance is crucial for market development.

10. International Assistance: Issue: International organizations and donor agencies often support insurance initiatives in developing countries to enhance resilience and financial inclusion.

Impact: These initiatives can provide much-needed funding and technical expertise to strengthen the insurance sector in these regions.

In summary, addressing the special issues related to insurance in developing countries is essential for promoting economic stability, protecting vulnerable populations, and fostering resilience against various risks. It requires a combination of regulatory reforms, financial education, technology adoption, and innovative product development to expand insurance coverage and enhance its effectiveness in these regions.

❖ Keywords

- **Insurer -** An insurer refers to an insurance company or entity that provides insurance coverage to policyholders in exchange for premium payments.
- **Insured** - The insured is the individual or entity that holds an insurance policy.
- **Insurance Policy** - An insurance policy is a legal contract between the insured and the insurer.
- **Insurance Premium -** An insurance premium is the periodic payment made by the insured to the insurer in exchange for insurance coverage.
- **Coverage** - Coverage refers to the scope of protection provided by an insurance policy. It specifies the types of risks or events for which the insurer will provide financial compensation or benefits to the insured.
- **Claim** - A claim is a formal request made by the insured to the insurer for compensation or benefits when a covered loss or event occurs.
- **Underwriting -** Underwriting is the process by which insurers assess the risks associated with potential policyholders.
- **Policyholder's Rights** - Policyholder's rights refer to the legal entitlements and protections afforded to individuals or entities who hold insurance policies.
- **Exclusion** - Exclusion refers to specific risks, events, or circumstances that are not covered by an insurance policy.
- **Deductible** - A deductible is the amount of money that the insured is responsible for paying out of pocket before the insurer begins to cover the remaining costs of a claim.

- **Policy Limit -** The policy limit is the maximum amount an insurer will pay for a covered loss or event.
- **Premium Adjustment** - Premium adjustment refers to changes in insurance premiums that can occur due to various factors, such as changes in risk exposure, coverage modifications, or policy renewals.

❖ **Exercise**

Write the Answers of Following Questions:

1. Write a Definition Meaning and Importance of Insurance.
2. Write on a Special Issues of insurance in Developing Countries.
3. Discuss the topic of impact of climate change on Insurance Industry.
4. What are the fundamental types of insurance, and how do they differ from each other?
5. Can you explain the key characteristics of life insurance and Health insurance?
6. How does marine insurance differ from Fire insurance?
7. What are the main differences between private insurance and public insurance programs?
8. Can you provide examples of public insurance programs in your country and how they operate?
9. How does the concept of risk pooling apply to both private and public insurance?
10. In what ways does the banking industry play a role in the insurance sector?
11. How can the collaboration between banks and insurance companies benefit consumers?
12. How is climate change affecting the insurance industry, particularly in terms of increased risks?
13. How can individuals and businesses adapt their insurance coverage to mitigate the impact of climate change?
14. What are some of the unique challenges faced by developing countries in terms of insurance coverage?
15. How can microinsurance schemes help address the insurance needs of low-income populations in developing nations?
16. What role can governments and international organizations play in improving insurance access and coverage in developing countries?

UNIT – 4 INTRODUCTION OF BANKING

4.1 Introduction of Banking

In the dynamic landscape of financial services, banking plays a pivotal role as the cornerstone of economic stability and growth. The inception and evolution of banking institutions have been integral to the development of modern financial systems. Finance is the life blood of trade, commerce and industry. Now-a-days, banking sector acts as the backbone of modern business. Development of any country mainly depends upon the banking system. In India, the Reserve Bank of India (RBI) is the apex banking institution that regulates the monetary policy in the country.

The term bank is either derived from old Italian word banca or from a French word banque both mean a Bench or money exchange table. A bank is a financial institution which deals with deposits and advances and other related services. It receives money from those who want to save in the form of deposits and it lends money to those who need it.

According to Banking Regulation Act 1949, Section 5(b), the term "Banking" means accepting for the purpose of lending or investment of deposits of money received from the public, repayable on demand or otherwise and withdrawal by cheque, draft, order or otherwise.

4.2 Definition of Banking

4.2.1 Different Definitions of a Bank

Different Authors and Economists have given some structural and functional definitions on Bank from different angles:

"Bank is an institution which collects idle money temporarily from the public and lends to other people as per need." **R.P. Kent.**
"Bank provides service to its clients and in turn receives perquisites in different forms." **P.A. Samuelson.**

"Bank is a financial intermediary institution which deals in loans and advances"- **Cairn Cross.**

"Bank is such an institution which creates money by money only." **W. Hock.**

"Bank is such a financial institution which collects money in current, savings or fixed deposit account; collects cheques as deposits and pays money from the depositors‟ account through cheques." **Sir John Pagette**.

Indian Company Law 1936 defines Bank as “A banking company which receives deposits through current account or any other forms and allows withdrawal through cheques or promissory notes

4.2.1 Bank from various perspectives

Here are several definitions of a bank from various perspectives:

- **Traditional Financial Intermediary:** A bank is a financial institution that serves as a custodian for people's money, providing a safe place for deposits and offering various financial services, including loans and investments. Banks act as intermediaries between those who have surplus funds (depositors) and those who need funds (borrowers).

- **Economic Stabilizer:** In an economic context, a bank is a key player in stabilizing the economy. Through monetary policy tools and credit creation, central banks influence interest rates and money supply, playing a crucial role in controlling inflation and ensuring the overall stability of the financial system.

- **Payment Facilitator:** Banks act as facilitators for monetary transactions, providing payment services that allow individuals and businesses to make and receive payments. This includes services such as checking accounts, wire transfers, and electronic funds transfers.

- **Risk Management Institution:** Banks are involved in managing various types of financial risks. They assess credit risk when lending money, market risk when investing, and operational risk in their day-to-day activities. Banks employ risk management strategies to ensure the safety and soundness of their operations.

- **Financial Innovator**: In the modern era, banks are hubs of financial innovation. They develop new financial products, services, and technologies to meet the evolving needs of customers. Online banking, mobile apps, and digital wallets are examples of innovations that have transformed the way people interact with financial institutions.

- **Interbank Intermediary:** Banks don't only serve individual customers; they also engage in transactions with each other. Interbank activities involve lending, borrowing, and trading financial instruments between banks, contributing to the liquidity and stability of the broader financial system.

- **Community Development Partner:** Many banks actively participate in community development initiatives. They support local businesses through loans, contribute to charitable causes, and play a role in fostering economic growth within the communities they serve.

- **Regulated Financial Entity**: Banks are subject to comprehensive regulatory frameworks to ensure their solvency, stability, and adherence to ethical and legal standards. Regulatory bodies oversee banking operations to maintain the integrity of the financial system and protect the interests of depositors and the broader economy.

These definitions highlight the multifaceted role that banks play in the economy, encompassing financial intermediation, risk management, innovation, and community engagement. The specific functions and characteristics of banks can vary based on factors such as their size, structure, and geographic location.

4.3 Product and Service in Indian Banking

Indian banks offer a wide range of products and services to their customers, including:

- **Deposit accounts**: Different types of accounts where you can put your money, including savings accounts, current accounts, fixed deposits, recurring deposits, and more.

- **Loans**: Different types of loans that banks offer, such as personal loans, home loans, car loans, education loans, business loans, and others.

- **Credit cards**: Various credit cards with different features and benefits that allow you to make purchases on credit.

- **Debit cards**: Cards linked to your savings or current accounts that allow you to make transactions and withdraw money.

- **Investment services**: Services that help you invest your money, including mutual funds, insurance, and other investment products.

- **Electronic banking services**: Services that let you manage your money electronically, like online banking, mobile banking, and ATM services.

In addition to these core products and services, Indian banks also offer a variety of other services, such as:

• **Foreign exchange services**: Services that involve buying and selling foreign currencies, traveller's checks, and transferring money internationally.

• **Safe deposit boxes**: Secure storage options provided by banks for keeping valuable items safe.

• **Bill payment services**: Services that allow customers to pay various bills, including utility bills, insurance premiums, and other regular payments.

• Government services: Banks assist in the collection of taxes and other dues owed to the government.

• **Other services**: Additional services offered by banks, including gold loans, locker facilities for safe storage, and merchant banking services.

Indian banks are constantly innovating and introducing new products and services to meet the needs of their customers. For example, many banks now offer contactless debit and credit cards, mobile wallets, and other digital payment solutions.

Here are some specific examples of popular banking products and services in India:

- **Savings accounts**: Savings accounts are the most common type of deposit account in India. They offer lower interest rates than other types of deposit accounts, but they are also more liquid, meaning that customers can withdraw their money at any time without penalty.

- **Fixed deposits**: Fixed deposits are a type of deposit account where customers deposit their money for a fixed period of time, such as 1 year, 2 years, or 5 years. Fixed deposits offer higher interest rates than savings accounts, but the money cannot be withdrawn before the maturity date without penalty.
- **Personal loans:** Personal loans are unsecured loans that can be used for any purpose, such as debt consolidation, home improvement, or medical expenses. Personal loans have higher interest rates than other types of loans, but they are also easier to qualify for.
- **Home loans:** Home loans are secured loans that are used to purchase or construct a home. Home loans have lower interest rates than personal loans, but they are also more difficult to qualify for.
- **Car loans:** Car loans are secured loans that are used to purchase a new or used car. Car loans have lower interest rates than personal loans, but they are also more difficult to qualify for.
- **Credit cards:** Credit cards allow customers to borrow money from the bank to make purchases. Credit cards have high interest rates, but they also offer a variety of benefits, such as rewards programs and purchase protection.
- **Debit cards:** Debit cards are linked to savings accounts or current accounts and allow customers to withdraw money or make purchases using their bank account balance. Debit cards do not have interest rates.
- **Online banking:** Online banking allows customers to manage their bank accounts and perform transactions online, such as transferring money, paying bills, and viewing account statements.
- **Mobile banking:** Mobile banking allows customers to manage their bank accounts and perform transactions using their smartphones. Mobile banking is similar to online banking, but it is more convenient because it can be done from anywhere.

Indian banks offer a wide range of products and services to meet the needs of their customers, from individuals to businesses. Customers can choose the products and services that are right for them based on their individual needs and financial goals.

4.4 Essence of Banking

The essence of banking lies in its fundamental role as a financial intermediary and catalyst for economic activity. Here are key aspects that capture the essence of banking:

1. **Financial Intermediation:** Banking is basically about connecting people who have extra money with those who need it. Banks allow individuals, businesses, and governments to save, invest, and borrow money. They do this by taking deposits and giving out loans, helping to use money effectively in the economy.

2. **Risk Management:** Banks are good at handling different financial risks. They evaluate the creditworthiness of borrowers, manage risks in their investments,

and make sure transactions are secure. This helps keep things stable and protects the interests of people who deposit money and those involved with the bank.

3. **Monetary Function:** Central banks, seen as the top level of the banking system, have a big impact on monetary policy. They control the amount of money, set interest rates, and make policies that affect inflation, economic growth, and jobs. Through these actions, banks help keep the economy stable and healthy.

4. **Payment Services:** Banks make it easy for money to move around through various payment services. Whether it's using traditional methods like checks and wire transfers or modern digital transactions through online banking and mobile apps, banks create the structure for people and businesses to do financial transactions.

5. **Innovation and Adaptation:** Banking isn't fixed; it changes as society's needs change. Banks lead in financial innovation, creating new products, services, and technologies. The use of digital banking, partnerships with fintech companies, and applications of blockchain are examples of how banks adjust to the needs of a fast-changing financial world.

6. **Trust and Confidence**: Banking is all about building and keeping trust. Customers trust banks with their money, expecting it to be safe and available when they need it. The stability of the banking system relies on people having confidence in the honesty and strength of financial institutions.

7. **Community Development**: Many banks see their role in helping the communities they serve. Through loans to local businesses, investments in community projects, and charitable initiatives, banks contribute to the economic and social health of the areas where they operate.

8. **Regulatory Compliance:** Banking follows rules and regulations. Sticking to these standards ensures the stability and honesty of the financial system. Regulatory bodies make rules to protect depositors, prevent financial crimes, and make sure banking practices are fair and clear.

In essence, banking is a dynamic and multifaceted industry that goes beyond the simple act of holding and transferring money. It is deeply intertwined with the functioning of economies, influencing economic growth, stability, and the overall prosperity of societies.

4.5 Risk in Banking

Risk in banking is inherent due to the nature of financial activities that banks engage in. Managing and mitigating risks is a critical function for banks to ensure their stability, protect the interests of depositors, and contribute to the overall health of the financial system. Here are some key types of risks that banks commonly face:

- **Credit Risk:** This is the risk that a borrower may fail to repay a loan or meet their financial obligations. Banks face credit risk when lending money to individuals, businesses, or other financial institutions. Effective credit risk management involves assessing the creditworthiness of borrowers and implementing measures to minimize the likelihood of defaults.

- **Market Risk:** Market risk arises from fluctuations in interest rates, exchange rates, commodity prices, and other market variables. Banks with investment portfolios, trading activities, or international operations are exposed to market risk. Hedging strategies and diversification are common approaches to manage market risk.

- **Operational Risk:** Operational risk is the risk of loss due to inadequate or failed internal processes, systems, people, or external events. It includes risks related to technology failures, fraud, human error, and natural disasters. Banks implement robust internal controls and contingency plans to mitigate operational risks.

- **Liquidity Risk**: Liquidity risk is the risk that a bank may not have enough funds to meet its short-term obligations. It can arise from a sudden withdrawal of deposits or an inability to convert assets into cash quickly. Liquidity management involves maintaining sufficient liquid assets and having access to funding sources.

- **Interest Rate Risk:** Banks are exposed to interest rate risk when there are changes in interest rates that impact the value of their assets and liabilities. For example, if a bank has a large portfolio of fixed-rate loans and interest rates rise, the value of those loans may decrease. Interest rate risk management involves strategies to mitigate the impact of interest rate fluctuations.

- **Compliance and Regulatory Risk**: Banks operate in a highly regulated environment, and non-compliance with laws and regulations poses a significant risk. Changes in regulations or failure to adhere to existing ones can lead to legal and financial consequences. Banks invest in compliance programs and risk management frameworks to ensure adherence to regulatory requirements.

- **Cybersecurity Risk:** With the increasing reliance on technology, banks face cybersecurity risks from potential cyberattacks, data breaches, and other malicious activities. Protecting sensitive customer information and maintaining the integrity of digital systems are paramount in mitigating cybersecurity risks.

- **Reputation Risk:** Reputation risk is the risk of damage to a bank's reputation due to negative public perception, whether justified or not. This risk can arise from operational failures, ethical lapses, or other adverse events. Maintaining a strong reputation is crucial for attracting and retaining customers.

Effective risk management involves a combination of risk identification, measurement, monitoring, and mitigation strategies. Banks employ risk management professionals, utilize advanced analytics, and adhere to regulatory guidelines to navigate the complex landscape of risks inherent in banking operations.

4.6 Bank Model and Prudential Requirement

A bank model is a framework that describes how a bank operates and generates profits. It includes the bank's business strategy, target market, product and service offerings, risk appetite, and capital structure.

Prudential requirements are regulations that are imposed on banks by supervisory authorities to reduce the risk of bank failure and protect the financial system. These requirements typically cover areas such as capital adequacy, liquidity, risk management, and governance.

The bank model and prudential requirements are closely related. The bank model should be designed to be consistent with the prudential requirements, and the prudential requirements should be designed to support a safe and sound banking system.

Here are some examples of how the bank model and prudential requirements interact:

- A bank that focuses on retail lending will need to have a different capital adequacy requirement than a bank that focuses on investment banking.
- A bank that operates in a high-risk environment will need to have a more rigorous risk management framework in place than a bank that operates in a low-risk environment.
- A bank that is expanding rapidly will need to have a different liquidity requirement than a bank that is growing slowly.

Prudential requirements can also influence the bank model. For example, a bank may decide to offer a different range of products and services in order to comply with a new prudential requirement.

Overall, the bank model and prudential requirements are both important for ensuring the safety and soundness of the banking system.

Here are some specific examples of prudential requirements that banks must comply with:

- **Capital adequacy requirements:** Banks must maintain a minimum level of capital relative to their risk-weighted assets. This capital serves as a buffer against losses and helps to protect the bank's depositors and other creditors.
- **Liquidity requirements:** Banks must maintain a certain level of liquid assets, such as cash and government securities, so that they can meet their short-term obligations.
- **Risk management requirements:** Banks must have a robust risk management framework in place to identify, assess, and manage their risks. This framework should include policies and procedures for managing credit risk, market risk, operational risk, and other risks.
- **Governance requirements:** Banks must have a strong governance structure in place to ensure that they are managed in a safe and sound manner. This structure should include a board of directors that is responsible for overseeing the bank's management and a risk committee that is responsible for overseeing the bank's risk management framework.

Prudential requirements are typically set by central banks or other financial supervisory authorities. These authorities monitor the banking system and make adjustments to the prudential requirements as needed.

❖ **Exercise**

Answer the Following questions:

1. What is the primary purpose of banking in an economy?
2. Name the key functions of a bank in supporting economic activities.
3. Explain the historical evolution of banking and its significance in modern times.
4. Provide a concise definition of banking.
5. How does the definition of banking encompass various financial services?
6. Explain how banking has evolved to meet the changing needs of society.
7. List and briefly describe the various deposit accounts offered by banks in India.
8. What are the common types of loans provided by Indian banks, and how do they contribute to economic growth?
9. Describe the electronic banking services available in the Indian banking sector.
10. What is the fundamental role of banking in connecting different segments of the economy?
11. How does banking contribute to the overall stability and health of an economy?
12. Identify and explain the various types of financial risks banks face.
13. Discuss the significance of risk management for maintaining stability in the banking sector.
14. Differentiate between traditional banking models and modern banking models.
15. Explain the concept of prudential requirements in banking and their importance.
16. How do prudential requirements contribute to the safety and soundness of the banking system?

Fill in the blanks:

1. Banking is the financial ____________ that plays a crucial role in the economy by connecting those with surplus funds to those who need funds. (**Answer: intermediary)**
2. Banks facilitate the efficient allocation of ____________ in the economy by accepting deposits and offering loans. (**Answer: capital)**
3. Banking can be defined as the business of ____________, lending, and providing financial services. **(Answer: accepting deposits)**
4. Banks are institutions that act as ____________ between savers and borrowers in the financial system. (**Answer: intermediaries)**
5. Indian banking offers a variety of deposit accounts, including savings accounts, current accounts, fixed deposits, and ____________ deposits. (**Answer: recurring)**

6. The essence of banking lies in building and maintaining ____________ with customers who trust the bank with their money. (**Answer: trust)**
7. Banks play a crucial role in managing various types of financial ____________ to maintain stability and protect the interests of depositors. (**Answer: risks)**
8. Banks operate within a framework of regulations and ____________ to ensure the stability and integrity of the financial system. (**Answer: oversight)**
9. The central banks, often considered the apex of the banking system, have a significant influence over ____________ policies. (**Answer: monetary)**

UNIT – 5	MUTUAL FUND

5.1 Introduction

A very popular and preferred investment for investors in the modern world is mutual fund. In recent years the concept of mutual fund in India has been adopted by public sector banks and private institutions (?) . It has been widely accepted by other financial institutions in the sector , and currently rapid development is taking place in mutual fund market. The added benefit can be in the form of capitalization of income received in the form of interest and dividends. Common people prefer mutual funds over bank deposits , life insurance policies, and bonds for better financial gains. By investing in mutual funds, even a small investor can gain access to a large company.

5.2 Meaning

Mutual Fund means collecting the savings from small investors and investing them in government securities or corporate securities and earning dividends and interest. For example, a common person invests his savings of Rs 1000 , and similarly the accumulated savings of Rs 1000-10000 from a large number of people will become a huge fund which can be invested in many different stocks and debentures and get good returns. Basically mutual funds are savings pooled from people.

5.3 Definition

As per The Securities and Exchange Board of India Mutual Regulation Act 1993, a mutual fund is defined as a "scheme for the collective investment and management of money collected by the trustee from a group of investors for the purchase of securities, the income and capital of which are required to be distributed among the participants in proportion to their respective investments."

In other words, a mutual fund is a pooled investment vehicle that collects money from many investors and invests it in a diversified portfolio of assets, such as stocks, bonds, and money market instruments. Mutual funds are managed by professional investment managers who make investment decisions on behalf of the fund's shareholders.

The Securities and Exchange Board of India (SEBI) is the regulatory body that oversees the mutual fund industry in India. SEBI has enacted a number of regulations to protect the interests of investors in mutual funds.

