Unit 1
Overview of Financial System

Syllabus

a. Lending, Payments and Risk Trading
b. Interest rates and Exchange rates
c. Capital Market and Money Market, Primary Market & Secondary Market
d. Stock Exchange
e. SEBI

Objectives of this unit:

This unit will enable you to develop an understanding of the following:

- Meaning of a financial system
- Components and functions of a financial system
- Key elements of a well-functioning financial system
- Lending, payments and risk-taking procedure
- Meaning, functions and types of money market
- Meaning, functions of Capital market, types of capital market
- Primary market- issue mechanism (IPO and FPO)
- Secondary market- Trading and Settlement
- Stock Exchanges- Functions, segments
- SEBI- Role and Functions

Introduction

The financial system plays the key role in the economy by stimulating economic growth, influencing economic performance of the actors, affecting economic welfare. This is achieved by financial infrastructure, in which entities with funds allocate those funds to those who have potentially more productive ways to invest those funds. A financial system makes it possible a more efficient transfer of funds. As one party of the transaction may possess superior information than the other party, it can lead to the information asymmetry problem and inefficient allocation of financial resources. By overcoming asymmetry problem, the financial system facilitates balance between those with funds to invest and those needing funds.

1.1Meaning of Financial System

Financial system is a set of complex and closely-connected or intermixed institutions, agents, practices, markets, claims, and so on in an economy. It can also be defined as a set of institutions, instruments and markets which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors). Financial system is divided into formal as well as informal. The informal financial system is a sector of the economy that consists of financial activities that take place outside of regulatory authorities.

1.2Functions of a Financial System

Important functions of financial system are as follows:

- **(i)** **Mobilise and allocate savings**: Financial system links the savers and investors and help in mobilizing and allocating the savings efficiently and effectively.
- **(ii)** **Monitor corporate performance:** Financial markets and institutions help to monitor corporate performance and exert corporate control through the threat of hostile takeovers for underperforming firms.
- **(iii)** **Provide payment and settlement systems:** It provides a payment mechanism for the **e**xchange of goods and services and transfer of economic resources through time and across geographic regions and industries. The clearing and settlement mechanism of the stock markets is done through depositories and clearing operations.
- **(iv)** **Optimum allocation of risk-bearing and reduction: I**t reduces risk by laying down the rules governing the operation of the system. This is also achieved through holding of diversified portfolios.
- **(v)** **Disseminate price-related information:** It acts as an important tool for taking economic and financial decisions and take an informed opinion about investment, disinvestment, reinvestment or holding of any particular asset.
- **(vi)** **Lower the cost of transactions:** It helps in the creation of a financial structure that lowers the cost of transactions.
- **(vii)** **Promote the process of financial deepening and broadening:** It promotes financial deepening and broadening through a well-functional financial system. Financial deepening refers to an increase of financial assets as a percentage of GDP. Financial depth is an important measure of financial system

development as it measures the size of the financial intermediary sector. Financial broadening refers to building an increasing number of varieties of participants and instruments.

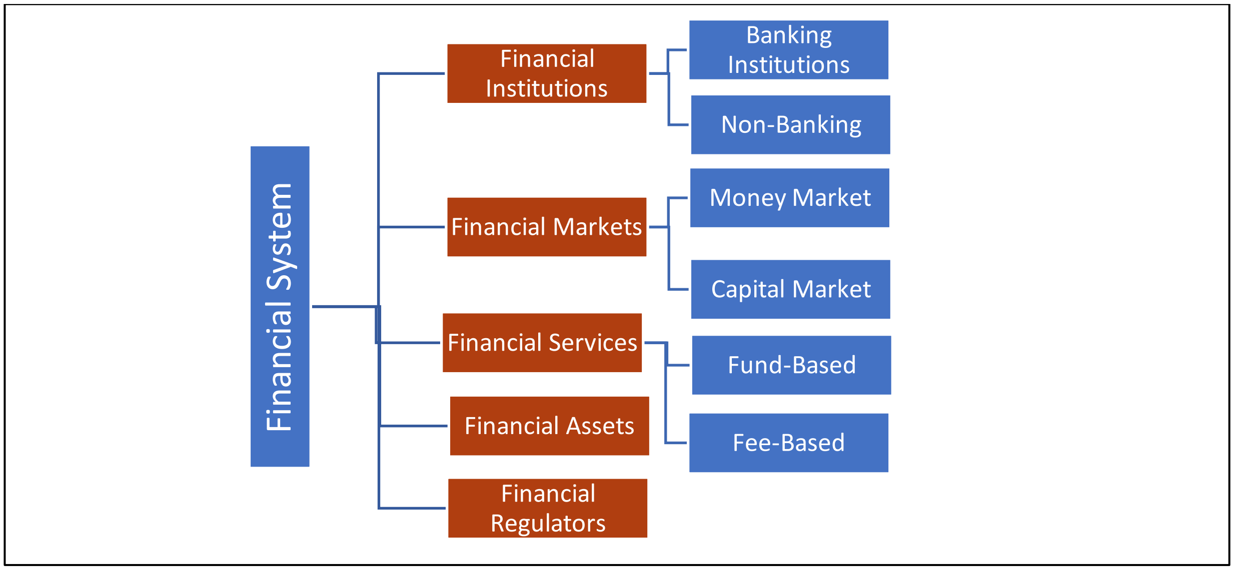
Pre-requisites of a well-functioning Financial System