Some of the key features of mutual funds as defined by the SEBI Mutual Regulation Act 1993 include:

- A mutual fund must be constituted as a trust.
- The trustee of a mutual fund must be a public company or a body corporate incorporated under the Companies Act, 1956.
- The investment manager of a mutual fund must be a registered asset management company (AMC).
- The custodian of a mutual fund must be a registered custodian.
- A mutual fund must offer a scheme document to investors that discloses all relevant information about the fund, such as its investment objectives, investment strategy, and risks.
- A mutual fund must have a net asset value (NAV) that is calculated and published on a daily basis.
- A mutual fund must allow investors to buy and sell shares at any time.
- A mutual fund must distribute its income and capital to investors in proportion to their respective investments.

Mutual funds are a popular investment vehicle in India because they offer a number of benefits to investors, including:

- Diversification: Mutual funds invest in a diversified portfolio of assets, which helps to reduce risk.
- Liquidity: Most mutual funds are open-end, which means that investors can buy and sell shares at any time.
- Professional management: Mutual funds are managed by professional investment managers who have the expertise and experience to make sound investment decisions.
- Affordability: Mutual funds are an affordable way to invest, as investors can start investing with a relatively small amount of money.

Overall, the SEBI Mutual Regulation Act 1993 provides a comprehensive framework for the regulation of mutual funds in India. This framework helps to protect the interests of investors and ensure the fair and orderly operation of the mutual fund industry.

5.4 History of Mutual Fund

The history of mutual funds can be traced back to the 18th century, when the first investment trusts were formed in the Netherlands. However, modern mutual funds as we know them today did not emerge until the early 20th century.

In 1924, the Massachusetts Investors Trust (MFS) was launched, becoming the first open-end mutual fund in the United States. Open-end mutual funds allow investors to buy and sell shares at any time, based on the fund's net asset value (NAV).

Closed-end mutual funds, on the other hand, have a fixed number of shares that are typically traded on an exchange. Closed-end mutual funds were more popular than open-end mutual funds in the early 1920s, but open-end mutual funds eventually became more popular because they offered investors greater flexibility. The mutual fund industry grew rapidly in the United States in the postwar era. In 1940, the Securities and Exchange Commission (SEC) passed the Investment Company Act of 1940, which regulated the mutual fund industry and helped to protect investors. The 1970s was a difficult time for the mutual fund industry, as the stock market experienced a series of bear markets. However, the industry rebounded in the 1980s and 1990s, as the stock market experienced a prolonged bull market. Today, mutual funds are one of the most popular investment vehicles in the world. There are over 40,000 mutual funds available to investors in the United States alone, with over $20 trillion in assets under management.

The mutual fund industry in India began in 1963 with the launch of the Unit Trust of India (UTI). UTI was a government-owned mutual fund company that dominated the Indian mutual fund industry for many years.

In the early 1990s, the Indian government began to liberalize the financial sector, which led to the entry of private sector mutual fund companies. The first private sector mutual fund company in India, Kothari Pioneer Mutual Fund, was launched in 1993.

The Indian mutual fund industry has grown rapidly since the early 1990s. As of March 2023, there are over 40 mutual fund companies in India, with over ₹40 trillion in assets under management.

5.5 Importance of Mutual Fund

The importance/advantages of mutual funds can be described as follows.

Mutual funds play a crucial role in the financial markets and has become an important investment vehicle for various reasons. Here are several key points highlighting the importance of mutual funds:

- Mutual funds pool money from a large number of investors to create a diversified portfolio of stocks, bonds, or other securities. This diversification helps to reduce risk by spreading investments across different assets.
- Mutual funds are managed by experienced fund managers who analyze market trends, conduct research, and make investment decisions on behalf of investors. This professional management is particularly beneficial for individuals who may not have the time or expertise to manage their investments actively.
- Mutual funds provide an accessible entry point for investors with varying levels of capital. Investors can participate with relatively small amounts of money, allowing for broad market exposure.

- Mutual funds generally offer high liquidity, allowing investors to buy or sell units on any business day. This liquidity provides flexibility for investors who may need to access their funds quickly.
- The affordability of mutual funds makes them suitable for investors with limited capital. Through systematic investment plans (SIPs), investors can contribute small amounts regularly, making it easier to build a diversified portfolio over time.
- Through diversification and professional management, mutual funds help manage investment risk. The risk associated with individual securities is spread across a portfolio, reducing the impact of poor performance by a single investment.
- Mutual funds are required to provide regular updates on their holdings, performance, and other relevant information. This transparency allows investors to make informed decisions about their investments.
- Mutual funds are subject to regulatory oversight by financial authorities, providing an additional layer of investor protection. Regulations are designed to ensure fair practices, disclosure of information, and the safety of investors' funds.
- Mutual funds benefit from economies of scale. As the fund size increases, the cost per unit of managing the fund decreases. This can result in lower expenses for investors compared to managing individual portfolios.
- Many mutual funds offer automatic reinvestment of dividends and capital gains. This can accelerate the compounding of returns over time, leading to the potential for higher long-term wealth accumulation.
- Mutual funds offer a wide range of investment objectives, allowing investors to choose funds that align with their financial goals and risk tolerance. This includes equity funds, bond funds, index funds, sector-specific funds, and more.
- Mutual funds can offer tax advantages, such as the ability to defer capital gains taxes until an investor sells their shares. Some funds are also designed to be tax-efficient, minimizing the tax impact on distributions.
- Fund managers have access to research tools, market data, and analytical resources that may not be readily available to individual investors. This professional analysis can contribute to more informed investment decisions.
- Balanced and target-date mutual funds automatically adjust the asset allocation based on market conditions and the investor's time horizon. This helps maintain an appropriate risk-return profile as investors move closer to their financial goals.
- Mutual funds offer a straightforward and convenient way for investors to participate in the financial markets. The administrative tasks, such as buying, selling, and record-keeping, are handled by the fund, making it easier for investors to manage their portfolios.

5.6 Types of Mutual Fund

Mutual Funds are mainly divided into two types which are as follows:

(1) Based on work and performance
(2) Depending on the yield and investment method

❖ **Based on work and performance**

(1) Open - ended Fund and Closed-ended Fund : If the duration of the mutual fund and the investment of the money to be made in it is definite and certain, then the fund is called fixed duration fund. On the other hand, if the duration of the mutual fund and the amount of investment funds for it is not fixed , it is called a perpetual fund. For example , the Unit Trust of India - 1964 was continuous throughout the scheme period and in terms of target amount.

❖ **Open Ended fund:**

This fund is opposite to a closed ended fund. In this scheme, the size of the fund and/or the time of the fund is not fixed. Investors are free to buy and sell any number of units at any time. For example Unit Trust of India 1964 The scheme is an open ended scheme both in terms of time and amount.Anyone can buy units at any time and sell at any time as per his wish.

The salient features of an open-ended scheme are as follows :

- It is fully flexible in terms of investment or non-investment of the individual. Open-ended funds can be entered and exited freely in terms of investment. There is no time limit. Investors can join and exit whenever they want.
- These units cannot be sold to the public but can be repurchased and resold in the fund at any time.
- Investors get quick liquidity as units can be sold on any business day. Virtually functions like a fund and bank account. In which a person can sell any number of units for cash.
- The main objective of these funds is to generate income. Investors receive dividend rights shares or bonuses in return for investment.
- Since the unit shares are not listed in the market, their value is linked to the net asset value. This value is determined by the fund and the price changes from time to time.
- Generally the net asset value is equal to its registered price. Funds charge different prices for buying and selling it.
- The manager takes great care to manage the investment as the funds have to be returned at any time during the entire life of the scheme.

In short, an open-ended scheme exists continuously and its funding varies depending on the admission and disposal of members.

❖ Closed Ended Fund:

Fixed term fund means a fund whose amount is fixed in advance and the period of the fund is also fixed before it is issued or bought to the shareholder , for a fixed period of time for which the shareholder invests in this fund till he cannot sell the investment of this fund. And only after a fixed time the investment of this fund can be sold in the stock market . In open ended investors can invest anytime and distribute it anytime. In a closed-ended scheme, if the stock market is in losses after the fixed period is over, the risk of loss to the investor increases. Whereas in a perpetual fund, this is less likely to happen because the investor has to seems so If the stock market goes down, he will immediately sell his investment, so he has less risk.

The salient features of a closed-ended scheme are as follows :

- The time and amount are fixed, so the investor is not free to sell until a certain time.
- These units are made available to the public for purchase but cannot be bought back or resold within the fund at any given point. The primary aim of this fund is to generate capital gains.
- The fund is available throughout the scheme period and the fund has to be invested and managed by the fund manager for efficiency and profitability. Hence, there is no need for the investor to maintain liquidity.
- In a close-ended scheme, the returns are distributed to each unit holder in a liquid manner. From an investor's point of view, the capitalization potential makes this scheme attractive.

❖ Depending on the yield and investment method

(1) **Income - oriented** Fund **:** The objective of this fund is to distribute the income fairly among the investors over a period of time. Hence the investment strategy of this fund is formulated in such a way. For this type of mutual fund Invests money in fixed income securities .

(**2**) **Growth -oriented Fund:** The objective of this fund is to increase the value of the capital invested by the investors in the fund. Therefore, this fund invests the investors' money mainly in stocks.

(3) Balanced Fund: Funds that invest in both stocks and bonds are called balanced funds. These funds invest in equity stocks when the economic environment is promising and in bonds when there is a possibility of losses.

(4) Money Market Mutual Fund: A money market mutual fund is an investment vehicle that places funds in money market instruments, including treasury bills, call money, notice money, commercial paper, and commercial bills, among others. Operating on a short-term basis and being open-ended, it provides flexibility to investors. In 1991, the Reserve Bank established a task force led by Mr. D. Basu, the then Deputy Managing Director of the State Bank of India. Following the task force's recommendations, the

Reserve Bank, in 1992, granted permission for commercial banks to establish money market mutual funds.

(5) Tax-Relief Fund : Some funds are established to get certain tax reliefs. For example, Unit Trust of India and Jeevan Bima Nigam etc.

(6) Equity Fund: Equity fund is shares of fund companies, who makes investments and faces risks associated with such investments . The main objective of this fund is to take advantage of expected capital appreciation.

(7) Bond Fund: In this type of funds, funds are invested in debentures and bonds, this fund gives fixed income. But the possibility of getting more capital is less because the risk is also less.

(8) Sector -Based Funds: In these funds, funds are invested in specific sectors such as certain industries, minerals, oil, gold, silver, land, gas companies and foreign investment. Also, sometimes funds of funds are also found. Mostly, such funds are found in western countries.
(9) Income and Growth Fund: Fund which gives fixed and regular income by investing as well as guaranteeing capital growth, it is called income and growth fund.

(10) Other types of funds: These funds include property funds , energy funds , commodity funds , ethical funds , environmental off-shore mutual funds , aggressive growth funds , index funds , leveraged funds , dual funds , which are held by some companies in Britain. Such funds generally avoid investing in undesirable activities like tobacco , alcoholic beverages etc.

In modern times, mutual funds are playing a very important role in the development of the financial sector. At present, mutual funds are developing significantly and rapidly all over the world. In countries like Britain, America, France, Germany, Australia, thousands of mutual funds are working.

- **Leverage fund :** These funds are also called borrowed funds , they are mainly used to increase the size of mutual fund value during portfolio allocation . When prices rise , so does the fund's ability to generate income. Its benefits are distributed to the unit holders. This is taken only when the benefits of hedge funds are greater than the costs of hedge funds.
- **Dual Funds:** These are fixed term funds. It provides investment strategies for two different types of investors . For this purpose , it sells two types of investment shares i.e. Income Shares and MUD Shares. Investors can buy Income Shares that receive income from current investments. They get all the interest and dividends earned from the entire investment portfolio. However , they are subject to minimum annual dividend payments . The holders of mutual shares receive all the mutual benefits earned on those shares and are not entitled to receive any kind of dividend. In this respect , a dual fund is different from any balanced fund.
- **Index Funds:** Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of a broadbased market index . This has the same relative security as the index . The price of these index linked

funds increases whenever the market index rises . Since the portfolio construction is entirely based on maintaining the right proportion of the index , it involves low administrative costs , low transaction costs , low number of portfolio managers, etc. Therefore , there will be only short buying and selling of securities.

- **Aggressive Growth Funds** : These funds are opposite to bond funds . These funds are capital gains oriented and thus the scope of these funds is ' capital gains ' . Hence , these funds generally invest in speculative stocks . They may also use special investment techniques such as short- term trading .
- **Off Shore Mutual Funds** : Offshore mutual funds are funds meant for non-resident investors. In other words , the sources of these fund investments are from abroad. Therefore , it is regulated by the provisions of the foreign countries where the fund is registered. These funds facilitate the flow of funds across countries , with no fees for investment and withdrawal .
- **Funds of funds:** These funds are funds in which investments are made from one mutual fund scheme to another mutual fund scheme. In India such funds are issued under the control of Department of Economic Affairs , Finance Department and RBI .

5.7 Money Market Mutual Fund

Following are the salient features of money market fund scheme.

1. Money market mutual funds can be set up only by scheduled commercial banks and public financial institutions and will be subject to the Reserve Bank.
2. Such funds can be set up as money market deposit accounts or money market mutual funds.
3. The maximum limit of such instruments to be raised by these funds shall not exceed 2% of the fortnightly average of the total deposits of the sponsoring bank for the year 1991-92.
4. Units of money market mutual funds can be allotted to individuals only.
5. Such funds have to invest the funds collected as follows.
   (a) Treasury bill (b) Call/notice money (c) Commercial paper (d) Commercial bill (e) Certificate of deposit.
6. Units/shares of this fund shall be exempted from stamp duty.
7. Such funds can be set up only after obtaining the prior approval of the Reserve Bank.
8. In 1996-97, Permission was given to set up market mutual funds to eight mutual funds from banks/public financial institutions/private sector
   Which includes the following.
   (1) IDBI Mutual Fund (2) Kothari Pioneer Mutual Fund (3) Unit Trust of India (4) AAZ Greenlays Bank (5) ABN Amro Bank (6) Canara Bank (7) Bank of Madura Ltd. (8) Dash Bank
9. These funds are permitted to provide check book facility to their investors.
10. From November 1999 provision has been made that these funds are allowed to be set up as a separate identity in the form of a trust and not in the form of a money market deposit account.

11. Since March 2000 money market mutual funds have been covered under the purview of the Securities and Exchange Board of India regulations.

5.8 Reasons for Development of Mutual Fund

Since1980s, India's capital market has played an important role in financing productive activities. This has resulted in the rapid growth of stock exchanges in the country . During the period 1977 to 1989 , the number of stock exchanges in India has increased significantly . Considering the rate at which the number of investors is increasing , the number of stock exchanges in the country which in 1987 was only 8 by the end of this century is estimated to be more than 50. Given the growth of the capital market , it is very important that stock market services are available quickly and efficiently to sustain it . These funds have a huge responsibility to sustain and keep the stock market healthy ; Due to the advanced information centers of mutual funds and their business oriented approach and the various services provided by them to the customers promptly, these funds have grown rapidly . Similarly , A new generation of experts has emerged to provide investors with the information and guidance they need and due to this the investors have got an incentive to participate in the capital market. This factor has also accelerated the development of mutual funds.

5.9 Advantage of Mutual Fund

Following are the advantage of mutual fund:

1. **Diversification:** Mutual funds pool money from multiple investors to invest in a diversified portfolio of stocks, bonds, or other securities. This diversification helps spread risk across various assets, reducing the impact of poor performance in any single investment.
2. **Professional Management**: Mutual funds are managed by experienced fund managers who make investment decisions on behalf of investors. Their expertise and research can potentially lead to better investment choices and returns.
3. **Liquidity:** Investors in mutual funds can easily buy or sell their shares on any business day, providing liquidity and flexibility compared to some other investment options.
4. **Affordability**: Mutual funds allow investors to participate in a diversified portfolio with a relatively small investment amount. This makes them accessible to a wide range of investors, including those with limited funds.
5. **Convenience**: Investors do not need to actively manage individual securities within the fund. The fund manager takes care of buying and selling decisions, making it convenient for investors who may not have the time or expertise for hands-on portfolio management.
6. **Economies of Scale:** Due to the large pool of assets under management, mutual funds can benefit from economies of scale. This can lead to lower transaction costs and management fees compared to an individual investor managing a similar portfolio.

7. **Regulatory Oversight**: Mutual funds are regulated by financial authorities, providing a level of investor protection. Regulatory requirements ensure transparency, disclosure, and fair practices within the mutual fund industry.
8. **Variety of Options:** Mutual funds offer a wide range of investment options catering to different risk appetites and investment objectives. Investors can choose funds that align with their financial goals and risk tolerance.
9. **Dividend Reinvestment:** Many mutual funds offer the option to reinvest dividends automatically. This can compound returns over time, potentially enhancing the long-term growth of the investment.
10. **Accessibility to Professional Markets**: Mutual funds provide individual investors access to markets and investment opportunities that may be difficult to access directly. This includes markets that are geographically distant or require large capital investments.
11. **Tax Efficiency:** Some mutual funds are designed to be tax-efficient, potentially providing tax benefits to investors. For example, certain types of funds may distribute capital gains in a tax-efficient manner.
12. **Risk Reduction through Asset Allocation**: Mutual funds often employ strategic asset allocation, spreading investments across different asset classes. This can help reduce risk by minimizing the impact of poor performance in any single type of investment.
13. **Automatic Investment Plans:** Investors can set up systematic investment plans (SIPs) to invest a fixed amount regularly. This disciplined approach to investing can be beneficial for long-term wealth accumulation.

5.10 Disadvantage of Mutual Fund

Following are the disadvantage of mutual fund:

1. **Market Risk**: Mutual funds are subject to market fluctuations, and the value of the fund's assets can go up or down based on changes in the financial markets. Investors may experience losses if the market performs poorly.
2. **Fees and Expenses**: Mutual funds often charge fees and expenses, including management fees and operating expenses. These costs can reduce the overall returns for investors, especially if the fund's performance is not strong enough to offset these fees.
3. **Lack of Control:** Investors in mutual funds have limited control over the management of the fund's portfolio. Decisions regarding buying, selling, and holding specific assets are made by the fund manager, and investors cannot directly influence these choices.
4. **Tax Implications:** Mutual fund investors may be subject to capital gains taxes if the fund manager sells securities within the portfolio for a profit. This can result in tax liabilities for investors, even if they did not personally sell any of their fund shares.

5. **Over-diversification:** While diversification is a key benefit of mutual funds, it's possible for a fund to become overly diversified, making it challenging for investors to fully understand the individual holdings and potential risks within the portfolio.
6. **Performance Variability:** Mutual fund performance is not guaranteed, and it can vary widely. Some funds may under perform compared to their benchmark or other investment options, leading to subpar returns for investors.
7. **Redemption Fees:** Some mutual funds impose redemption fees when investors sell their shares within a certain time frame. These fees can erode returns for short-term investors or those who need to access their funds quickly.
8. **Market Timing Challenges:** Mutual funds are subject to the same market timing challenges as individual stocks. Investors may face difficulties in trying to time the market effectively, potentially leading to losses.
9. **Style Drift:** Fund managers may deviate from the fund's stated investment strategy over time, a phenomenon known as "style drift." This can result in the fund's performance no longer aligning with the investor's initial expectations.
10. **Dependency on Fund Manager:** The success of a mutual fund is heavily dependent on the skills and decisions of the fund manager. If the manager changes or is unable to perform effectively, it may impact the fund's performance.

❖ Exercises

Fill in the following blanks

1. .... The fund invests in highly liquid securities like commercial paper .
2. A mutual fund underwriting company is called.................
3. The intrinsic value of each unit of this mutual fund is nothing but ....
4. The gateway for small investors to enter big companies is ....

Answers: [1. Money market mutual, 2. Sponsor 3. Net Asset Value ,4 Mutual Fund]

Answer by choosing the correct option from the following.

1. The facility given to investors to transfer from one scheme to another scheme under the same fund is called...........
   (a) Roll over facility
   (b) Reissue facility
   (c) Repurchase facility
   (d) Lateral shifting facility
2. Mutual funds are popular among these?
   (a) USA
   (b) Japan
   (c) UK
   (d) India
3. Mutual fund investment method under which fixed income securities ?
   (a) Growth Fund Scheme
   (b) Balanced Fund Scheme

(c) Income Fund Scheme
(d) Money Market Mutual Fund Scheme

4. In India , the company that actually deals with the corpus of mutual funds is called...........
(a) Sponsor Company
(b) Mutual Fund Company
(c) Asset Management Company
(d) Trust Company

Ans. 1. (d) 2. (a) 3. (c) 4. (c).

❖ **State whether the following statements are true or false.**

(1) Open-ended Units of the Fund are not publicly traded.
(2) Roll over facility is available only in case of closed-ended funds.
(3) Commercial banks can do mutual fund business directly.
(4) In India, RBI regulates the functioning of mutual funds.
(5) Purchase of shares of mutual fund public limited companies can purchase a share of mutual fund.

[1. True 2. True 3.False 4.False 5.True]

Give answers of the following questions in short.

1. What is Mutual Fund ? Give an example
2. Discuss any two schemes that can be offered by mutual funds.
3. What are the special features of Open-ended fund?
4. Write the importance of mutual fund?
5. Write the advantage of mutual fund?
6. State the limitation of mutual fund?

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UNIT – 6 MERCHANT BANKING

6.1 Introduction

Every country in the world is trying to become a super power along with strengthening its economy and technology. Financial soundness has always been one of the criteria that play a major role in determining the rank and power of any country. Banking institutions have always been the backbone of any economy and the same is true for the Indian economy. After going through many ups and downs, India has come on the path of development. Banking sector plays an important role in the development of every nation's economy. Today, the functioning of banks has changed drastically. RBI and Government of India have become more vigilant for the development of banks.

Some apex banks were also established to meet some specific needs like agriculture, housing, foreign trade, industry etc. NABARD, EXIM, NHB and SIDBI are the second tier banking institutions. Besides, in the second phase, to run fund flow smoothly in the economy SEBI has also introduce the new concept of the banking, that is, 'Merchant Banking' which is established specifically to deal with companies, investments and foreign trade.

6.2 Meaning of Merchant Banking

Merchant banking is a specialized branch of banking that provides financial services to medium to small size businesses. They can help with underwriting, fundraising, credit or financial advice. Commercial banks can also provide services to high net worth individuals.

Merchant banks primarily work with small-scale enterprises that are unable to raise funds through initial public offerings (IPOs) by providing mezzanine financing, bridge financing, equity financing and corporate credit products. They issue and sell securities to refined investors through private placements on behalf of corporations that require less regulatory disclosure.

Merchant banking is a set of select banking and financial services offered by merchant banks to large corporations, institutional investors like mutual funds, banking institutions, hedge funds, insurance companies, venture capital funds, and pension providers, and high net worth individuals (HNIs). Some of the most common merchant banking services include, fundraising, financial advisory, lending, underwriting, corporate portfolio management, international trade advisory, mergers and acquisitions, and asset sale and management advisory. Typically, merchant banks do not work like normal commercial banks and depository services, which mean their services, are mostly limited to large companies, and multinational businesses.

For example, Company X wants to raise funds worth ₹10,000 Crore from the market and decides to issue debentures and preference shares worth the same amount. Now, they hire Merchant Bank Y to oversee the issue and sale of shares.

Merchant Bank Y will use its expertise to create a detailed action plan and budget for the entire exercise. They will also hire and coordinate with equity underwriters, who will use their own distribution networks to sell the debentures and preference shares of Company X to investors.

As part of the action plan, Merchant Bank Y may also hire advertising and marketing agencies to drum up support and publicity before and after the issue of shares. In addition, this merchant bank will obtain regulatory clearances from the relevant authorities and handle the associated paperwork.

6.3 History of Merchant Banking

The history of merchant banks can be traced back to late medieval Italy and France in the 17th and 18th centuries. Merchant banks began to function as an organized money market consisting of merchants financing the transactions of other merchants. A French merchant banker integrated the banking business into his mercantile activities and invested all his profits and became a merchant banker.

The growth of trade and industry in the 19th century led to the emergence of merchant banks in the United States. The first commercial banks in the United States were JP Morgan & Company and Citibank. The industry was mainly dominated by German-Jewish immigrant bankers and Yankee houses with close ties to overseas Americans who had settled in London as merchant bankers. However, with the growth of the financial world, corporations eclipsed family-owned businesses in the banking business. Corporations included merchant banking as one of their areas of interest, a characteristic that banks hold to this day.

In India, National Grindlays Bank started merchant banking services in 1969. Citibank then joined the financial services sector in 1970. State Bank of India was the first Indian commercial bank to set up a separate merchant banking division in 1973, followed by ICICI. 1974. Currently, there are more than 200 SEBI registered merchant banks in India. Today, the top ten merchant banks are defined as follows:

Top 10 Merchant Banks in India:

1. Kotak Mahindra Capital
2. Morgan Stanley India
3. JM Financial
4. Avendus Capital
5. Edelweiss Financial Services
6. Goldman Sachs India
7. Axis Capital
8. Citigroup Global Markets India
9. Nomura Financial Advisory and Securities India
10. Bank of America Securities India

6.4 Characteristics of Merchant Banking

Following characteristics or features can be derived of merchant banking:

- Merchant banks have a strong network, a large team of financial experts, and generally sit on a huge pile of data.
- Merchant banking is a selected set of professional services available to large corporations, HNIs, institutional investors, and venture capitalists, among others.
- These banks usually make money through commissions and consultation charges.
- Merchant banks are known for their premium services, speed of decision-making, and customer-centricity.
- Merchant banks are non-depository banks that generally do not cater to the banking and finance needs of the general public.
- These banks can even advise their customers on matters of international trade, and overseas acquisitions or mergers.
- These banks tend to be cash-rich.

6.5 Regulatory Framework

In India, merchant banking activities are regulated and managed by the Securities and Exchange Board of India (SEBI). SEBI has established a comprehensive framework that outlines the eligibility criteria, registration process, code of conduct and compliance requirements for commercial banks.

To act as a merchant banker, institutions must obtain registration from SEBI and meet minimum capital requirements. SEBI ensures that commercial banks follow ethical practices, maintain transparency and protect the interests of investors.

The eligibility criteria for becoming a merchant banker in India includes:

- The entity must be a company registered under the Companies Act, 2013.
- The company must have a minimum net worth of INR 5 crore.
- The company's principal officer and directors should have the necessary qualifications and experience as prescribed by SEBI.

6.6 Functions of Merchant Banking

Merchant Banks are playing a vital role to assist the trading activities of the Indian companies or businesses which can be explained as under:

- **Portfolio Management:** Merchant banking companies provide portfolio management services to high-net-worth individuals and corporate investors. These services include advice on securities selection, portfolio monitoring and review, portfolio rationalization and tax planning.

- **Fund raising:** Merchant banking helps businesses raise funds from the public by issuing shares and debentures, rights issue of shares, preferential allotment of shares, private placement of shares and debentures and other instruments.

- **Credit Syndication:** Merchant banks help process loan applications for short and long term financing from financial institutions. They provide these services by estimating the total costs involved, developing a financial plan for the entire project, and adopting loan applications for commercial lenders. They also assist in choosing the ideal financial institutions to provide credit facilities and act on the terms of the loan application with the financiers.

- **Equity Underwriting:** Large companies often use the services of commercial banks to raise capital through the stock market. Equity underwriting is achieved by evaluating the amount of stock to be issued, the value of the business, the use of proceeds and the timing of issuing new stock. Merchant banks handle all the necessary paperwork and liaison with the appropriate marketing department to advertise the stock.

- **Leasing Service:** Merchant banks provide leasing services to companies in the form of capital goods, vehicles and office equipment. This helps to reduce the overall financial burden of the companies.

- **Promotional Activities:** These act as financial intermediaries for promoting new enterprises in their initial phases and getting approval from the government.

- **Mergers and Acquisitions (M&A) Advisory:** Providing advisory services for evaluating potential acquisitions, conducting due diligence, and structuring transactions.

- **Corporate Restructuring:** Assisting companies in implementing financial and operational restructuring strategies to optimize performance and capital structure.
  Besides performing the above-mentioned functions by merchant bank, there are some other key functions that are also performed by them to contribute to the growth of Indian economy as explained below.

- **Capital Formation:** Merchant banks facilitate the mobilization of capital by assisting companies in raising funds from the public. This enables businesses to finance expansion plans, invest in new projects, and create employment opportunities.

- **Efficient Allocation of Capital:** Merchant banks help channel savings from investors toward productive investments. By evaluating investment opportunities, conducting due diligence, and providing expert advice, they ensure the efficient allocation of capital to projects with growth potential.

- **Market Expansion:** Merchant banks contribute to the development of the capital market by facilitating the listing of companies, and increasing the depth and liquidity of the stock exchanges. They play a crucial role in attracting domestic and foreign investments, thereby broadening the investor base.

- **Advisory Services:** Merchant banks provide valuable advisory services to corporates, enabling them to make informed decisions on capital structure, expansion plans, and strategic partnerships. Such guidance promotes competitiveness, enhances corporate governance, and improves overall business performance.

6.7 Service offered by Merchant Bank

Merchant banks provide the following services to their customers for the development of their business:

- Marketing and underwriting of new issues
- Merger and acquisitions
- Corporate finance management and advisory
- Project financing and management
- Management of customer security
- Portfolio services
- Investment banking
- Trade finance and advisory
- Venture capital fundraising and advisory
- Management of assets

6.8 Merchant Banking Vs. Investment Banking

Though there is a thin line of difference between Merchant Banking and Investment Banking, it can be said that Investment banking is elaborate form of the Merchant Banking, the differences between them are as follows:

Sr. No.	Points	Merchant Banking	Investment Banking
1	Focused on	International finance, business loans for companies, and underwriting	Underwriting and issuance of securities on behalf of large corporations
2	Customers	Small and medium-sized businesses, high-net-worth individuals, and family offices	Large corporations and government entities

3	Facilities/ Services	Mergers and acquisitions (M&A), project finance, trade finance, leasing, and advisory services	Underwriting, private placement, initial public offering (IPO) management, debt and equity securities issuance, and financial restructuring
4	Risk Appetite	Higher risk appetite since they deal with smaller businesses	Lower risk appetite, generally not open to doing business with riskier, high-growth businesses
5	Base of Profit	Fee-based	Commission-based
6	Earnings	Usually earns by offering advisory, trade finance, custodial, and safe keeping services	Usually earns through commissions, lease rentals, and interest charges
7	International Financial Service	Yes	Rarely found

6.9 Merchant Banking Vs. Commercial Banking

Sr. No.	Points	Merchant Banking	Commercial Banking
1	Definition & Meaning	Merchant bank refers to the financial institutions that specializes in international trade and provide an array of services to its clients.	Commercial banking can be defined as the banking establishment which provides basic banking functions to the general public like lending of the money and accepting the deposits.
2	Regulated by	Rules and Regulations designed by SEBI	Regulated by Banking Regulation Act, 1949
3	Focused on	Consultancy type business	General banking business
4	Nature of Loan	Nature of the loan given by the merchant bank is more equity-related	Nature of the loan given by the commercial bank is more Debt-related
5	Risk	The risk exposure is more when compared with commercial banking.	The risk exposure is less when compared with merchant banking.
6	Working as	As a financial advisor	As a Financier
7	Economic effect	The main impact of merchant banking is on large corporations, to whom it is providing its services, thereby impacting prices in the stock market and national economy.	The main impact of commercial banking is on the economy of the local area where it is providing its services
8	Earning	The primary earning in case of the merchant banking is through fees that are paid for the advisory services given by them.	The primary earnings of commercial banks are in the form of interest received on various loans issued.

6.10 Conclusion

Merchant banking has emerged as an essential component of India's financial system, acting as a catalyst for economic growth, capital market expansion, and corporate entities. Merchant banks are non-depository financial institutions that offer services to wealthy individuals and enterprises that require capital raising, financial advisory, or assistance with international trade. Currently, i.e. in 2024, there are 135 SEBI-registered merchant banks in India that are working relentlessly to meet the financing and banking needs of their customers.

- **Exercises**

Answer the following questions in detail.

1. What is merchant banking? What are the functions of it?
2. Explain the characteristics of merchant banking in detail.
3. What is the regulatory framework and for merchant banking in India? And what are the eligibility criteria for becoming a merchant banker in India?
4. Describe the history of merchant bank and current scenario of merchant bank in India.
5. Which kinds of facilities/ services are provided by Merchant bank in India?
6. Write down the difference between Merchant Banking and Investment Banking.
7. What are the differences between Merchant Bank and Commercial Bank?

UNIT – 7	LEASING & HIRE PURCHASE

7.1 Introduction

It is generally accepted that any business man always tries to maximize the profit in his business. That is why he is always creating new policies to increase sales. Leasing and hire purchase are examples of such policies, which help in increasing the sale of expensive products like land and building property, machines, plants, car, domestic things etc. Due to this policy, expensive items can be brought within the reach of the common man, thus creating a win-win situation for both parties. In leasing and hire purchase, the total amount of goods or services will not be called at once but will be paid gradually in the form of installments over a pre-determined period of time including interest on the amount produced. Although the practices of leasing and hire purchase are based on the same concept, there are some differences such as process, method of payment, contract, ownership and many more aspects, which are explained in depth in this unit.

7.2 Definition and Meaning of Leasing

Definition:

A lease is an agreement outlining the terms under which one party agrees to rent property- in this case, property owned by the other party. It guarantees the use of property by the person, also known as a tenant, and in return guarantees regular payments to the lessor (property owner or landlord) for a specified period of time.

Meaning:

In simple terms, Lease is a legal/contractual agreement whereby the owner of the asset (Lessor), gives exclusive right to use the asset to another party (Lessee) for an agreed period of time for a consideration.

Two parties are involved in this agreement. One is **lessor** who is agreeing to rent property and another is **lessee** who agrees to accept the property on specific amount of rent. In this agreement, capital assets like land, building, equipment, machinery, vehicles are usually included. The lessor remains owner of the asset, but possession and economic use of the asset is given to the lessee for the pre-determined time period of the agreement.

7.3 Features of Leasing

From the definition and meaning of leasing, the following key elements can be derived as characteristics of leasing:

- **Purpose:** Goods are delivered to the lessee with the specific purpose of exercising the specified legitimate activity throughout the term of the lease.
- **Consideration:** The lessee promises to pay the lessee rent on a regular basis, in consideration of the use of the goods.
- **Parties:** There are two parties involved in this agreement, namely, the **lessor** who is willing to give the asset on rent and the **lessee** who accepts the asset on the lease agreement.
- **Ownership:** The lessor, after handing over possession of the leased asset, remains the owner of the asset throughout the lease term and beyond.
- **Contract:** A leasing agreement is executed by entering into a valid contract between the lessee and the lessee. Both parties must be able to enter into an agreement. The lessor must have clear and indisputable title to the assets being leased. The contract must satisfy the requirements of a valid contract as per the Indian Contract Act.
- **Delivery of Goods:** Movable property, commonly known as 'goods' must be delivered by the lessor to the lessee. Delivery of goods can be either actual delivery or constructive delivery. In the former case the physical possession of the goods is handed over to the lessee, but in the latter, there is no change in physical possession, but some instruction or direction is given to the owner of the goods to hold them on his behalf.
- **Methodology:** The prospective lessee identifies the equipment to be leased and its supplier and enters into a lease arrangement with the leasing company. He presents certain details, such as his name, address, details about his business, name and address of the guarantor, if any, description of the equipment, name and address of the supplier and price quoted by the supplier, place of installation. , duration of lease, etc.
- **Return of the Goods:** After the lease period ends, the goods must be returned to the lessor in exactly the same form.

7.4 Legal Framework of Leasing

There is no separate statute for equipment leasing in India, as provisions relating to bailment in the Indian Contract Act also govern equipment leasing agreements.

In essence, it means the following:

- The lessee has a duty to deliver the asset to the lessee, legally authorize the lessee to use the asset and leave the asset in the peaceful possession of the lessee during the term of the contract.
- The lessee has the obligation to pay the lease rent specified in the lease agreement, to protect the title of the lessor, to take reasonable care of the asset and to return the leased asset on expiry of the lease term.

7.5 Rights & Duties of Parties

7.5.1 Rights of Lessor:

- The Lessor has the right to collect rent or any form of consideration as mentioned in the terms and conditions of the contract from the tenant without any form of interruptions.
- The Lessor has right to take back the possession of his property from the Lessee, if the Lessee commits any breach of condition.
- The Lessor has right to take back the possession of his property from the Lessee on the termination of the lease term prescribed in the agreement or if the Lessee commits any breach of condition.
- The Lessor has right to recover the amount of damages from the Lessee if there is any damage done to the property.

7.5.2 Duties of Lessor:

- It is the duty of the Lessor to not cause any form of interruptions during the tenancy period.
- The Lessor must give possession of the property to the Lessee on Lessee’s request. However, this liability only arises when there is a request on behalf of the Lessee.
- The Lessor is bound to disclose any form of a material defect in the property.

7.5.3 Rights of Lessee:

- The Lessee has the right to avoid the lease in case of any destruction of property by fire or flood, or violence of an army or of a mob, or other irresistible force.
- The Lessee has right to repair the property when Lessor fails to do so and to deduct the cost of repairs from the rent.
- The Lessee has right to make such payments which are obligatory on the Lessor and to deduct that amount from the rent.
- The Lessee has right to enjoy the accretions to the leased property.
- The Lessee has right to remove the fixtures made by him during the tenancy.
- He has right to enjoy the benefit of crops growing on the land sown or planted by the Lessor.
- The Lessee can sub-lease the property or the Lessee can absolutely transfer his interests. However, if the lease deed restricts a Lessee to assign his interest then the

Lessee is prohibited to do so and even after the transfer of his rights, the Lessee is still subject to all the liabilities related to the lease deed.

7.5.4 Duties of Lessee:

- The Lessee is bound to pay the rent or the premium to the Lessor or his agent in the proper time and proper place as decided by the lease deed.
- If the Lessee becomes aware that any person has tried or is trying to damage the rights of the Lessor or the title of the Lessor is endangered then, in that case, the Lessee must give notice to the Lessor.
- The Lessee has duty to use the property in a manner as if it was his/her own property.
- The Lessee is bound to inform the Lessor of any material fact which the Lessee is aware of and the Lessor is not. In case the Lessee does not disclose such fact and the Lessor suffers any loss then the Lessee is bound to compensate the Lessor.
- If Lessee gets to know about any proceedings relating to the property or any encroachment or any interference, then Lessee is under an obligation to give notice to the Lessor.
- The Lessee has duty to not to erect on the property any permanent structure without Lessor's consent.

7.6 Types of Leasing

On the basis of different criteria, the type of the lease contract can be defined as under:

1. **Operating Lease:** An operating lease is a type of lease where a company leases equipment or assets for a relatively short period of time compared to the expected useful life of the asset. It offers advantages such as low upfront costs, flexibility to upgrade and maintenance coverage by the lessee.

   An operating lease is a leasing arrangement typically used by businesses to acquire equipment, machinery or other assets without the commitment of ownership. In this arrangement, the lessee leases the property for a specified period, usually shorter than its useful life, from the lessor. Operating leases offer advantages such as lower initial costs, flexibility for upgrades, and maintenance relief, allowing companies to effectively manage their resources and adapt to changing needs. Unlike capital leases, operating leases are treated as operational expenses, providing businesses with financial flexibility and the ability to maintain up-to-date assets.

2. **Financial Lease:** In case of a financial lease, the lessor remains the owner of the leased asset during the lease period, but does not undertake its necessary maintenance. The rental received by the lessor fully amortizes the cost of the equipment and earns a profit for him. These leases are non-cancellable. Ultimately, the ownership of the leased asset may be transferred to the lessee at an agreed price. The lessor thus acts as a financier only and earns a return on his investment in the leased asset by way of rentals. Financial leases are for the major part of the useful life of the asset.

3. **Sale and Lease Back:** This is another type of lease arrangement wherein the lessee who already owns the assets, sells the same to the lessor, and thereafter takes the same asset from him on lease basis. This is called 'Sale and Lease Back

arrangement'. Under this arrangement, the lessee immediately recovers the value of his already owned assets from the lessor. Thereafter, the lessee makes payment of the lease rentals periodically as usual. Such a lease arrangement enhances the liquid resources of the lessee immediately, which can be utilized otherwise to meet his working capital requirements or to purchase another asset on cash payment basis. This type of lease is an alternative to a mortgage of the assets.

4. **Leveraged Lease:** In case of an ordinary lease, the lessor purchases the asset with an appropriate mix of debt and equity. But the creditor (i.e., supplier of the debt funds) does not have recourse to the lessee. In other words, in case the lessor defaults in making repayment of the debt, the creditor cannot claim the same from the lessee. He will have recourse to the lessor only.

   Leveraged lease is just opposite to the above. In such case, the creditor remains entitled to have recourse to the lessee, i.e., he can recover his claims from the lessee also. The lease rental is assigned to the creditor. The lessee is required to pay the lease rental directly to the creditor of the lessor. Generally this transaction is undertaken through a trustee, who receives the lease rental and appropriates it as debt service component to the creditor and the balance amount to the lessor.

5. **Single investor Lease:** In Single investor lease, there are two parties – lessor and lessee. The lessor arranges the money to finance the asset or equipment by way of equity or debt. The lender is entitled to recover money from the lessor only and not from the lessee in case of default by a lessor. Lessee is entitled to pay the lease rentals only to the lessor.