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- A sound banking system,
- An information system, and
- A well-functioning securities market

1.3Components of Financial System

There are five main components of the Indian Financial System. This includes:

(A) Financial Institutions
(B) Financial Assets
(C) Financial Services
(D) Financial Markets
(E) Financial Regulators



(A) Financial Institutions

Financial Institutions are the business organizations that act as mobilisers of savings, and as purveyors of credit or finance. Their main activities are:

(a) They provide various financial services to the community.
(b) They are business organizations dealing in financial resources.
(c) They collect resources by accepting deposits from individuals and institutions and lend them to trade, industry and others.
(d) This means financial institutions mobilize the savings of savers and give credit or finance to the investors.

Financial institutions may be classified into two broad categories:

(i) Banking Financial Institutions and
(ii) Non-banking Financial Institutions

Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), the Industrial Financial of India (IFCI), the Small Industries Development Bank of India (SIDBI), and the Industrial Investment Bank of India (IIBI).

Financial institutions can be specialized finance institutions like the Export Import Bank of India (EXIM), the Tourism Finance Corporation of India (TFCI), ICICI Venture, the Infrastructure Development Finance Company (IDFC), and sectoral financial institutions such as the National Bank for Agricultural and Rural Development (NABARD) and the National Housing Bank (NHB).

There are state-level financial institutions such as the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) which are owned and managed by the State governments.

Banking Institutions

(a) Banking institutions mobilize the savings of the people.
(b) They provide a mechanism for the smooth exchange of goods and services.
(c) They extend credit while lending money.
(d) They not only supply credit but also create credit.
(e) Mobilize financial resources directly or indirectly from the people.

Non-banking Financial Institutions

Non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions.

(B) Financial Markets

Financial markets are an important component of the financial system. They are a mechanism for the exchange trading of financial products under a policy framework. The participants in the financial markets are the borrowers (issuers of securities), lenders (buyers of securities), and financial intermediaries.

Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. They create financial assets.

(i) Financial markets exist wherever financial transactions take place.
(ii) Financial transactions include issue of equity shares by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc.

The marketplace where buyers and sellers interact with each other and participate in the trading of money, bonds, shares and other assets is called a financial market.

The financial market can be further divided into four types:

(i) Money Market: Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorised for small-term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments. The money market can further be divided into two types:

(a) Organised Money Market
(b) Unorganised Money Market

(ii) Capital Market: Designed to finance the long-term investment, the Capital market deals with transactions which are taking place in the market for over a year. The capital market can further be divided into three types:

(a) Corporate Securities Market
(b) Government Securities Market
(c) Long-Term Loan Market

(iii)Foreign exchange Market: One of the most developed markets across the world, the foreign exchange market, deals with the requirements related to multi-currency. The transfer of funds in this market takes place based on the foreign currency rate.

(iv)Credit Market: A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial and Non-Financial Institutions is called Credit Market.

(C) Financial Instruments

A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. Financial instruments represent paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organized markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing risk.

Different types of financial instruments can be designed to suit the risk and return preferences of different classes of investors. Savings and investments are linked through a wide variety of complex financial instruments known as ‘securities.

(i) They represent claims on a stream of income and/or assets of another economic unit and are held as a store of value and for the return that is expected.
(ii) The maturity and sophistication of the financial system, indeed, depends on the prevalence of a variety of securities/ financial assets to suit the investment requirements of heterogeneous investors.
(iii)Ordinary/equity shares, preference shares, debentures/bonds including innovative debt instruments.
(iv)Treasury bills, gilt-edge securities, state government and public sector instruments, commercial paper, certificate of deposit, commercial bills etc.