6. **Domestic and International Lease:** This classification is based on the domicile of the parties to a lease contract. If all the parties, viz. equipment supplier, lessor and the lessee are residing in the same country, the lease is called domestic lease. If they are residing in different countries, it is called international lease. If the lessor and the lessee are domiciled in the same country and equipment is imported from another country, it is called import lease. If the lessor and lessee are domiciled in different countries, the lease is called cross-border lease. In such cases, the equipment supplier may be the resident of any country. In case of international lease, there are two additional risks, i.e., country risk and currency risk.

7. **Sub Lease:** A sub lease is a rental agreement where the original lessee (tenant) rents out the premises to another person called the sub-tenant or sub-lessee. The new tenant gets few rights as the sub-lessee. The original tenant (lessee) can only give those rights to the new tenant (sub-lessee) which he has got from the original landlord (lessor). He cannot pass on more rights of use on the property. The flow of rent is from the sub-lessee to the lessee and the lessor/owner. The risk of rent is always mainly borne by the lessee. In case the sub-lessee is unable to make full or timely payment to the original lessee, the lessor is still entitled to his timely rents and the risk is borne by the lessee.

7.7 Advantages of Leasing

At present leasing activity shows an increasing trend. Leasing appears to be a cost-effective alternative for using an asset.

Advantages to Lessor:

- **Assured Regular Income:** Lessor gets lease rental by leasing an asset during the period of lease which is an assured and regular income.
- **Preservation of Ownership:** In case of finance lease, the lessor transfers all the risk and rewards incidental to ownership to the lessee without the transfer of ownership of asset hence the ownership lies with the lessor.
- **Benefit of Tax:** As ownership lies with the lessor, tax benefit is enjoyed by the lessor by way of depreciation in respect of leased asset.
- **High Profitability:** The business of leasing is highly profitable since the rate of return based on lease rental, is much higher than the interest payable on financing the asset.

Advantages to Lessee:

- **Use of Capital Goods:** A business will not have to spend a lot of money for acquiring an asset but it can use an asset by paying small monthly or yearly rentals.
- **Tax Benefits:** A company is able to enjoy the tax advantage on lease payments as lease payments can be deducted as a business expense.
- **Cheaper:** Leasing is a source of financing which is cheaper than almost all other sources of financing.
- **Technical Assistance:** Lessee gets some sort of technical support from the lessor in respect of leased asset.
- **Inflation Friendly:** Leasing is inflation friendly, the lessee has to pay fixed amount of rentals each year even if the cost of the asset goes up.
- **Ownership:** After the expiry of primary period, lessor offers the lessee to purchase the assets by paying a very small sum of money.

7.8 Disadvantages of Leasing

Disadvantages of Lessor:

- **Unprofitable in Case of Inflation:** Lessor gets fixed amount of lease rental every year and they cannot increase this even if the cost of asset goes up.
- **Double Taxation:** Sales tax may be charged twice: First at the time of purchase of asset and second at the time of leasing the asset.
- **Greater Chance of Damage of Asset:** As ownership is not transferred, the lessee uses the asset carelessly and there is a great chance that asset cannot be useable after the expiry of primary period of lease.

Disadvantages of Lessee:

- **Compulsion:** Finance lease is non-cancellable and even if a company does not want to use the asset, lessee is required to pay the lease rentals.
- **Ownership:** The lessee will not become the owner of the asset at the end of lease agreement unless he decides to purchase it.
- **Costly:** Lease financing is more costly than other sources of financing because lessee has to pay lease rental as well as expenses incidental to the ownership of the asset.
- **Understatement of Asset:** As lessee is not the owner of the asset, such an asset cannot be shown in the balance sheet which leads to understatement of lessee's asset.

7.9 Definition and Meaning of Hire Purchase

Definition:

According to the Hire Purchase Act, 1972, hire-purchase is defined as "an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement, and includes an agreement under which:

(i) Possession of goods is delivered by the owner thereof to a person on the condition that such person pays the agreed amount in periodic payments.
(ii) The property of the goods is to pass to such a person on the payment of the last of such installments.
(iii) Such person has a right to terminate the agreement any time before the property passes.

In short, Hire purchase is an arrangement made while buying expensive goods. The consumer makes a down payment during the purchase, and the outstanding balance will be paid in installments with an interest charge.

Meaning:

Let us understand Hire Purchase in depth. In simple terms, it is an agreement, in which the hire vendor (seller) transfers an asset to the hire purchaser (buyer or hirer), for consideration. The consideration is in the form of Hire Purchase Price which includes cash down payment and installments. The hire purchase price is normally higher than the cash price of the product because interest charges are included in that price. The installment is to be paid by the hirer at periodical intervals up to a specified period. The installment is a sum of finance charges i.e. interest and the capital payment i.e. principal.

Under Hire Purchase, hirer gets only the possession of the assets. However, there is a condition of the transfer of ownership, i.e., hire-purchaser ought to pay all the installments due on the asset transferred. By virtue of this, if the hire purchaser is unable to pay the outstanding installments, then the hire vendor can repossess the asset without paying any compensation to the hirer.

7.10 Characteristics of Hire Purchase

From the definition and meaning of Hire Purchase several key features are derived which can be as under:

- The asset ownership is transferred to the buyer only after the final installment is paid.
- Buyer pays for the asset in regular installments, which includes both the principal amount and the interest.
- Asset itself serves as security. In case the buyer fails to pay installments, the seller can repossess the asset.
- The buyer has the option to buy the asset at any time by paying the remaining installments in one go.

- Interest is charged over unpaid balance instead of the original price of the asset.
- Until the final payment is made, the maintenance of asset remains the responsibility of the buyer, not the seller.
- Buyer can terminate agreements at any time before taking ownership of the asset.

7.11 Legal Framework of Hire Purchase

According to Section 4 of the Act, every hire purchase agreement shall contain the following particulars:

- The hire purchase price of the goods to which the agreement relates;
- The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
- The date on which the agreement shall be deemed to have commenced;
- The number of installments by which the hire purchase price is to be paid, the amount of cash of those installments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and
- The goods to which the agreement relates, in the manner sufficient to identify them.

7.12 Rights & Duties of Parties

7.12.1 Rights of Owner:

- **Right to sue for payment:** If hirer does not pay the amount of installment on time, than owner of the goods has right to sue for payment.
- **Right of action for damages:** Where goods have deteriorated in the possession of hirer, the owner may sue for damages. Or where hirer fails to accept goods, any defect, the owner is entitled to damages.
- **Right to action for specific performance:** Where hire Purchase agreement fails, he may sue for redelivery of the goods in order to repossess.
- **Right to refusal:** When hirer fails to perform his obligation, than owner has right to refuse the agreement and repossess the goods.

7.12.2 Duties of Owner:

- **Duty to deliver goods:** The owner is obliged to deliver goods to the hirer and such goods must be in good condition. This is a fundamental term in the Hire Purchase agreement and breach of which, the hirer may repudiate the contract or sue for an action of specific performances, or damages.
- **Duty to transfer goods title:** The owner must possess a good title, as he cannot transfer what he does not have. Therefore, there's is an implied condition that the owner must possess good title and transfer such to the hirer.
- **Goods must be according to description:** The owner is obliged to deliver the goods to the hirer, not just delivering the goods, but he must ensure the goods meet the description of the hirer, a breach of which the hirer may reject such goods.

- **Duty to transfer possession:** There's an implied warranty, that the hirer must enjoy quiet possession of the goods and such goods must be free from encumbrances or charges which may hinder quiet possession of such goods.
- **Deliver goods fit for the purpose:** In situations where hirer notifies owner of the goods he needs, such goods delivered by the owner must be fit for such particular purpose. Also, the goods must be free from defect which the owner could foresee or notice.
- **Duty to furnish information:** The owner is duty-bound to furnish necessary information regarding the hire Purchase agreement, the technique of using the goods, durability and any necessary or relevant information.

7.12.3 Rights of Hirer:

- **Right to demand for delivery of goods:** After the hire purchase agreement, hirer has a right to demand the goods from the owner for use it.
- **Right to rejection:** Where owner fails to deliver goods of merchantable quality, quantity as stated, the hirer may reject the goods or repudiate the contract.
- **Right to action for damages:** He is entitled to bring an action for damages, where owner fails to deliver goods fit for purpose as stated in the Hire Purchase agreement.
- **Right for a declaration of specific performance:** Where installments have been made, and owner refuses to deliver goods, hirer has a right to bring an action for specific performance.
- **Free from any charges:** As hirer has only right of possession, he is not bound to pay any expenses related to goods.

7.12.4 Duties of Hirer:

- **Obligation to accept delivery:** The hirer is obliged to accept or take delivery of the goods, refusal or negligence; he (hirer) would be liable for damages.
- **Punctual payment of installments:** The hirer is obliged to pay installments punctually, as stated in the hire Purchase contract. This is a fundamental duty, as failure to do so amounts to non-performance of the contract and goes to the root of the contract. Failure to pay installments punctually and complete such, property in goods would not pass to him (hirer), and he must return the goods back to the owner.
- **Obligation of Care:** The hirer must take custody of the goods, and handle such with care and diligence.
- **Obligation to redelivery of goods:** In situation where the hire Purchase agreement fails, the hirer is obliged to redeliver the goods to the owner.

7.13 Advantages of Hire Purchase

1. **Convenience of Payment:** The buyer is greatly benefited as he has to make the payment in installments. This system is greatly advantageous to the people having limited income.
2. **Increases volume of sale:** This system attracts more customers as the payment is to be made in easy installments. This leads to increased volume of sales.

3. **Increases profit:** Large volume of sales ensures increased profits to the seller.
4. **Encourages saving:** It encourages thrift among the buyers who are forced to save some portion of their income for the payment of the installments. This inculcates the habit to save among the people.
5. **Helpful for small traders:** This system is a blessing for the small manufacturers and traders. They can purchase machinery and other equipment on installment basis and in turn sell to the buyer charging full price.
6. **Earning of interest:** The seller gets the installment which includes original price and interest. The interest is calculated in advance and added in total installments to be paid by the buyer.

7.14 Disadvantages of Hire Purchase

1. **Higher Price:** A buyer has to pay higher price for the article purchased which includes cost plus interest. The rate of interest is quite high.
2. **Artificial Demand:** Hire purchase system creates artificial demand for the product. The buyer is tempted to purchase the products, even if he does not need or afford to buy the product.
3. **Heavy Risk:** The seller runs a heavy risk under such system, though he has the right to take back the articles from the defaulting customers. The second-hand goods would fetch little price.
4. **Difficulties in Recovery of Installments:** It has been observed that the sellers do not get the installments from the purchasers on time. They may choose wrong buyers which may put them in trouble. They have to waste time and incur extra expenditure for the recovery of the installments. This sometimes led to serious conflicts between the buyers and the sellers.
5. **Late payments could affect your credit score:** It’s usual for a hire purchase agreement to be registered with credit agencies. So if over the term, you miss a payment or even make a late payment, it will be flagged on your credit report and may affect your credit score or even your ability to borrow in the future.

7.15 Difference between Hire Purchase and Sale

Sr. No.	Points	Hire Purchase	Sale
1	Meaning	The deal in which one party can use the asset of the party for the payment of equal monthly installments known as hire purchase system.	The goods are sold to the customer for full payment at the time of purchase.
2	Act	Hire Purchase Act, 1972	Sales of goods Act, 1930
3	Down Payment	Required	Not Required, as full payment made at a time
4	Need to check Creditworthiness	Required	Not Required
5	Termination	The hirer can terminate the contract by returning the asset to the seller and has no liability	The buyer cannot terminate the contract and he is obligated to pay the price of

		to pay the installments in full	goods
6	Ownership	The asset ownership is transferred to the hirer at the end of the payment term upon completion of all installments.	Ownership of the goods is transferred to the customer immediately upon full payment.
7	Repairs & Maintenance	Bear by the owner of the goods	Bear by purchaser
8	Resale	The hirer does not enjoy this right till all installment completed	The buyer can resale the goods as and when he wants
9	Interest	Included in the total price of the product	Interest is not included in total price of the product

7.16 Difference between Hire Purchase and Leasing

Sr. No.	Points	Hire Purchase	Leasing
1	Meaning	The deal in which one party can use the asset of the party for the payment of equal monthly installments known as hire purchase system.	Leasing is an agreement where one party buys the asset and allows the other party to use it by paying consideration over a specific period is known as Leasing.
2	Accounting Standard	No specific accounting standard is provided for it	Accounting Standard- 19 is applicable for leasing
3	Down Payment	Required	Not Required
4	Payment Structure	The cost of the asset is divided into equal installments, including interest, that hirer pays over a specific period.	The lessee makes periodic payments for the use of the asset without any intention of ownership transfer.
5	Duration	This system is generally for shorter period of time	It is stand for comparatively longer period of time
6	Ownership	The asset ownership is transferred to the hirer at the end of the payment term upon completion of all installments.	The asset ownership remains with the lessor throughout the lease term.
7	Repairs & Maintenance	Bear by the owner of the goods	Depends upon the type of leasing
8	Financing	Hire purchase is a form of financing where the hirer gradually pays for the asset over time.	Leasing is a contractual arrangement for the use of an asset without ownership transfer.
9	Installments	Principal plus interest	Cost of using the asset
10	Example	This system generally used to purchase Vehicles, Home appliances, Smart phone, or any expensive products	This system generally used to get benefit of Land, Building, Property, Equipment etc.

7.17 Conclusion

With the help of this unit, one can easily understand two important concepts of selling system, namely, hire purchase system and leasing as well as the difference between them. In hire purchasing, the hirer has to pay an advance along with periodical installment as consideration, but in the case of leasing the lessee has to pay lease rentals at specified intervals. Although both are selling strategies; there is a difference of the basic concept of the sale which has been explained in this unit.

❖ Exercise

Answer the following questions:

1. What do you understand by leasing? Explain its features.
2. Who is Lessor? Discuss rights and duties of Lessor.
3. Who is Lessee? Discuss rights and duties of Lessee.
4. Explain the various types of leasing.
5. What are the merits and demerits of leasing?
6. What do you mean by hire purchase? Explain its characteristics.
7. Explain legitimate framework of leasing and hire purchase in detail.
8. Explain rights of both parties of hire purchase.
9. Explain duties/ obligations of both parties of hire purchase.
10. Difference between hire purchase and sale.
11. Explain the difference between leasing and hire purchase.

UNIT – 8	CREDIT RATING

8.1 Introduction

Credit refers to the branch, and rating refers to the measurement of qualifications. Credit rating pertains to opinions about credit risk. Credit ratings are provided by rating agencies that are experts in assessing credit risk. Each agency uses its own method to measure creditworthiness and employs a robust rating scale to publish their rating opinions. Rating agencies also express their views on a corporation or government's ability to fulfil financial responsibilities in a comprehensive and timely manner. Various agencies also prepare credit ratings for corporate governance. In this context, efforts are made to encompass issues related to credit ratings, regulators, agencies, types of processes, and stakeholders.

"Credit rating is a financial tool or a measure associated with the assessment of risks pertaining to securities. In the context of future endeavors, letters and financial reports from companies are considered proper or improper based on their credit ratings." Credit rating is commonly used to assess an entity's creditworthiness in the context of financial responsibility. Credit rating can be sought by any individual, corporation, government, or a supra-national authority in the future. It is often obtained through personal credit bureaus like FICO, which uses a 3-digit numerical scale to evaluate personal credit for credit applications from Experian and TransUnion, among others.

According to SEBI (Credit Rating Agencies) Regulations, 1999, Clause 2(1)(h), a credit rating agency is an entity that engages in the business of rating securities. This explanation makes it clear that the primary purpose or function of a rating agency is to provide credit ratings for securities issued by companies or offered to the general public. International and Indian credit rating agencies have provided several explanations that make the concept of credit rating more transparent.

According to Moody's Investor Services, "A rating is an opinion about the future ability and legal responsibility of the issuer to make timely principal and interest payments."

ICRA also provides a similar definition, stating that credit ratings are a reflective indicator of the issuer's ability to meet its obligations in accordance with the terms of issue, in the context of the issuer's creditworthiness and its credit program linked to the issuer's terms and conditions.

According to CARE, credit rating agencies express their opinions on the ability to fulfil debt service responsibilities of entities issuing debt instruments. As per Standard & Poor's, corporate or municipal debt ratings are evaluations of creditworthiness in the context of financial responsibility in the current scenario.

In line with Australian Ratings, corporate credit rating agencies provide a straightforward system of grading that notes the relevant capabilities of companies to make timely interest and principal payments in the context of their financial responsibility and timely debt servicing.

CRISIL credit ratings, on the other hand, provide an impartial, supportive, and independent commentary on issuers' financial responsibilities, with the ability to offer a comprehensive assessment.

The above explanations, definitions, and opinions make it clear that credit rating agencies provide their views on an institution's credit quality. It's worth noting that the impartiality of the opinion is based on the rating agency's independence.

8.2 Objectives of Credit Rating

The objectives of credit ratings are as follows.

- To maintain simplicity in decision-making regarding investments.
- To assess the creditworthiness of individuals, corporations, or a country.
- To enhance the confidence of investors.
- To maintain a healthy financial discipline.
- To evaluate the credibility of agencies like Moody's.
- To enable issuers or borrowers to fulfill the requirements of interest and principal payments efficiently.
- Credit rating agencies evaluate the financial strength of a company based on financial information.
- Requests for credit ratings are submitted regularly, i.e., ratings are shown as AAA, BBB, which can be understood even by ordinary individuals.
- Credit ratings are provided by recognized, accredited institutions.
- Credit rating is only guidance for investors; it is not a guarantee for investment in a particular company.

8.3 Regulatory Framework

Under the provisions of the Securities and Exchange Board of India Act, 1992 (Section 11), SEBI had issued a circular on July 7, 1999, titled "Credit Rating Agencies (Regulations)" which regulated the functioning of Credit Rating Agencies (CRAs) in India. The regulation of CRAs is carried out under the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The regulations encompass two important aspects, namely (01) Registration and (02) Eligibility Criteria.

To safeguard the interests of investors, SEBI has mandated that every Credit Rating Agency must continuously monitor the ratings assigned by them on securities. SEBI does not play any role in the rating process undertaken by rating agencies.

SEBI has specified the following rules under the (Credit Rating Agencies) Regulations, 1999, to address various scenarios separately. In Part-1, guidelines and explanations related to the credit rating agencies are provided. In Part-2, the conditions for establishing credit rating agencies are outlined.

Part-1

Guidelines and Explanations Related To the Credit Rating Agencies

(1) Procedure for Obtaining Registration Certificate:

Under Clause 2, Subsection 3(1), any individual intending to commence operations as a Credit Rating Agency must submit an application to SEBI (Securities and Exchange Board of India) in the prescribed format (as provided in the first schedule to these regulations, Form A). The application must be accompanied by a non-refundable application fee of INR 50,000 (as per SEBI (Credit Rating Agencies) (Amendment) Regulations, 2006).

(2) Credit Rating Agencies' Promoters:

If the applicant (Suitable Rating Agency) is promoted by any entity falling under any of the following categories as per Regulation 4, the Board shall consider the application for grant of registration: I. Companies registered under the Companies Act, 2013. II. Entities included in the Second Schedule to the Reserve Bank of India Act, 1934, at that point in time. III. Commercial Banks. IV. Foreign Banks operating in India with RBI approval. V. Foreign Credit Rating Agencies with a minimum of five years of experience in rating securities in the international markets. VI. Credit Rating Agencies whose establishment in India is not prohibited by any prevailing laws at the time. VII. Any company or body corporate applying for a Certificate for providing credit rating services under these regulations shall have a net worth of at least INR 100 crores as per its audited annual accounts, based on the latest audited financial statements.

(3) Eligibility Criteria:

- Eligibility criteria for Credit Rating Agencies must be in accordance with Regulation 5, as outlined below.
- The applicant is registered as a company under the Companies Act, 2013.
- In the Memorandum of Association (MoA) of the applicant, rating activities are mentioned as one of its main objectives.
- The applicant has a minimum net worth of INR 5 crores.
- The applicant, its promoters, or its directors do not engage in any legal activity that could adversely affect the interests of investors, as per the regulations or laws.
- The applicant or its promoters, directors, or any person connected with the applicant, have not been declared insolvent or convicted of an offense involving moral turpitude.
- The applicant possesses adequate infrastructure and experienced personnel in line with the Board's satisfaction.

- The applicant or any person directly or indirectly connected with the applicant, at any time in the past, has not been denied a certificate by the Board.
- The applicant shall have at least 26% of its shareholding as promoters.
- The Board shall issue a registration certificate to the applicant upon being satisfied with the eligibility criteria, as per Regulation 8, along with Form B and the prescribed registration fee, as per the SEBI (Fees) Regulations, 2012. The validity of the registration certificate shall be three years. If a Credit Rating Agency wishes to renew its certificate, it shall apply to the Board by submitting Form B along with the renewal fees.

These terms and conditions outline the requirements and procedures for establishing a Credit Rating Agency in India, subject to SEBI regulations.

PART-2

Terms and Conditions for Establishing Credit Rating Agencies

(1) Procedure for Obtaining Registration Certificate:

Under Clause 2, Subsection 3(1), any individual intending to commence operations as a Credit Rating Agency must submit an application to SEBI (Securities and Exchange Board of India) in the prescribed format (as provided in the first schedule to these regulations, Form A). The application must be accompanied by a non-refundable application fee of INR 50,000 (as per SEBI (Credit Rating Agencies) (Amendment) Regulations, 2006).

(2) Credit Rating Agencies' Promoters:

If the applicant (Suitable Rating Agency) is promoted by any entity falling under any of the following categories as per Regulation 4, the Board shall consider the application for grant of registration: I. Companies registered under the Companies Act, 2013. II. Entities included in the Second Schedule to the Reserve Bank of India Act, 1934, at that point in time. III. Commercial Banks. IV. Foreign Banks operating in India with RBI approval. V. Foreign Credit Rating Agencies with a minimum of five years of experience in rating securities in the international markets. VI. Credit Rating Agencies whose establishment in India is not prohibited by any prevailing laws at the time. VII. Any company or body corporate applying for a Certificate for providing credit rating services under these regulations shall have a net worth of at least INR 100 crores as per its audited annual accounts, based on the latest audited financial statements.

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- The applicant or its promoters, directors, or any person connected with the applicant, have not been declared insolvent or convicted of an offense involving moral turpitude.
- The applicant possesses adequate infrastructure and experienced personnel in line with the Board's satisfaction.
- The applicant or any person directly or indirectly connected with the applicant, at any time in the past, has not been denied a certificate by the Board.
- The applicant shall have at least 26% of its shareholding as promoters.
- The Board shall issue a registration certificate to the applicant upon being satisfied with the eligibility criteria, as per Regulation 8, along with Form B and the prescribed registration fee, as per the SEBI (Fees) Regulations, 2012. The validity of the registration certificate shall be three years. If a Credit Rating Agency wishes to renew its certificate, it shall apply to the Board by submitting Form B along with the renewal fees.

These terms and conditions outline the requirements and procedures for establishing a Credit Rating Agency in India, subject to SEBI regulations.

8.4. Types of Credit Rating

The types of credit ratings are as follows.

- **Bonds and Debentures Rating**: Ratings are popular for bonds and debentures in various segments. Practically, all credit rating agencies rate debentures and bonds.
- **Equity Share Rating**: In India, equity share ratings are not mandatory, but credit rating agency ICRA has prepared a system for equity ratings.
- **Preference Share Rating**: Preference shares in India do not receive ratings, although Moody's Investor Service has been providing ratings for preference shares since 1973, and ICRA has also started rating them.
- **Medium-Term Loan Rating (Public Placements, CDs, etc.):** Fixed deposits taken by companies in India are rated on a regular basis.
- **Short-Term Instrument Ratings [Commercial Papers (CPs)]:** Credit rating for short-term instruments like commercial papers started in 1990. Credit ratings for CPs are mandatory and are done by CRISIL, ICRA, and CARE.
- **Debenture Rating**: Debenture ratings can be individual or for a company as per the rating agencies' criteria.
- **Real Estate Builders and Developers Rating**: Many private properties and flat builders operate in big cities. Ratings for them ensure that they will develop properties properly or build flats. CRISIL has started rating builders and developers.
- **Chit Fund Rating**: Chit fund subscribers pool monthly contributions and give loans to participants offering the highest interest rates. Ratings for chit funds are based on their ability to repay the subscribers' dues in a timely manner. CRISIL rates chit funds.
- **Insurance Companies Rating**: In addition to the insurance sector's entry with private players, credit ratings for insurance companies have also increased. Ratings for insurance companies are given based on their ability to settle claims (be it high, adequate, medium, or low) later. ICRA rates insurance companies.

- **Collective Investment Schemes Rating**: When a large number of depositors collectively invest in schemes, they are called collective investment schemes. Ratings for such schemes determine whether the schemes will be successful or not. ICRA rates these schemes.
- **Banks Rating**: Private and cooperative banks in India are failing regularly. People prefer to deposit money in banks that are financially strong and capable of repaying deposits. CRISIL and ICRA now rate banks.
- **States Rating**: States in India are also being rated now because they are capable of raising loans or not. Credit rating agencies rate states based on their industrial and agricultural production, total household production, government policies, interest on loans, etc.
- **Countries Rating**: Foreign investors and lenders are keen to know the country's financial condition and whether it is beneficial for them to lend or not. While rating a country, its industrial and agricultural production, total household production, government policies, interest on loans, etc., are taken into consideration.

8.5 Challenges in Achieving Success/Development in Credit Rating

(1) Impartiality: They provide an impartial opinion to investors. A good credit rating agency is impartial because it has no vested interest in the rated companies.

(2) Quality Information: They provide high-quality and reliable information. Credit rating agencies conduct through assessments of risks and employ trained and experienced staff to ensure they have important information, which they can provide to assess the creditworthiness of borrowing companies.

(3) Concise and Clear Ratings: Credit rating agencies distill information, analyze it, and present it in an understandable form. Their ratings are not in technical language but are represented in simple symbols like AAA, BB, C, etc., which are easy to comprehend.

(4) Availability of Information without a Fee: Information is available free of charge or at a nominal cost. Credit rating reports are published in financial newspapers and company announcements, and the public does not have to pay to access them. Anyone can obtain their credit rating agency's report on the payment of a nominal fee. Compiling this information for personal use is beyond the capability of individual investors.

(5) Usefulness in Decision-Making: Helps investors in making investment decisions. Credit rating agencies assist investors in assessing risks and making investment decisions.

(6) Encouragement of Corporate Governance: Encourages corporate governance from the credit rating they receive. When a borrowing company receives a high credit rating, it tends to improve its corporate governance, and other companies also strive to maintain their financial discipline to secure good ratings, promoting ethical practices in these companies.

(7) Formation of Public Policies on Borrowing: Regulatory authorities (SEBI, RBI, etc.) can frame policies when credit rating agencies rate instruments. For example, they can decide that mutual funds, provident fund trusts, and various other organizations can invest in securities that have a specific rating, such as only those with an AAA rating.

(8) Basis for Sound Risk Analysis: Credit rating agencies conduct sound risk analysis using a well-defined process and methodology.

(9) More Credibility for Financial and Other Requests: They maintain higher credibility for financial and other requests for ratings.

(10) Investor Protection: Credit rating agencies ensure investor protection in the context of credit ratings.

8.6 Benefits of Credit Rating

Credit rating companies provide the benefits, categorized as follows:

A. Benefit to Investors.

B. Benefit to Rated Companies.

C. Benefit to Intermediaries.

D. Benefit to the Business World.

A. Benefit to Investors.

1. **Risk Assessment**: Credit ratings allow investors to assess the risks involved in investing. Individual investors may not have the expertise, time, and resources to conduct detailed risk assessments for each investment. Credit rating agencies, with their specialized knowledge, skills, and resources, can do this work for them. Additionally, ratings such as AAA, BBB, etc., are easily understood by investors.
2. **Access to Information at Lower Costs:** Credit rating information is published in financial newspapers and is available at nominal fees from rating agencies. This enables borrowers looking for loans at lower costs to access credit information.
3. **Continuous Monitoring**: Credit rating agencies do not rate securities just once. They continuously monitor and upgrade or downgrade ratings based on changing circumstances.
4. **Investor's Choice**: Credit rating agencies provide investors with a choice to invest in one company's securities over another. They gather information on the creditworthiness of various companies and make it available. Therefore, investors have the option to invest in one company's securities over another.

B. Benefits to Rated Companies:

- **Easier Access to Credit**: If a company obtains a higher credit rating for its securities, it can raise funds more easily in the bond market.
- **Lower Borrowing Costs**: A favorable rating instills confidence in lenders, enabling the company to borrow at lower interest rates.
- **Development Facilities**: Development facilities are provided. They are motivated by favourable ratings, promoters, expansion, diversification, and development plans. Furthermore, companies with high ratings find it easy to raise capital or credit security issuances from the public. Borrowing from banks becomes simpler for them.
- **Recognition for Lesser-Known Companies**: Lesser-known or unknown companies' access to credit ratings gives them credibility and recognition in the eyes of potential investors and lenders.

- **Improvement in Credibility**: Ratings enhance a rated company's credibility. If a company receives a high rating from rating agencies, its credibility automatically increases in the market.
- **Financial Discipline**: Financial discipline is instilled. Companies seeking loans know that when they manage their finances in a disciplined manner, they will automatically earn high credit ratings. This means they maintain good solvency, operational efficiency, quality assets, and more.
- **More Information Disclosure**: To obtain credit ratings from recognized agencies, companies must publicly disclose a lot of information about their operations. This encourages greater transparency, improved accounting practices, and enhanced financial information that benefits investors in assessing risk.

C. Benefits for Intermediaries

- **Simplified Role for Merchant Bankers and Brokers**: In the absence of credit rating, merchant bankers or brokers have to educate investors about the financial health of borrowing companies. When credit ratings are available through reputable credit agencies, the role of merchant bankers and brokers becomes much simpler.

D. Benefits for the Business World

- **Increased Asset Base of Lenders**: When lenders have guidance through credit ratings to extend loans to companies in corporate debt, more people are encouraged to invest in corporate bonds.
- **Guidance for Foreign Borrowers**: Foreign collaborators or foreign financial institutions can invest in companies that have higher credit ratings. Credit ratings enable them to assess the company's position more effectively.

8.7 Drawback of Credit Rating

Understanding the credit rating plays a crucial role in providing comprehensive information to global borrowers. However, credit ratings have a significant impact on various financial concerns and issues, such as environmental and social risks, stability of financial markets, and issues related to sustainability and inclusiveness. Credit ratings of developing countries are influenced by the following three factors:

(i) Downgrades due to the country's borrowing expenses and stability of financial markets, alleged prior predictions, and instability.

(ii) Public sector initiatives and restructuring of power, such as the Debt Service Suspension Initiative (DSSI), which are included in rating analysis.

(iii) Changes in the rating methodology and integration of non-economic vulnerabilities: the search for categories of tasks that encourage increased confidence in credit ratings and motivate ratings to contribute more to the stability of the international financial system, not only restraining development.

8.8 Credit Rating Agencies

Definition of Credit Rating Agencies: A credit rating agency is a private company that assesses the creditworthiness of entities, whether companies or countries with high borrowing capacity, but not individual consumers. It affects their ability to borrow and repays their loans in an impactful way. International credit rating agencies include:

In 1841, Lewis Tappan established the first commercial credit rating agency in New York.

In 1849, John Bradstreet founded a rating agency, which published a rating book in 1857.

In 1924, Fitch Publishing was established.

In 1933, Robert Dun and John Bradstreet merged to form Dun & Bradstreet, which later became Moody's Investor Service owners in 1962.

In 1941, Standard & Poor's Corporation began its credit rating operations.

Companies and governments commonly undergo credit rating and evaluation processes carried out by credit rating agencies such as Standard & Poor's (S&P), Moody's, or Fitch. Organizations that require credit ratings provide the agencies with relevant information, and the agencies then assess and assign ratings. Credit rating is a highly centralized industry, with the "big three" credit rating agencies controlling nearly 95% of the business. Moody's Investors Service and Standard & Poor's (S&P) together dominate around 80% of the global market, while Fitch Ratings oversees more than 15%.

Credit rating advancement in India: As per SEBI's LODAR 2015 Regulations 55, credit rating agencies registered with SEBI are required to review each non-convertible debt security issued by a listed company at least once a year. Six credit rating agencies are recognized by SEBI, including CRISIL, ICRA, CARE, Fitch India, Brickwork Ratings, and SMERA.

Notable milestones in the history of credit rating agencies in India:

- 1987: CRISIL (Credit Rating and Information Services of India Limited) was established as the first rating agency in India.
- 1991: ICRA Limited (Investment Information and Credit Rating Agency of India Limited) came into existence.
- 1994: CARE (Credit Analysis and Research Limited) was founded.

1. Credit Rating and Information Services of India Limited (CRISIL)

- It is India's first credit rating agency, established and promoted by UTI and other financial institutions, including the former ICICI Limited, in 1987.
- It commenced its operations one year later, in 1988.
- Its headquarters are located in Mumbai.
- CRISIL is a leading provider of ratings, data and research, analysis, and solutions in India, with a strong track record of development and innovation.
- It is known for its independent views and efficient services.
- CRISIL operates in 8 countries, including the USA, Argentina, Poland, the UK, China, Hong Kong, and Singapore.
- It is majority-owned by Standard and Poor's (S&P).
- In addition to working with governments and policy-makers in the infrastructure domain, it also operates in emerging markets and other segments.

2. Investment Information and Credit Rating Agency of India Limited (ICRA)

- ICRA was established in India in 1991 as the second credit rating agency.

- It provided independent and professional credit rating and information services to financial institutions, commercial banks, and financial services companies.
- ICRA is a public limited company.
- Its headquarters are located in New Delhi.
- Majority shares of ICRA are held by Moody's.

3. Credit Analysis and Research Ltd. (CARE)

- CARE, founded in 1993, is a leading credit rating agency in India.
- It is the second-largest credit rating agency in India.
- Its headquarters are in Mumbai.
- CARE ratings are among the five categories of international ratings agencies called ARC Ratings.
- UTI, IDBI, and Canara Bank are major promoters of CARE.
- CARE provides ratings for various instruments like debentures, fixed deposits, commercial paper, and structured obligations.

4. ONICRA

- ONICRA is a specialized agency established by Onicra Financial Services.
- Its main office is in Gurgaon.
- ONICRA provides ratings, risk assessment, and analytical challenges to individuals, MSMEs, and corporations.
- It is one of the seven agencies licensed by NSIC (National Small Industries Corporation) to rate SMEs.
- ONICRA has offices at 125 locations across India.

5. **SMERA**

- SMERA is India's first rating agency that primarily focuses on the Indian micro, small, and medium-sized enterprises (MSME) segment.
- Its primary objective is to provide ratings that are comprehensive, transparent, and credible.
- It serves as a valuable source of information for investors, trading patterns, and potential customers.

These agencies play essential roles in providing credit ratings and information services to various sectors of the Indian economy and contribute to the country's financial and economic stability.

8.9 Credit Rating Process and Methodology

In India, the credit rating is primarily carried out on the request of companies that borrow or issue debt. Companies seeking to borrow or issue debt submit a request to a credit rating agency to provide a rating. The major credit rating agencies in India follow the process outlined below:

- Agreement: A contract is entered into between the rating agency and the issuing company. It specifies the rules and terms for conducting the rating.
- Formation of Analytical Team: The rating agency assigns a team of analysts, typically consisting of two analysts with expertise in the relevant industry. These analysts are responsible for assessing the creditworthiness of the company.
- Data Collection: The analytical team gathers essential information from the client company, including financial position, cash flow, competitive position,

market share, management capability, operating expenses, sales, and distribution records, power (electricity) availability, and labor conditions.

- Meetings with Officials: To gain clarity and understanding of the client's business, the analytical team conducts meetings with key officials and executives of the client company.
- Discussion on Assumptions: After conducting a thorough analysis, the analytical team presents its findings to an internal committee (which often includes senior analysts) for a discussion on the ratings.
- Rating Committee Meeting: The internal committee, also known as the "Rating Committee," is responsible for making the final decision on the credit rating. It usually includes several directors and holds the ultimate authority on assigning ratings.
- Disclosure to the Public: The rating company publishes the rating through reports and press releases.
- Rating Surveillance: Once a company has received a credit rating, the rating agency continues to monitor the company's performance and financial health regularly.

Considerations in Credit Ratings

a) Ability to provide the service of issuing credit ratings: Credit rating agencies evaluate

i) The historical and future cash flow of the issuing company.

ii) The interest to be paid on the company's outstanding debt and assess its ability to repay.

iii) Any remaining debts.

iv) Solvency of the company's lowest-rated bonds as assessed by current credit rating.

v) Value of collateral securities provided by the company as security.

vi) Availability and quality of unprocessed raw materials, favorable location, cost-profit.

vii) Track record of promoters, directors, and staff.

- **Market Position of the Company:** What is the market share of various products of the company, will it remain stable, will the company benefit from competitive advantages due to distribution network, customer base research and development facilities, etc.
- **Quality of Management:** Credit rating agencies also consider the track record, structure, qualifications, and philosophy of senior management.
- **Legal Status of Assets:** Whether the assets issued are legally valid, terms and conditions of issuance and redemption rules, and terms of debenture trust deeds, etc.
- **Industry Risks:** An analysis of industry risks (e.g., automotive or electronics) in terms of demand and supply conditions, international competition, what are the future prospects of the industry, will it face a downturn or expand?
- **Regulatory Environment:** Whether the industry is regulated by the government (e.g., the liquor industry), whether pricing is controlled, whether it enjoys government support, whether it benefits from tax incentives, etc.

- **Other Factors:** In addition to the above, other factors that may be considered in credit rating include the cost of borrowings, the availability of information, the privacy of information, the credibility of the rating, the coverage of the rating, etc.

In the credit rating process, the following important issues are included:

- Request for Proposal
- Submission of application form, relevant documents, and fees
- Site visits and management interviews
- Rating methodology process
- Rating determination by the rating committee
- Rating dissemination
- Monitoring of the assigned rating
- Rating validity
- Confidentiality of information
- Credibility of the rating
- Rating coverage.

8.10 Credit Rating Reports

Under the SEBI (Credit Rating Agencies) Regulations, 1999, as per clause 2(1)(q), a credit rating signifies an opinion on securities, either in the form of symbols or in any other recognized manner, provided by a credit rating agency and issued by them. Issuers of such securities are bound by the requirements mentioned in these regulations.

SEBI has certified the rating symbols. Indian rating agencies (IND-RA) have made improvements in their rating symbols. Ratings are typically expressed in alphanumeric symbols or alphabetical representations. Therefore, the responsibility to provide clear credit ratings lies with the rating agency, not the company. As a result, credit ratings issued by rating agencies/agencies can vary from one instrument to another within an issuer. Furthermore, credit rating agencies do not provide any guarantee for investors to buy, hold, or sell securities because they focus solely on assessing credit quality and do not consider individual investor risk perceptions or market prices.

Credit Grades/Symbols are given to companies as follows.

Rating Scale	India Ratings & Research	CRISIL	Brick Work Ratings	CARE	ICRA
High Security: Very low credit risk	IND AA	CRISIL AA	BWR AA	CARE AA	ICRA AA
less risk	IND A	CRISIL A	BWR A	CARE A	ICRA A
General Security: General credit risk	IND BBB	CRISIL BBB	BWR BBB	CARE BBB	ICRA BBB
General Risk: The general risk of default	IND BB	CRISIL BB	BWR BB	CARE BB	ICRA BB
High Risk: High risk of default	IND B	CRISIL B	BWR B	CARE B	ICRA B
Very high risk: Very high probability of default	IND C	CRISIL C	BWR C	CARE C	ICRA C

Default: An instrument that is in default or about to default.	IND D	CRISIL D	BWR D	CARE D	ICRA D

8.11. Future Outlook of Credit Rating

In the latter half of 1980, some financial institutions in India felt the need to establish an agency experienced in assessing credit ratings, similar to the rating agencies prevalent in Western countries, to facilitate evaluation and assistance in assessing the risks associated with lending. Credit rating agencies collectively found their footing in the country in 1987 when they encouraged the establishment of Credit Rating Information Services of India Limited (CRISIL). This rating agency set the tone for credit rating trends in India. In the last two decades, the importance of credit ratings in the country's financial market has grown significantly. Many credit rating agencies exist in the country, which assess the ability of companies and institutions to repay borrowed amounts.

Currently, India has seven rating agencies, including those recognized by the Securities and Exchange Board of India (SEBI): CRISIL, ICRA, CARE, SMERA, Fitch India, and Brickwork Ratings. Infomerics Valuation and Rating Private Limited is not registered with SEBI. Furthermore, a personal credit assessment agency, such as ONICRA, operates in India.

In recent years, credit ratings for speculative-grade debt have become increasingly common, indicating the likelihood of loan defaults within a year compared to investment-grade debt. During economic downturns, credit ratings for long-term debt have gained more significance. Credit rating agencies typically assign ratings on a letter grade scale, ranging from AAA (excellent) to C and D. Ratings below BB are considered speculative-grade or junk bonds. Personal consumers do not receive credit ratings from credit rating agencies but rather have credit scores issued by credit bureaus (also known as consumer reporting agencies), which assess creditworthiness. The number of credit rating agencies, their individual rating methodologies, processes, and rating scales, combined with the participation of companies and investors, contribute to the transparency and future outlook of credit ratings in the country.