(D) Financial Services

Financial services are those that help with borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The term ‘financial services' in a broad, sense means "mobilizing and allocating savings". Thus, it includes all activities involved in the transformation of savings into investment. Financial services can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilizing from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers.

Financial Services may be classified into two broad categories:

(i) **Fee based services**: Leasing, hire purchase, factoring, credit financing and house financing

(ii) **Fund based services**: Issue management, portfolio management, corporate counselling, merchant banking and credit rating.

(E) Financial Regulators

Financial Regulators in India

(i) SEBI: The market regulator in the Indian capital market is the Securities and Exchange Board of India (SEBI).

(ii) IRDAI: The Insurance Regulatory and Development Authority (IRDA) does the same for the insurance sector.

(iii) RBI: Reserve Bank of India (RBI) conducts the country's monetary policy.

(iv) PFRDA: Pension Funds Regulatory and Development Authority (PFRDA) regulates pensions.

(v) MCA: Ministry of Corporate Affairs (MCA) regulates the corporate sector.

2. Lending, Payments and Risk Trading

In this section, we shall learn lending types, payment mechanisms and risk-taking institutions.

2.1 Lending

In finance, "lending" refers to the act of providing money or property to another party with the expectation of repayment, often with interest. Lending plays a crucial role in the economy by enabling businesses to grow and invest, and allowing consumers to purchase goods and services they might otherwise be unable to afford.

Lending involves a financial institution or individual (the lender) providing funds to a borrower, who agrees to repay the principal amount plus interest.

Lending Institutions

In India, lending institutions are financial entities that provide loans and credit, encompassing banks, credit unions, and other financial organizations, playing a vital role in the economy by facilitating investment and economic growth.

(i) **Banks:** These are the most common type, offering a wide range of loan products, including personal loans, mortgages, business loans, and working capital financing.

(ii) **Credit Unions:** These are cooperative financial institutions owned and operated by their members, providing loans and financial services to their members.

(iii) **Non-Banking Financial Companies (NBFCs):** These are financial institutions that are not banks but are regulated by the Reserve Bank of India (RBI), offering various lending products.

(iv) **Microfinance Institutions (MFIs):** These focus on providing small loans to low-income individuals and small businesses.

Terms used in Lending

(i) **Lenders:** Lenders can be banks, credit unions, peer-to-peer lending platforms, or even individuals.

(ii) **Borrowers:** Borrowers can be individuals, businesses, or governments seeking funds for various purposes like home purchases, car loans, student loans, or business investments.

(iii) **Types of Lending:** Lending can be categorized into various types, including secured loans (backed by collateral), unsecured loans, commercial loans, personal loans, and more.

(iv) **Lending Industry:** The lending industry, also known as the credit industry, encompasses a wide range of financial institutions, products, and services, contributing to the overall functioning and growth of the economy.

Corporate Lending

Corporate lending involves financial institutions, typically banks, providing loans to companies to fund their business operations, which are generally larger than retail loans and often handled by specialized lending institutions.

(i) **Purpose:** Corporate lending aims to provide businesses with the necessary funds to manage their operations, including procuring capital, acquiring assets, paying wages, and managing short-term liabilities.

(ii) **Target:** Unlike retail lending which focuses on individuals, corporate lending targets companies, ranging from small enterprises to large corporations.

(iii) **Scale:** Loans in corporate lending are typically much larger than those offered to individuals, reflecting the substantial financial needs of businesses.

(iv) **Lenders:** Larger banks with specialized lending divisions are often the providers of corporate loans.

Types of Corporate Loans:

Corporate loans are various types. These are discussed below:

(i) Term Loans: These are loans where the borrower draws the entire facility upfront, incurs interest, and repays the full balance at the end of the term.

(ii) Revolving Credit Facilities (RCFs): These are credit lines that allow businesses to borrow and repay funds repeatedly within a certain limit.

(iii) Overdrafts: These are short-term loans that allow businesses to draw funds beyond their account balance, up to a pre-agreed limit.

(iv) Letters of Credit (LOCs): These are financial instruments that guarantee payment to a seller if a buyer fails to pay, ensuring transactions are secured.

(v) Working Capital Loans: These loans are used to fund day-to-day operations and short-term business needs.

(vi) Equipment Finance: These loans are specifically used to finance the purchase of equipment or machinery.