Credit rating is an independent evaluation conducted by agencies through which it can be determined how financially stable a company or institution is and how much financial responsibility it can bear. Credit rating takes into consideration the current and future profitability of the company and its ability to repay debts. The credit rating also assesses the company's current and future financial health. A higher credit rating instills confidence in the company's ability to repay debts and ensures the safety of investments and loans.

❖ **Exercise**

Choose the correct option from the given options for the following questions:

1. When was SEBI Credit Rating Regulation introduced?
(1) 1998 (2) 1999 (3) 1995 (4) 1997
Answer: (2) 1999
2. In what format is credit rating provided?
(1) Report/Grade (2) Certificate (3) Application (4) Letter

Answer: (1) Report/Grade

3. Credit rating according to __________ evaluates the current valuation of corporate or municipal debt ratings.
(1) CRISIL (2) CARE (3) Standard & Poor's (4) ICRA
Answer: (3) Standard & Poor's

4. How many sections are Credit Rating Regulations-1999 divided into?
(1) Seven (2) Three (3) Four (4) Five
Answer: (1) Seven

5. Under which case do credit rating agencies provide creditworthiness rating to corporate or municipal debt?
(1) Case-2 (2) Case-3 (3) Case-4 (4) Case-5
Answer: (2) Case-3

6. Who benefits from credit ratings among the following?
(1) Investors (2) Intermediaries (3) Rated Companies (4) All of the above
Answer: (4) All of the above

7. In the global credit rating market, Moody's and Investor Service and Standard & Poor's control what percentage?
(1) 95% (2) 15% (3) 85% (4) 80%
Answer: (4) 80%

8. How many credit rating agencies are recognized by SEBI?
(1) 5 (2) 7 (3) 4 (4) 6
Answer: (4) 6

9. Where is the head office of CRISIL located?
(1) Mumbai (2) Kolkata (3) New Delhi (4) Gurugram
Answer: (1) Mumbai

10. In which year was ICRA established?
(1) 1987 (2) 1991 (3) 1994 (4) 1999
Answer: (2) 1991

Answer the following questions briefly:

1. Explain the various aspects of credit rating.
2. Name any four types of credit ratings.
3. Explain the benefits of credit ratings to investors.
4. Provide a brief overview of CARE.
5. Mention some criteria used by credit rating agencies for eligibility.
6. List the types of credit rating agencies.
7. Describe the process of obtaining a certification for credit rating agencies.

Provide detailed answers to the following questions:

1. What is credit rating? Discuss it comprehensively.
2. Explain the role of a credit rating regulator in detail.
3. Describe the benefits of credit ratings in detail.
4. Explain the credit rating process step by step.
5. Discuss the family aspect of credit rating success.
6. Enumerate the types of credit ratings.

Write briefly:

1. Credit Rating Agencies in India.
2. Credit Rating Agencies' Responsibilities.
3. Credit Rating Grades.
4. CRISIL.

UNIT – 9 VENTURE CAPITAL

❖ **Objectives**

After studying this unit, you will be able to understand:

- Meaning and chief characteristics of Venture Capital.
- Modus operandi of Venture Capital Funds.
- Regulatory framework for Venture Capital Funds in India and the tax concessions granted to them.
- Venture Capital Funds in India.

9.1 Introduction

Venture capital (VC) serves as a catalyst for innovation and entrepreneurship, fueling the growth of groundbreaking ideas and promising startups. It is a form of financing provided to early-stage, high-potential companies with the expectation of significant returns on investment. Venture capitalists, or VCs, deploy capital into these ventures in exchange for an ownership stake, often taking on considerable risk in pursuit of substantial rewards.

The essence of venture capital lies in its support for disruptive concepts and visionary founders who are poised to revolutionize industries. Unlike traditional financing methods such as bank loans or public offerings, venture capital is tailored specifically for startups that may lack established revenue streams or collateral. This unique form of investment not only injects vital funds into fledgling enterprises but also provides invaluable mentorship, strategic guidance, and access to networks crucial for their success.

Venture capitalists operate within an ecosystem characterized by risk-taking, innovation, and the pursuit of exponential growth. They carefully select and nurture promising startups, recognizing that many ventures will fail, but the potential for outsized returns from the few successes can outweigh these losses. Moreover, venture capital plays a vital role in driving technological advancements, fostering economic growth, and shaping the future landscape of industries worldwide.

9.2 Meaning

Venture capital (VC) refers to a type of private equity investment typically provided to early-stage, high-growth potential companies that are deemed too risky for traditional forms of financing, such as bank loans. In exchange for funding, venture capitalists receive an ownership stake in the company. Venture capital is often sought by startups and emerging businesses in industries such as technology, biotechnology, and renewable energy, where there is a high degree of uncertainty but also the potential for significant returns on investment. Venture capitalists not only provide capital but also offer strategic guidance, mentorship, and access to networks to help foster the growth and success of the companies in which they invest.

9.3 Definition

1. "Venture capital is a type of financing provided to early-stage companies that have the potential for high growth and significant returns. It typically involves investing in innovative startups or emerging businesses in exchange for an equity stake." - **Source: Entrepreneur.com**
2. "Venture capital refers to the investment of funds in small and medium-sized enterprises with high growth potential. It is characterized by a willingness to take on higher levels of risk in exchange for potential higher returns, often involving active involvement in the management and strategic direction of the invested companies." - **Source: Investopedia**
3. "Venture capital is a form of private equity financing that is provided to startups and early-stage companies by investors who believe in their potential for rapid growth and substantial returns. It involves deploying capital into innovative ventures in exchange for an ownership stake and often entails significant involvement in the company's operations and strategic decision-making." - **Source: Harvard Business Review**
4. "Venture capital is a specialized form of financing that provides capital, expertise, and guidance to early-stage, high-potential companies with the aim of generating substantial returns on investment. It involves investing in innovative ideas and entrepreneurial ventures, often taking on significant risks in pursuit of outsized rewards." - **Source: Stanford Graduate School of Business**
5. "Venture capital is an investment made by professional investors in innovative startups or small companies with high growth potential. It typically involves providing funding, strategic guidance, and operational support to help these companies scale their businesses and achieve success." - **Source: Forbes**

9.4 Characteristics

1. **High Risk:** Venture capital investments are inherently risky due to the early-stage nature of the companies involved, the uncertainty of future market conditions, and the potential for failure of the startups.
2. **High Potential Return**: Despite the risks, venture capital investments offer the potential for significant returns if the invested companies succeed and achieve rapid growth or become acquired or go public.
3. **Long-Term Investment Horizon:** Venture capital investments typically have a longer investment horizon compared to other forms of financing, often spanning several years before realizing returns.
4. **Equity Stake:** Venture capitalists typically acquire an ownership stake in the companies they invest in, usually through the purchase of preferred stock or convertible debt, giving them a share of ownership and potential profits.
5. **Active Involvement:** Venture capitalists often play an active role in the companies they invest in, providing strategic guidance, mentorship, and access to networks to help the startups succeed.
6. **Illiquidity:** Venture capital investments are often illiquid, meaning that it can be challenging to sell or transfer ownership stakes in the invested companies until they are acquired or go public.
7. **Portfolio Diversification:** Venture capitalists often invest in a portfolio of companies to mitigate risk, recognizing that some investments may fail while others may succeed, leading to an overall positive return.
8. **Limited Partnerships:** Venture capital funds are typically structured as limited partnerships, with institutional investors, high-net-worth individuals, and other accredited investors serving as limited partners and professional venture capitalists as general partners managing the fund.
9. **Focus on Innovation:** Venture capital investments focus on funding innovative startups and emerging businesses with disruptive ideas or technologies that have the potential to transform industries and create significant value.
10. **Exit Strategy:** Venture capitalists invest with the expectation of achieving an exit, either through an initial public offering (IPO), acquisition by a larger company, or other means, allowing them to realize returns on their investments.

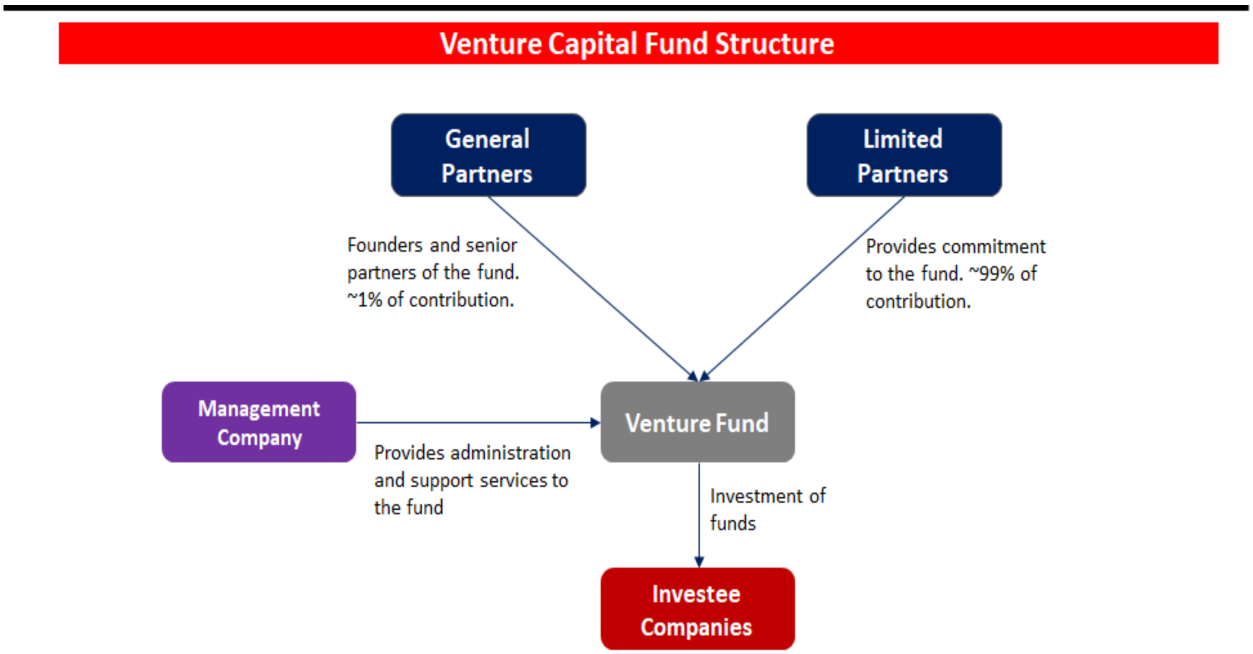
9.5 How Does Venture Capital Fund Works?

Venture capital funds operate through a structured process starting with fundraising, where capital is secured from institutional investors and high-net-worth individuals. The fund's managers, known as general partners, devise an investment strategy outlining target industries, geographic regions, and investment criteria. They actively seek investment opportunities through deal sourcing, evaluating potential startups based on rigorous due diligence, assessing factors like market potential, team strength, and competitive landscape.

Upon favorable evaluation, negotiations determine investment terms, including valuation and ownership stake. Once invested, the fund provides ongoing support and guidance to portfolio companies, aiding in strategic decision-making, networking, and resource allocation. The ultimate goal is value creation, achieved through milestones, growth, and strategic exits, whether through acquisitions, IPOs, or secondary sales.

The fund's performance is evaluated based on returns generated for investors, measured against the initial investment thesis and strategy. Successful funds may raise subsequent funds, while underperforming ones may face challenges in renewal or raising follow-on capital.

9.6 Structure of Venture Capital Fund



The structure of a venture capital fund typically consists of the following key components:

1. **General Partners (GPs):** General partners are the fund managers responsible for overseeing the fund's operations, investment decisions, and portfolio management. GPs are typically experienced investors with expertise in venture capital and specific industries. They raise capital from limited partners, source investment opportunities, conduct due diligence, negotiate terms, and provide ongoing support to portfolio companies.
2. **Limited Partners (LPs):** Limited partners are the investors in the venture capital fund who provide the majority of the capital. LPs can include institutional investors such as pension funds, endowments, foundations, insurance companies, and high-net-worth individuals. LPs have limited liability and typically do not participate in the day-to-day management of the fund but instead rely on the expertise of the general partners to generate returns on their investment.
3. **Fund Structure:** Venture capital funds are typically structured as limited partnerships, with the general partners acting as the managing partners and the limited partners as passive investors. The fund is governed by a limited

partnership agreement (LPA), which outlines the terms and conditions of the fund, including the investment strategy, management fees, carried interest, distribution waterfall, and governance structure.

4. **Management Fees:** Venture capital funds charge management fees to cover operating expenses, including salaries, office rent, due diligence costs, and administrative overhead. Management fees are typically calculated as a percentage of committed capital, ranging from 1% to 2% annually, and are paid by the limited partners throughout the life of the fund.
5. **Carried Interest (Carry):** Carried interest is the share of profits that general partners receive from successful investments. Typically, carried interest is set at 20% of the fund's profits after the return of capital and the preferred return to limited partners. Carried interest aligns the interests of the general partners with those of the limited partners, incentivizing the former to maximize returns on investments.
6. **Investment Period:** Venture capital funds have a defined investment period during which they deploy capital into portfolio companies. This period typically ranges from three to five years from the fund's initial closing. Once the investment period ends, the fund focuses on managing and supporting its existing portfolio companies and preparing for exits.
7. **Fund Term:** Venture capital funds have a finite lifespan, typically ranging from seven to ten years, during which they invest in and manage portfolio companies, seek exits, and distribute returns to limited partners. The fund term may be extended in certain circumstances to allow for additional time to manage and exit investments.
8. **Distribution Waterfall:** The distribution waterfall outlines the order in which profits from successful investments are distributed among the fund's partners. Typically, distributions are first used to return capital to limited partners, followed by the payment of carried interest to general partners, and finally, any remaining profits are shared between the general and limited partners based on their ownership interests.

Overall, the structure of a venture capital fund is designed to align the interests of general and limited partners, provide a framework for investment decision-making and portfolio management, and facilitate the generation of attractive returns for all stakeholders.

9.7 Types of Venture Capital Fund

Venture capital funds can be categorized into various types based on their investment focus, stage of investment, industry sector, and geographical region. Some of the common types of venture capital funds include:

1. **Early-Stage Venture Capital:** These funds primarily invest in startups and early-stage companies in exchange for an ownership stake. They provide seed funding or Series A financing to support the development and growth of innovative ideas and technologies.
2. **Expansion or Growth Capital:** Expansion or growth capital funds invest in companies that have already demonstrated market traction and revenue growth but

require additional capital to scale their operations, expand into new markets, or invest in product development. These funds typically participate in later-stage financing rounds, such as Series B or Series C.

3. **Seed Funds:** Seed funds focus on providing capital to startups at the earliest stages of development, often before they have a fully developed product or established revenue stream. These funds take on high risk but offer the potential for significant returns if the startup succeeds.
4. **Series A Funds:** Series A funds invest in startups that have achieved some level of product-market fit and are ready to scale their operations. These funds provide capital to support the company's growth and expansion plans, typically in exchange for preferred stock.
5. **Industry-Specific Funds:** Some venture capital funds specialize in investing in specific industry sectors, such as technology, healthcare, biotechnology, cleantech, or fintech. These funds have deep industry expertise and networks and focus on identifying and supporting innovative startups within their respective sectors.
6. **Regional Funds:** Regional venture capital funds focus on investing in startups and emerging companies within a specific geographical region or market. These funds may target local entrepreneurs and businesses and provide capital, mentorship, and support to foster innovation and economic development in their region.
7. **Corporate Venture Capital (CVC) Funds:** Corporate venture capital funds are established by corporations to invest in startups and emerging technologies that align with their strategic objectives. These funds provide capital, strategic partnerships, and access to markets and resources to support the growth and development of portfolio companies.
8. **Social Impact or Impact Investing Funds:** Social impact or impact investing funds focus on generating both financial returns and positive social or environmental impact. These funds invest in startups and companies that address pressing social or environmental challenges while also generating financial returns for investors.
9. **Secondary Funds:** Secondary venture capital funds specialize in purchasing existing venture capital investments from other investors, providing liquidity to early investors and allowing them to exit their positions. These funds may acquire portfolios of companies at various stages of development.

Overall, the diversity of venture capital funds reflects the wide range of investment strategies, risk profiles, and objectives within the venture capital ecosystem, catering to the needs of entrepreneurs, investors, and specific industry sectors.

9. 8 Stages of Venture Capital Financing

The stages of venture capital financing typically encompass various phases of a startup's growth and development, each with its own characteristics, funding sources, and investment objectives. These stages include:

1. **Seed Stage:** The seed stage is the earliest phase of venture capital financing, where startups are often at the ideation or concept stage. Funding at this stage is used to conduct market research, develop prototypes, validate business models, and build initial teams. Seed funding is typically provided by angel investors, friends and family, and early-stage venture capital funds.
2. **Early Stage (Series A):** The early stage, also known as Series A financing, occurs once the startup has achieved some level of product development, market validation, and user traction. Funding at this stage is used to scale the business, hire key team members, and expand market reach. Series A financing is typically provided by venture capital firms in exchange for an equity stake in the company.
3. **Growth Stage (Series B and Beyond):** The growth stage involves further scaling and expansion of the startup's operations, often with the goal of capturing a larger market share and achieving profitability. Funding at this stage, typically in the form of Series B, C, D, and subsequent rounds, is used to accelerate growth, invest in sales and marketing, expand product offerings, and enter new markets. Growth stage financing may be provided by venture capital firms, private equity investors, and sometimes strategic corporate investors.
4. **Mezzanine or Late Stage:** The mezzanine or late stage represents the final stage of venture capital financing before a potential exit event, such as an initial public offering (IPO) or acquisition. Funding at this stage is used to further scale the business, optimize operations, and prepare for the exit. Mezzanine financing may involve a combination of equity and debt instruments, and investors may include venture capital firms, private equity investors, and hedge funds.
5. **Exit:** The exit stage involves the realization of returns on investment for venture capital investors through various means, such as an IPO, acquisition by a larger company, merger, or secondary sale of shares. The exit event allows investors to monetize their investments and generate liquidity, providing a return on their capital and enabling them to reinvest in new opportunities.

Overall, the stages of venture capital financing reflect the evolution of a startup from ideation to exit, with each stage providing funding and support to fuel growth, achieve milestones, and create value for both entrepreneurs and investors.

9.9 Modes of Financing

In venture capital, there are several modes of financing available to startups and emerging companies, each serving different needs and stages of development. These modes include:

1. **Equity Financing:** Equity financing involves the sale of ownership stakes in the company in exchange for capital investment. Venture capitalists typically provide equity financing by purchasing preferred stock or convertible securities, giving them ownership rights and potential returns based on the company's performance and valuation.
2. **Convertible Debt:** Convertible debt is a form of financing where the startup borrows money from investors with the understanding that the debt will convert into equity at a later date, typically upon the occurrence of a specified event, such

as a future financing round or an IPO. Convertible debt provides flexibility for startups to raise capital without immediately determining the company's valuation.

3. **Venture Debt:** Venture debt is a type of debt financing provided to startups alongside equity financing. Venture debt typically takes the form of term loans, lines of credit, or convertible notes and is often used to extend the startup's cash runway, finance specific growth initiatives, or bridge the gap between equity financing rounds. Venture debt providers may include specialized lenders or banks familiar with the needs of high-growth startups.
4. **Mezzanine Financing:** Mezzanine financing refers to a hybrid form of financing that combines elements of debt and equity. Mezzanine financing is typically provided to startups in the later stages of development and is used to fund growth initiatives, acquisitions, or other strategic initiatives. Mezzanine financing may involve subordinated debt, preferred equity, or convertible securities and is often used to bridge the gap between equity financing and a potential exit event.
5. **Grants and Subsidies:** Startups may also access non-dilutive financing in the form of grants, subsidies, or government incentives. These sources of funding do not require the issuance of equity or repayment and can provide valuable support for research and development, technology commercialization, or other qualifying activities. Grants and subsidies may be available from government agencies, research institutions, or private foundations.
6. **Corporate Venture Capital (CVC):** Corporate venture capital involves equity investments made by established corporations in startups and emerging companies that align with their strategic objectives. Corporate venture capital can provide startups with access to industry expertise, resources, and potential commercial partnerships, in addition to capital investment. CVC investments may take the form of direct equity investments, strategic partnerships, or joint ventures.
7. **Initial Public Offering (IPO):** An IPO represents a mode of financing where a startup or emerging company goes public by offering shares of its stock to the public for the first time. IPOs provide startups with access to capital from public investors and enable existing shareholders, including venture capitalists, to monetize their investments and realize liquidity. IPOs are typically pursued by startups in the later stages of development with established revenue streams and market traction.

Overall, the modes of financing available in venture capital provide startups with a range of options to raise capital, manage risk, and support growth at various stages of development. Entrepreneurs and investors can tailor financing strategies to meet the specific needs and objectives of the startup and its stakeholders.

9.10 How Is Venture Capital Different From Angel Investors

Venture capital and angel investors serve as crucial sources of funding for startups and early-stage companies, yet they operate with distinct characteristics and approaches. Venture capital funds, managed by professional investors who raise capital from institutional investors and wealthy individuals, deploy pooled investment funds into startups. These investments tend to be substantial, often millions of dollars per company, and span various stages of development, from seed rounds to later stages of growth.

Venture capital firms have specific investment criteria, focusing on high-growth potential, disruptive technologies, and scalable business models. They take an active role in the companies they invest in, providing strategic guidance, governance oversight, and networking opportunities.

On the other hand, angel investors are typically affluent individuals who invest their personal funds directly into startups. Their investments are often smaller compared to venture capital, ranging from tens of thousands to a few hundred thousand dollars per company. Angel investors play a significant role in the early stages of a startup's journey, providing critical capital to help them get off the ground. They may invest at the seed stage or even before formal seed rounds, offering flexibility and often prioritizing personal connections and the founder's vision.

While venture capital firms have structured processes and specific investment criteria, angel investors may have more flexibility and may be more willing to invest based on intuition, personal relationships, and passion for the startup's mission. While both venture capital and angel investors provide essential funding and support, startups often seek a combination of both to meet their financing needs and benefit from the unique strengths and perspectives each brings to the table.

9.11 Regulatory Framework

In India, the regulatory framework surrounding venture capital is governed by various laws, regulations, and guidelines issued by regulatory authorities. The primary regulatory framework for venture capital activities includes:

1. **Securities and Exchange Board of India (SEBI):**
   - SEBI regulates venture capital funds (VCFs) and their activities in India under the SEBI (Venture Capital Funds) Regulations, 1996. These regulations govern the registration, operation, and management of VCFs and set forth guidelines for investment criteria, fund structure, valuation, disclosures, and reporting requirements.
2. **Foreign Exchange Management Act (FEMA):**
   - The Reserve Bank of India (RBI) administers FEMA regulations, which govern foreign investment in India, including foreign direct investment (FDI) and foreign portfolio investment (FPI). Venture capital funds with foreign investment are required to comply with FEMA regulations, which prescribe guidelines for investment limits, reporting requirements, and repatriation of funds.
3. **Income Tax Act:**
   - The Income Tax Act governs the tax treatment of venture capital investments, both for venture capital funds and their investors. Tax provisions relevant to venture capital include provisions related to capital gains tax, taxation of carried interest, tax incentives for startups, and withholding tax on dividends and interest income.
4. **Company Law:**

- The Companies Act, 2013, and related regulations govern the incorporation, governance, and operations of companies in India. Venture-backed startups are subject to company law requirements, including registration, corporate governance, shareholder rights, disclosure obligations, and compliance with board composition and meeting requirements.

5. **SEBI (Alternative Investment Funds) Regulations, 2012:**
   - Venture capital funds are classified as alternative investment funds (AIFs) under SEBI regulations. The SEBI (AIF) Regulations, 2012, provide a broader regulatory framework for various categories of AIFs, including venture capital funds. These regulations prescribe registration requirements, investment restrictions, valuation norms, reporting obligations, and governance standards for AIFs.
6. **Start-up India Initiative:**
   - The Government of India has launched the Start-up India initiative to promote entrepreneurship and facilitate the growth of startups in the country. The initiative includes various policy measures, incentives, and support programs aimed at fostering innovation, ease of doing business, access to funding, and incubation and mentoring support for startups.

Overall, the regulatory framework for venture capital in India encompasses regulations issued by SEBI, RBI, and other regulatory authorities governing venture capital funds, foreign investment, taxation, company law, and alternative investment funds. Compliance with these regulations is essential for venture capital firms and startups to operate legally and sustainably in India's dynamic and rapidly evolving startup ecosystem.

9.12 Example

One notable example of venture capital in India is the investment made by Sequoia Capital in Flipkart, one of India's largest e-commerce companies. In 2009, Sequoia Capital led a Series B funding round in Flipkart, investing approximately $10 million in the company. This investment marked a significant milestone in Flipkart's journey, providing the capital needed to fuel its growth and expansion in the highly competitive e-commerce market in India.

Over the years, Sequoia Capital continued to support Flipkart through subsequent funding rounds, including Series C, D, and E rounds, alongside other prominent venture capital firms. The investments helped Flipkart strengthen its market position, expand its product offerings, and scale its operations to become a leading player in the Indian e-commerce industry.

In 2018, Flipkart achieved a major milestone when it was acquired by Walmart in a deal valued at $16 billion, making it one of the largest e-commerce acquisitions globally. Sequoia Capital's early investment in Flipkart not only generated significant returns for the firm but also demonstrated the transformative impact of venture capital in supporting the growth and success of innovative startups in India's burgeoning startup ecosystem. This example illustrates how venture capital can play a pivotal role in fueling entrepreneurship, driving innovation, and creating value for both investors and the broader economy in India.

SUMMARY:

This Unit on venture capital provides a comprehensive overview of the venture capital landscape, focusing on its role in financing startups, fostering innovation, and driving economic growth. It begins by defining venture capital as a form of private equity investment that provides capital to high-potential, early-stage companies in exchange for an ownership stake. The Unit explores the evolution of venture capital, tracing its origins, key milestones, and trends shaping the industry's growth.

Venture capital's significance in fueling entrepreneurship and innovation is highlighted, emphasizing its role in providing crucial funding, mentorship, and strategic guidance to startups. The chapter discusses the impact of venture capital on job creation, wealth generation, and the development of new technologies, business models, and industries. It also examines the challenges and opportunities facing venture capital investments, including regulatory hurdles, market dynamics, and access to talent and capital.

Regulatory considerations are addressed, with a focus on the regulatory framework governing venture capital activities in different jurisdictions, including India. The chapter assesses the effectiveness of regulations in promoting investor confidence, protecting stakeholders' interests, and facilitating capital formation. It identifies key regulatory challenges and proposes potential reforms to enhance the efficiency and competitiveness of the venture capital ecosystem.

The role of foreign investment in shaping the venture capital landscape is explored, emphasizing the contribution of foreign investors and funds in providing capital, expertise, and global market access to startups. Investment criteria and strategies employed by venture capital firms are analyzed, with a discussion on sectoral preferences, growth potential, and founder attributes influencing investment decisions.

Furthermore, the Unit examines the impact of venture capital on social and environmental sustainability, highlighting the emergence of impact investing and social venture capital as avenues for funding enterprises with a dual mission of profit and purpose. Opportunities for venture capital investments in emerging sectors of the economy, such as agritech, healthtech, and clean energy, are discussed, along with the need for continued government policies and initiatives to foster a conducive environment for venture capital.

In conclusion, the Unit underscores the critical role of venture capital in driving innovation, entrepreneurship, and economic development, while also acknowledging the challenges and opportunities inherent in venture capital investments. It emphasizes the importance of a supportive regulatory environment, access to capital, and strategic partnerships in nurturing a vibrant and dynamic venture capital ecosystem.

❖ Exercise

Essay Type Questions:

1. "Analyse the evolution and current state of venture capital in India, highlighting key milestones, trends, and challenges faced by the industry. Discuss the role of venture capital in driving innovation, entrepreneurship, and economic growth in the country."
2. "Examine the impact of venture capital funding on the Indian startup ecosystem. Explore the significance of venture capital in providing capital, mentorship, and market access to startups, and assess its role in catalyzing the growth of emerging industries and fostering job creation."
3. "Critically assess the regulatory framework governing venture capital in India. Discuss the effectiveness of regulations in promoting investor confidence, protecting stakeholders' interests, and facilitating capital formation. Identify key regulatory challenges and propose potential reforms to enhance the efficiency and competitiveness of the venture capital ecosystem."
4. "Evaluate the role of foreign investment in shaping the Indian venture capital landscape. Analyze the contribution of foreign investors and funds in providing capital, expertise, and global market access to Indian startups. Discuss regulatory considerations, investment trends, and the potential impact of foreign capital on India's economic development."
5. "Explore the investment criteria and strategies employed by venture capital firms operating in India. Assess the factors influencing investment decisions, such as sectoral preferences, growth potential, and founder attributes. Discuss the implications of investment trends on startup funding dynamics and ecosystem development."
6. "Assess the impact of venture capital on social and environmental sustainability in India. Explore the emergence of impact investing and social venture capital as avenues for funding enterprises with a dual mission of profit and purpose. Discuss examples of successful impact investments and their contributions to addressing social and environmental challenges in India."
7. "Discuss the challenges and opportunities for venture capital investments in emerging sectors of the Indian economy, such as agritech, healthtech, and clean energy. Analyze the market dynamics, investment trends, and regulatory considerations shaping opportunities for venture capital in these sectors. Assess the potential for innovation, disruption, and sustainable growth in each sector."
8. "Examine the role of government policies and initiatives in fostering a conducive environment for venture capital in India. Evaluate the effectiveness of policy measures, such as Startup India, Make in India, and regulatory reforms, in promoting entrepreneurship, innovation, and investment. Discuss the need for continued policy support and reforms to address challenges and unlock the full potential of the venture capital ecosystem."

Short Questions:

1. What regulatory body oversees venture capital activities in India?

2. What are the primary objectives of the SEBI (Venture Capital Funds) Regulations?
3. How do venture capital funds differ from traditional investment funds in India?
4. What tax incentives are available for venture capital investors in India?
5. How does the Startup India initiative support the venture capital ecosystem?
6. What role do foreign investors play in the Indian venture capital landscape?
7. What are the key stages of venture capital financing for startups in India?
8. How do venture capital funds contribute to the growth of India's startup ecosystem?
9. What are the typical investment criteria for venture capital firms operating in India?
10. What are some of the challenges facing venture capital investments in India?

MCQ

1. Which regulatory authority oversees venture capital funds in India?
   a) Reserve Bank of India (RBI)
   b) Securities and Exchange Board of India (SEBI)
   c) Ministry of Corporate Affairs
   d) Ministry of Finance

Answer: b) Securities and Exchange Board of India (SEBI)

2. Which regulations govern the registration and operation of venture capital funds in India?
   a) SEBI (Alternative Investment Funds) Regulations, 2012
   b) SEBI (Venture Capital Funds) Regulations, 1996
   c) Companies Act, 2013
   d) Foreign Exchange Management Act (FEMA)

Answer: b) SEBI (Venture Capital Funds) Regulations, 1996

3. What is the primary tax treatment for venture capital investments in India?
   a) Exempt from all taxes
   b) Subject to regular income tax rates
   c) Eligible for special tax incentives
   d) Only subject to capital gains tax

Answer: d) Only subject to capital gains tax

4. Under the Startup India initiative, what types of support are provided to startups in India?
   a) Tax exemptions and subsidies
   b) Access to funding and mentorship
   c) Regulatory exemptions and fast-track approvals
   d) All of the above

Answer: d) All of the above

5. Which category of funds do venture capital funds fall under according to SEBI regulations?

a) Mutual Funds
b) Alternative Investment Funds (AIFs)
c) Pension Funds
d) Hedge Funds

Answer: b) Alternative Investment Funds (AIFs)

6. What is the main objective of the SEBI (Venture Capital Funds) Regulations, 1996?
   a) To regulate foreign exchange transactions
   b) To promote and regulate venture capital activities in India
   c) To govern the operations of commercial banks
   d) To regulate corporate governance practices

Answer: b) To promote and regulate venture capital activities in India

7. How are venture capital funds classified under SEBI regulations?
   a) Category I Alternative Investment Funds
   b) Category II Alternative Investment Funds
   c) Category III Alternative Investment Funds
   d) Category IV Alternative Investment Funds

Answer: a) Category I Alternative Investment Funds

8. Which type of investors are typically involved in venture capital funding in India?
   a) Individual investors only
   b) Institutional investors only
   c) Both individual and institutional investors
   d) Government agencies only

Answer: c) Both individual and institutional investors

9. What role does the Reserve Bank of India (RBI) play in venture capital financing?
   a) Setting interest rates for venture capital investments
   b) Regulating foreign investment in venture capital funds
   c) Administering tax incentives for venture capital funds
   d) None of the above

Answer: b) Regulating foreign investment in venture capital funds

10. What is the primary source of funding for venture capital funds in India?
   a) Government grants
   b) Charitable donations
   c) Investment by limited partners
   d) Loans from commercial banks

Answer: c) Investment by limited partners

UNIT – 10	HOUSING FINANCE

10.1 Introduction

In pursuance of National Housing Policy of Central Government, Reserve Bank of India has been facilitating the flow of credit to housing sector. Since housing has emerged as one of the sectors attracting a large quantum of bank finance, the current focus of RBI's regulation is to ensure orderly growth of housing loan portfolios of banks.

10.1.1 National Housing Policy

As a part of the strategy to overcome the colossal housing shortage, the Central Government adopted a comprehensive National Housing Policy which, among other things, envisaged:

I. Development of a viable and accessible institutional system for the provision of housing finance;

II. Establishing a system where housing boards and development authorities would concentrate on acquisition and development of land and infrastructure; and

III. Creation of conditions in which access to institutional finance is made easier and affordable for individuals for construction/buying of houses/flats. This may include outright purchase of houses/flats constructed by or under the aegis of public agencies.

IV. Banks with their vast branch network throughout the length and breadth of the country occupy a very strategic position in the financial system and were required to play an important role in providing credit to the housing sector in consonance with the National Housing Policy.

10.1.2 Housing Finance Allocation

Keeping in view the objectives of National Housing Finance Policy, RBI used to announce minimum housing finance allocation annually on the basis of the growth of deposits recorded during the previous year till the year 2002-03. Banks could deploy their funds under the housing finance allocation in any of the three categories, i.e.

I. Direct finance,
II. Indirect finance,
III. Investment in bonds of NHB/HUDCO, or combination thereof.

10.2 Direct Housing Finance

Direct Housing Finance refers to the finance provided directly to individuals or groups of individuals including co-operative societies. Banks are free to evolve their own guidelines with the approval of their Boards on aspects such as security, margin, age of dwelling units, repayment schedule, etc.

Other Guidelines

The following types of bank finance may be included under Direct Housing Finance:

I. Bank finance extended to a person who already owns a house in town/village where he resides, for buying/ constructing a second house in the same or other town/ village for the purpose of self-occupation.
II. Bank finance extended for purchase of a house by a borrower who proposes to let it out on rental basis on account of his posting outside the headquarters or because he has been provided accommodation by his employer.
III. Bank finance extended to a person who proposes to buy an old house where he is presently residing as a tenant.
IV. Bank finance granted only for purchase of a plot, provided a declaration is obtained from the borrower that he intends to construct a house on the said plot, with the help of bank finance or otherwise, within such period as may be laid down by the banks themselves.

V. Supplementary finance

a) Banks may consider requests for additional finance within the overall ceiling for carrying out alterations/ additions/repairs to the house/flat already financed by them.

b) In the case of individuals who might have raised funds for construction/ acquisition of accommodation from other sources and need supplementary finance, banks may extend such finance after obtaining *paripassu* or second mortgage charge over the property mortgaged in favour of other lenders and/or against such other security, as they may deem appropriate.

10.3 Indirect Housing finance

10.3.1 General

Banks should ensure that their indirect housing finance is channelled by way of term loans to housing finance institutions, housing boards, other public housing agencies, etc., primarily for augmenting the supply of serviced land and constructed units. It should also be ensured that the supply of plots/houses is time bound and public agencies do not utilise the bank loans merely for acquisition of land. Similarly, serviced plots should be sold by these agencies to co-operative societies, professional developers and individuals with a stipulation that the houses should be constructed thereon within a reasonable time, not exceeding three years. For this purpose, the banks may take advantage of various guidelines issued by NHB for augmenting the supply of serviced land and constructed units.

10.3.2 Lending to Housing Intermediary Agencies

10.3.2.1 Lending to Housing Finance Institutions

I. Banks may grant term loans to housing finance institutions taking into account (long-term) debt-equity ratio, track record, recovery performance and other relevant factors.
II. In terms of NHB guidelines, housing finance companies' total borrowings, whether by way of deposits, issue of debentures/ bonds, loans and advances from banks or from financial institutions including any loans obtained from NHB, should not exceed 16 times of their net owned funds (i.e. paid-up capital and free reserves less accumulated balance of loss, deferred revenue expenditure and intangible assets).
III. All housing finance companies registered with NHB are eligible to apply for refinance from NHB and will be eligible subject to the refinance policy. The quantum of term loan to be sanctioned to them will not be linked to net owned fund as NHB has already prescribed the above referred ceiling on total borrowing of housing finance companies.

10.3.2.2 Lending to Housing Boards and Other Agencies

Banks may extend term loans to state level housing boards and other public agencies. However, in order to develop a healthy housing finance system, while doing so, the banks must not only keep in view the past performance of these agencies in the matter of recovery from the beneficiaries but they should also stipulate that the Boards will ensure prompt and regular recovery of loan instalments from the beneficiaries.

10.3.2.3 Financing of Land Acquisition

In view of the need to increase the availability of land and house sites for increasing the housing stock in the country, banks may extend finance to public agencies and not private builders for acquisition and development of land, provided it is a part of the complete project, including development of infrastructure such as water systems, drainage, roads, provision of electricity, etc. Such credit may be extended by way of term loans. The project should be completed as early as possible and, in any case, within three years, so as to ensure quick re-cycling of bank funds for optimum results. If the project covers construction of houses, credit extended therefore in respect of individual beneficiaries should be on the same terms and conditions as stipulated for direct finance.

It has been observed that while financing real estate developers, certain banks were found to be valuing the land for the purpose of security, on the basis of the discounted value of the property after it is developed, less the cost of development. This is not in conformity with established norms. In this connection, it is advised that banks should have a Board approved policy in place for valuation of properties including collaterals accepted for their exposures and that valuation should be done by professionally qualified independent valuers. As regards the valuation of land for the purpose of financing of land acquisition as also land secured as collateral, banks may be guided as under:

(a) Banks may extend finance to public agencies and not to private builders for acquisition and development of land, provided it is a part of the complete project, including development of infrastructure such as water systems, drainage, roads, provision of electricity, etc. In such limited cases where land acquisition can be financed, the finance is to be limited to the acquisition price (current price) plus development cost. The valuation of such land as prime security should be limited to the current market price.

(b) Wherever land is accepted as collateral, valuation of such land should be at the current market price only.

10.3.2.4 Terms and Conditions for Lending to Housing Intermediary Agencies

I. In order to enhance the flow of resources to housing sector, term loans may be granted by banks to housing intermediary agencies against the direct loans sanctioned/ proposed to be sanctioned by the latter, irrespective of the per borrower size of the loan extended by these agencies.

II. Banks can grant term loans to housing intermediary agencies against the direct loans sanctioned/proposed to be sanctioned by them to Non-Resident Indians also. However, banks should ensure that housing finance intermediary agencies being financed by them, are authorised by RBI to grant housing loans to NRIs as all housing finance intermediaries are not authorised by RBI to provide housing finance to NRIs.

III. Banks have freedom to charge interest rates to housing intermediary agencies without reference to Benchmark Prime Lending Rates (BPLR) upto June 30, 2010. Under the Base Rate System effective from July 1, 2010, all categories of loans will be priced with reference to Base Rate which is the minimum interest rate for all loans.

10.3.3 Term Loans to Private Builders

- In view of the important role played by professional builders as providers of construction services in the housing field, especially where land is acquired and developed by State Housing Boards and other public agencies, commercial banks may extend credit to private builders on commercial terms by way of loans linked to each specific project. However, the banks are not permitted to extend fund based or non-fund based facilities to private builders for acquisition of land even as part of a housing project. The period of credit for loans extended by banks to private builders may be decided by banks themselves based on their commercial judgement subject to usual safeguards and after obtaining such security, as banks may deem appropriate. Such credit may be extended to builders of repute, employing professionally qualified personnel. It should be ensured, through close monitoring, that no part of such funds is used for any speculation in land.

- Care should also be taken to see that prices charged from the ultimate beneficiaries do not include any speculative element, that is, prices should be based only on the documented price of land, the actual cost of construction and a reasonable profit margin.

- It is advised that banks should adhere to the National Building Code (NBC) formulated by the Bureau of Indian Standards (BIS) in view of the importance of safety of buildings especially against natural disasters. Banks may consider this aspect for incorporation in their loan policies. Banks should also adopt the National Disaster Management Authority (NDMA) guidelines and suitably incorporate them as part of their loan policies, procedures and documentation.

Incorporating clause in the terms and conditions to disclose in Pamphlets / Brochures / advertisements information regarding mortgage of property to the bank

In a case which came up before the Hon'ble High Court of Judicature at Bombay, the Hon'ble Court observed that the bank granting finance to housing / development projects should insist on disclosure of the charge / or any other liability on the plot, in the brochure, pamphlets etc., which may be published by developer / owner inviting public at large to purchase flats and properties. The Court also added that this obviously would be part of the terms and conditions on which the loan may be sanctioned by the bank. Keeping in view the above, while granting finance to specific housing / development projects, banks are advised to stipulate as a part of the terms and conditions that:

i. the builder / developer / company would disclose in the Pamphlets / Brochures etc., the name(s) of the bank(s) to which the property is mortgaged.
ii. the builder / developer / company would append the information relating to mortgage while publishing advertisement of a particular scheme in newspapers / magazines etc.
iii. the builder / developer / company would indicate in their pamphlets / brochures, that they would provide No Objection Certificate (NOC) / permission of the mortgagee bank for sale of flats / property, if required.
iv. Banks are also advised to ensure compliance of the above terms and conditions and funds should not be released unless the builder/developer/company fulfils the above requirements.

On a review, it has been decided that the above-mentioned provisions will be mutatis-mutandis, applicable to Commercial Real Estate also.

10.4 Housing Loans under Priority Sector

Banks may refer to the Master Circular on Lending to Priority Sector issued by Rural Planning and Credit Department.

10.5 Construction Activities Eligible for Bank Credit as Housing Finance

The following types of bank credit will be eligible for being treated as housing finance:

(i) Loans to individuals for purchase/construction of dwelling unit per family and loans given for repairs to the damaged dwelling units of families;
(ii) Finance provided for construction of residential houses to be constructed by public housing agencies like HUDCO, Housing Boards, local bodies, individuals, co-operative societies, employers, priority being accorded for financing construction of houses meant for economically weaker sections, low income group and middle income group;

(iii) Finance for construction of educational, health, social, cultural or other institutions/centers, which are part of a housing project and which are necessary for the development of settlements or townships;
(iv) Finance for shopping complexes, markets and such other centers catering to the day to day needs of the residents of the housing colonies and forming part of a housing project;
(v) Finance for construction meant for improving the conditions in slum areas for which credit may be extended directly to the slum-dwellers on the guarantee of the Government, or indirectly to them through the State Governments;
(vi) Bank credit given for slum improvement schemes to be implemented by Slum Clearance Boards and other public agencies;
(vii) Finance provided to –

(a) the bodies constituted for undertaking repairs to houses, and
(b) the owners of building/house/flat, whether occupied by themselves or by tenants, to meet the need-based requirements for their repairs/additions, after satisfying themselves regarding the estimated cost (for which requisite certificate should be obtained from an Engineer/Architect, wherever necessary) and obtaining such security as deemed appropriate;

(viii) Housing finance provided by banks for which refinance is availed of from National Housing Bank (NHB);

(ix) Investment in the guarantee/non-guaranteed bonds and debentures of NHB/HUDCO in the primary market, provided investment in non-guaranteed bonds is made only if guaranteed bonds are not available.

10.6 Construction Activities Not Eligible for Bank Credit

- Banks should not grant finance for construction of buildings meant purely for Government/Semi-Government offices, including Municipal and Panchayat offices. However, banks may grant loans for activities, which will be refinanced by institutions like NABARD.

- Projects undertaken by public sector entities which are not corporate bodies (i.e. public sector undertakings which are not registered under Companies Act or which are not Corporations established under the relevant statute) may not be financed by banks. Even in respect of projects undertaken by corporate bodies, as defined above, banks should satisfy themselves that the project is run on commercial lines and that bank finance is not in lieu of or to substitute budgetary resources envisaged for the project. The loan could, however, supplement budgetary resources if such supplementing was contemplated in the project design. Thus, in the case of a housing project, where the project is run on commercial lines, and the Government is interested in promoting the project either for the benefit of the weaker sections of the society or otherwise, and a part of the project cost is met by the Government through subsidies made available and/or contributions to the capital of the institutions taking up the project, the bank finance should be restricted to an amount arrived at after reducing from the total project cost the amount of subsidy/capital contribution receivable from the Government and any other resources proposed to be made available by the Government.

- Banks had, in the past, sanctioned term loans to Corporations set up by Government like State Police Housing Corporation, for construction of residential quarters for allotment to employees where the loans were envisaged to be repaid out of budgetary allocations. As these projects cannot be considered to be run on commercial lines, it would not be in order for banks to grant loans to such projects.

10.7 The Development of the Formal Housing Finance System

Formal housing finance in India first came with the setting up of HUDCO in 1971. HUDCO sought mainly to cater to low-income groups, but at the same time provided technical and financial assistance to State Housing Boards, urban development institutions and the co-operative sector (Garg, 1998).Private sector involvement in retail housing finance did not begin until the Housing Development Finance Corporation Limited (HDFC) was established in 1977. HDFC provides housing finance to individuals-operative societies and the corporate sector.

HDFC's initial share capital included subscriptions from HH the Aga Khan and the International Finance Corporation (IFC). Around the mid- and late 1980s a few housing finance

companies were set up either as private limited companies (e.g., Dewan Housing Finance Limited) or as joint ventures with State governments (e.g., Gujarat Rural Housing Finance Corporation) or bank sponsored housing finance companies (e.g., Can Fin Homes, SBI Home Finance, PNB Housing Finance). At that time, even State-owned insurance companies like the Life Insurance Corporation and the General Insurance Corporation of India set up their own housing finance arms. With the recognition of the need to develop a network of specialised housing finance companies, also came the need for a dedicated supervisory agency specialising in the promotion and financial functions of housing finance, which until then had been in the purview of the Reserve Bank of India. As an outcome of the recommendations of the High-Level Group on housing set up by the Union government (under the chairmanship of Dr. C. Rangarajan, then Deputy Governor of the Reserve Bank of India) with the National Commission on Urbanisation, in July 1988 the National Housing Bank (NHB) was established under an act of Parliament (NHB Act 1987). The National Housing Bank is the principal agency for the promotion and support (including financial) of housing finance institutions. The 1987 act empowers the National Housing Bank to issue directives to housing finance institutions in order to ensure sound business growth. NHB can also grant loans and advances or provide financial assistance to registered banks and housing finance institutions, or to any such authority established by or under any central, State or provincial act and engaged in slum improvement. Finally, NHB can devise schemes for the mobilisation of resources and extension of credit for housing.

10.8 India's Changing Housing Finance Market

Aggressive entry by commercial banks from the late 1990s onward changed a housing loan market that had so far been dominated by specialist finance companies. With increased competition this turned from a seller to a buyers' market, where the customer is provided with choice and bargaining power and can demand quality service. The initial phase of banks' serious entry into housing finance could almost be termed as *'irrational competition* 'in a drive to gain market share as quickly as possible. Some commercial banks devised extremely aggressive marketing campaigns to ramp up the size of their housing portfolios. This included intensive advertising, waiving of processing and administration fees, gift offers and other incentives, combined with on-the-spot loan approvals without sufficient documentary evidence, loan-to-value ratios in excess of 100 per cent and no prepayment charges on fixed rate loans. This was supplemented by cut-throat competition on the pricing front, with each new participant trying to undercut the other. Fortunately, in the recent period, the market has seen some rationalisation and stability. Several banks came to realise that sheer undercutting in terms of pricing would ultimately affect profitability. As banks also found out, imprudent lending practices led to an increase in defaults as well as frauds. On top of this, constant cautionary warnings by the Reserve Bank of India of potential problems arising out of overheating in the sector and the need closely to monitor developments have helped to bring some semblance of order in the market. This led some banks to withdraw from housing credit, especially the public sector banks. Today, the housing finance market has evolved into an oligopolistic structure (SSKI, 2006) with three dominant providers – HDFC, the largest housing finance company; ICICI Bank, the largest private sector bank; and State Bank of India, the largest bank in the country, which is also a public sector bank. Though there is no official data on market shares, SSKI India Research estimates that in 2005, the three leading housing credit providers accounted for approximately 75 per cent of the market. Only a few foreign banks are involved and they tend to focus on 'high net worth' individuals. As regards housing finance companies, some of the smaller have been bought out by the larger ones, some bank-sponsored ones have been merged with their parent arm, while others have wound up business altogether. Barring three or four, most housing finance companies tend to be small, local, niche providers.

10.9 Enhanced Affordability

Housing has hardly ever been at more affordable levels in Indian history. Estimates show that affordability (i.e., the ratio of the price of a residential property to the annual income of the borrower) has improved significantly. For instance, for a typical Mumbai suburb in 1995, it took about 22 times a borrower's total annual income to purchase a house, while in 2006 this ratio dropped to only five times (HDFC, 2006). Such enhanced affordability can also be attributed to the rapid rise in household earnings over the past decade. According to CRISIL, a credit-rating body, the average household income in urban areas has grown at a compounded 10 per cent in nominal terms over the last decade (CRISIL, 2006).

10.9.1 Interest Rates

Throughout the 1980s, interest rates were stable in India, predominantly as a result of a closed economy. By 1991 economic liberalisation resulted in volatility in interest rates. The 1996-1997 period was characterised by an acute liquidity crunch in the economy, with interest rates on housing loans peaking at 17 to 18 per cent per annum. Until 1999 only fixed rates were available on home loans. By the year 2000, commercial banks were actively offering home loans, and preferably with adjustable rates for a better fit with their liability structures. As market preference shifted to floating rate loans, most housing finance companies soon felt compelled to follow suit. However, adjustable-rate housing loans are linked to an internal benchmark based on the cost of funds of each bank or housing finance company. From 2000 to 2005, the interest rate cycle in India was on a downward trend with the cost of a 15-year home loan reaching an all-time low of 7.5 per cent. A low cost of credit gave a fillip to housing loans as the lower the interest rate, the higher the loan amount that a borrower can take for a given monthly payment. In a decreasing interest rate cycle most borrowers began opting for floating rates. These are a function of the bank/housing finance company's prime lending rate. Most high-cost fixed rate loans were re-priced through conversion to floating for a nominal fee. First-time borrowers in particular focus excessively on initial monthly mortgage costs and have little understanding of the interest rate risks associated with various mortgage products (Miles, 2004). Therefore, it became important to explain the risks associated with floating rate loans to customers. Most lenders offer customers an option to convert from fixed to floating rates (though most lenders do not allow the reverse option; the typical fee charged for converting a fixed to a floating rate would be 0.5 per cent of the outstanding principal of the loan amount.) Moreover, as the risks involved with floating rate loans became more evident to them, customers were offered combination loans of part fixed, part floating rates in a bid to hedge the interest rate risk. Towards the end of 2005, India saw a gradual inching up of interest rates. Despite this, close to 85 per cent of housing credit customers still prefer floating rates as they are currently lower than fixed rates.

10.9.2 Loan Structures

Due to increased competition, loan maturities have lengthened to a maximum of 15 to 20 years for floating rate loans. This has proved to be beneficial to borrowers as it reduced the amount of the monthly instalments and thereby enabled larger loan sizes. However, the average maturity of most loans at origination is approximately 13 years. Some public sector banks today prefer to offer loans of up to 10 years in order to prevent any mismatch on their balance sheets, as most housing loans offered by banks are funded from current and savings accounts. In a competitive environment, customisation of loan products is essential and most providers offer flexible repayment options in a bid to cater to individual needs. These, for instance, include various repayment options such as 'step-up repayment facilities' where the repayment schedule is linked to a customer's expected rise in income and repayment is accelerated in due proportion. Alternatively, under a 'flexible loan instalment plan' the repayment schedule is segmented, with an initial higher instalment followed by a lower instalment for the remainder of the term. Another formula, the 'balloon repayment facility', provides for repayment to be made on redemption of a financial investment, such as an insurance policy or bond, which is assigned as security for the loan. Another outcome of increased competition was an increase in loan-to-value ratios (LTVs). In a bid to capture market share early on, some banks offered LTVs as high as 90 to 95 percent. A few banks went over the top with LTVs over 100 percent. Fortunately, the regulators were quick to step in to stop imprudent lending practices. Soon enough the few banks involved found that they had to curb any further housing credits, as non-performing assets began to build up. For an experienced lender like HDFC, competition did not alter its approach to credit risk. HDFC typically has been conservative as regards credit appraisals. While HDFC's maximum LTV is 85 percent, on a portfolio basis it is in a 65 to 68 per cent range and the income to instalment ratio is between 35 and 40 percent.

10.9.3 Tax Benefits

To help boost home ownership, the government has offered tax incentives to individuals who opted for home loans. Interest payments on a housing loan up to INR 150,000 per annum (USD 3,333) and annual repayments up to INR 100,000 (USD 2,222) are eligible for deduction from a borrower's gross income. These tax benefits have considerably reduced the effective rates of interest on loans, to the extent that it is more beneficial to borrow from a bank or housing finance company than to use one's own funds. For instance, a borrower opting for an INR two million (USD

44,444), 15-year loan at 9.5 per cent per annum will effectively be paying an interest rate of 5.68 per cent per annum (HDFC, 2006). While various tax committees have declared in favour of removing a host of current exemptions and deductions in the Income Tax Act, it is unlikely that the government will eliminate those on housing loans, in recognition of the fact that fiscal incentives have boosted home ownership.

10.10 Loan Products

Financial firms lend to individuals, members of cooperative societies and companies for the construction or purchase of residential housing in India. With competition currently the norm, products are designed to be as flexible as possible in order to satisfy borrowers' diverse needs Many financial firms have devised various innovative products to meet this purpose, offering flexible repayment facilities, or add-on benefits such as insurance or credit card facilities, on top of a housing loan.

10.10.1 Individual Loans

The most common form of credit is the 'plain vanilla 'home loan to acquire or construct residential accommodation. The principal eligibility criterion is the borrower's repayment capacity. Loans are generally repaid in equal monthly instalments over a period of five to 20 years. Some lenders place a ceiling on loan amounts of either INR 10 million (USD 222,222)

or 85 per cent of the cost of the property, whichever is lower; other lenders place no such constraints on loan amounts, but are driven solely by the repayment capacity of the borrower. The security for the loan generally takes the form of an equitable mortgage of the property and/or such other collateral security as may be necessary. Maturities vary according to the purpose of a loan, but most are for a maximum 15 to 20 years, or until the retirement age of the borrower, whichever is earlier. A borrower can choose between a pure fixed rate of interest, a fixed rate with a money market condition clause (wherein interest rates would change only in case of extreme fluctuations in money market conditions), a variable rate or a combination of fixed and floating rates. Banks (as opposed to financial firms) generally offer only floating rate loans. Other types of home loans include home improvement for internal and external repairs and other structural improvements of the house. Home extension loans are for additions/extensions in the form of an additional room, floor and any other extension to the house. Home equity loans are advances against the value and security of a customer's existing property for purposes such as education or medical costs or other approved expenditures. Loans related to non-residential premises are provided to professionals such as doctors, chartered accountants or other such professionals to facilitate the purchase, construction or renovation of occupational premises. Short-term bridging loans facilitate the transition between purchase of a new house and sale of the old one. Land loans are granted for acquisition of land prior to construction of a residential unit. Most financial firms in India also offer loans to non-resident

Indians and individuals of Indian origin for the purchase or construction of dwelling units anywhere in India.

10.10.2 Corporate Loans

Financial firms lend to corporate bodies for the construction or purchase of new residential housing for the use of their employees anywhere in India. Loans to business enterprises for non-residential premises are also readily available. Some financial firms provide loans against rent receivables. In recent years, the demand for business loans has primarily been driven from the information technology and business process outsourcing sectors, which generally prefer to take premises on lease. Some financial bodies grant loans to the owners of these properties based on lease rental discounting. Loans to approved corporates for the purchase or construction of staff accommodation and office premises are also available in India, as they are to housing boards and co-operative housing societies.

10.10.3 Developer Loans

The larger housing finance institutions offer loans to approved developers for the construction of housing projects that are secured on rent receivables from their tenants. Developer loans are typically for maturities of one to two years. Financial firms generally require security by way of mortgage over the property, including personal guarantees in respect of the amounts due under the loan.

Summary:

- To consolidate framework of rules/regulations and clarification on Housing Finance issued by Reserve Bank of India from time to time.
- The demand for housing is ever-increasing with the growing population and urbanisation and access to housing finance need to keep pace with it; therefore, the regulators, lenders, and other market participants need to be incentivised to continue to progressively cater to the growing housing finance needs.
- The policy initiatives of the government of India to propel the access to housing finance and to make it sustainable and viable for the financiers are much needed, and such initiatives have generally not been lacking.
- Increasing access to capital markets, long term funds, facilitating regulations, etc. have been key efforts from the government and the regulators.
- National Housing Bank has also been proactively registering more and more housing finance companies to cater to areas ignored by conventional lenders thus far.
- Several of these housing finance companies are finding ways and means of offering financial inclusion by replacing collateral requirements from proper land titles to pseudo collaterals, introducing qualitative measures for assessment of low-income borrowers, offering developmental housing loans and more.

❖ **Exercise**

Long Questions:

(1) Explain the role of Recent Government scheme in housing finance
(2) Explain types of Housing Finance.
(3) Direct Housing finance Vs indirect housing finance.
(4) Explain roles & responsibility of NHB.
(5) Explain HUDCO.
(6) Explain due Diligence FOR BANK CREDIT AS HOUSING FINANCE
(7) Describe growth of Housing fiancé in India.

Multiple Choice Questions (MCQ):

1. Who was the chairman of high-level group who recommended the set of National Housing Bank (NHB)?

A. M Narasimham
B. R N Malhotra
C. Dr Manmohan Singh
D. Rangarajan

2. Under which act National Housing Bank was set up as an apex institute of housing finance in the country?
A. National Housing Bank Act, 1986
B. **National Housing Bank Act, 1987**
C. National Housing Bank Act, 1988
D. National Housing Bank Act, 1989

3. When did National Housing Bank set up?
A. 1st July 1987
B. 1st July 1988
C. **9th July 1988**
D. 9th July 1987

4. Who is the largest shareholder of National Housing Bank?
A. **Reserve Bank of India**
B. Government of India
C. NABARD
D. State Bank of India

5. Where does headquarters of National Housing Bank situated?
A. Mumbai
B. Hyderabad
C. **New Delhi**
D. Kolkata

6. Who regulates the housing finances companies in India?
A. Reserve Bank of India
B. **National Housing Bank**
C. SEBI
D. Government of India

7. Who launched the first housing price index 'RESIDEX' in India?
A. NABARD B. **NHB**
C. BSE D. NSE

8. When did RESIDEX launched to monitor housing prices in prominent cities in the country?
A. 2003 B. 2005
C. 2006 D. **2007**

9. As on date, how many cities are covered by RESIDEX?
A. 26 B. 40
C. 50 **D.** 100

10. NHB stands for:
A. National Housing Business
B. **National Housing Bank**
C. Non - Housing Bank
D. None of The Above

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Education for All

યુનિવર્સિટી ગીત

સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ

શિક્ષણ, સંસ્કૃતિ, સદ્‌ભાવ, દિવ્યબોધનું ધામ
ડૉ. બાબાસાહેબ આંબેડકર ઓપન યુનિવર્સિટી નામ;
સૌને સૌની પાંખ મળે, ને સૌને સૌનું આભ,
દશે દિશામાં સ્મિત વહે હો દશે દિશે શુભ-લાભ.

અભણ રહી અજ્ઞાનના શાને, અંધકારને પીવો ?
કહે બુદ્ધ આંબેડકર કહે, તું થા તારો દીવો;
શારદીય અજવાળા પહોંચ્યાં ગુર્જર ગામે ગામ
ધ્રુવ તારકની જેમ ઝળહળે એકલવ્યની શાન.

સરસ્વતીના મયૂર તમારે ફળિયે આવી ગહેકે
અંધકારને હડસેલીને ઉજાસના ફૂલ મહેંકે;
બંધન નહીં કો સ્થાન સમયના જવું ન ઘરથી દૂર
ઘર આવી મા હરે શારદા દૈન્ય તિમિરના પૂર.

સંસ્કારોની સુગંધ મહેંકે, મન મંદિરને ધામે
સુખની ટપાલ પહોંચે સૌને પોતાને સરનામે;
સમાજ કેરે દરિયે હાંકી શિક્ષણ કેરું વહાણ,
આવો કરીયે આપણ સૌ
ભવ્ય રાષ્ટ્ર નિર્માણ...
દિવ્ય રાષ્ટ્ર નિર્માણ...
ભવ્ય રાષ્ટ્ર નિર્માણ

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