(vii) Bridge Loans: These are short-term loans used to bridge the gap between the need for funds and the availability of long-term financing.

(viii) Export Financing: This pre-shipping credit is given to export businesses. The loan amount may be applied to purchasing raw materials, packaging, shipping, and storing items intended for export.

(ix) Real Estate Loans: A commercial real estate loan might benefit companies requiring capital to purchase commercial real estate. Similar to loans for equipment, the asset being purchased acts as collateral to guarantee the loan.

(x) Short-term Loans: Businesses can opt for loans spanning shorter durations and lower amounts while they wait for bugger financing.

Features of Corporate Loan

The key features of corporate loans are:

(i) **Reasonably priced interest rates-** Many reputable financial institutions have interest rates lower than the industry standard.

(ii) **Fast Approvals -** Delays can adversely affect business earnings, particularly those resulting from inadequate capital. Almost all lenders provide rapid approvals for their corporate loans.

(iii) **Collateral-free** – Most corporate loans do not require collateral.

(iv) **Online Transaction** – Corporate loans can be availed through a simple online application.

(v) **Prolonged Loan Period** – A flexible repayment plan with a business loan based on the company's cash flow can be selected.

(vi) **Streamlined Procedure for Documentation** – Most banks and lenders require essential documentation for application.

(vii) **Greater Amounts Disbursed for Loans -** The company need enough funding to cover its expenses and working capital requirements. Through corporate loans, amounts as high as 20 crores can be availed.

Corporate Loan Interest Rate

There is no fixed interest rate for corporate loans. It depends on the lender, the amount, and the loan repayment tenure.

2.2 Payments

In finance, "payments" refer to the transfer of monetary value from one party to another, whether in cash or non-cash forms, to settle debts, purchase goods/services, or fulfill legal obligations.

Payments are the transfer of money or its equivalent from a payer (the person or entity making the payment) to a payee (the person or entity receiving the payment).

The process of transferring funds between the payer and the payee, involving various stakeholders like issuing banks, acquiring banks, payment processors, and payment networks.

Forms of Payment:

- **Cash:** Physical currency (notes and coins).
- **Non-cash:**
    - **Bank Transfers:** Direct transfer of funds between bank accounts.
    - **Credit/Debit Cards:** Using plastic cards for purchases.
    - **Digital Wallets:** Mobile apps or online platforms for storing payment information and making payments (e.g., Apple Pay, Google Pay, PayPal).
    - **Checks:** Negotiable instruments for making payments.
    - **Wire Transfers:** Electronic transfers of funds.
    - **Cryptocurrencies:** Digital or virtual currencies.
    - **Prepaid Cards:** Cards with a pre-loaded amount of money.
    - **Contactless Payments:** Using NFC technology or mobile devices to make payments.
    - **Online Banking:** Making payments through online banking platforms.
    - **E-commerce:** Making payments through online stores.

Corporate Payments

Corporate payments are the financial transactions between companies to meet various business-related expenses—these can include salaries, supplier payments, taxes, insurance, and more.

Trends in corporate payments

(i) **ERP integrated with payments channel:** Corporates need ERP solutions that can meet their complete needs and address both front and back-end requirements. Various banks/financial institutions (FIs) offer an end-to-end integration of banking channels with ERP systems. This can be done through host to-host connectivity or by integrating ERP with SWIFT applications at the corporate's end. A few companies offer solutions that interact with the ERP systems of B2B companies and post transactions on their ERP platform.

   (a) **Automated invoicing:** The provision of digital invoicing along with integrated payment methods can help corporates to improve their collections. They can integrate and submit their digital invoices to customers through automated clearing houses supporting direct debits. These auto debits can be useful for the timely collection of recurring payments such as utility and subscription-based payments. Further, in the B2C segment, corporates can utilise the 'request-to-pay' mechanism to improve collections and reduce costs associated with customer disputes.

   (b) **Integrated expense management**: FinTechs and ERP solution providers today offer integrated solutions which include corporate credit card/ corporate prepaid cards along with petty cash management and expense management solutions.

(ii) **Virtual account management (VAM):** VAM is a cash collection solution provided by banks. It enables an actual corporate account to be tagged with multiple virtual accounts for better reconciliation and reporting. The virtual account number can be uniquely generated by the corporate for each of its child entities.

(iii) **Payments tracking capability**: When a corporate initiates a cross-border payment or is expecting an international remittance, it may not be able to track the payment status and fees charged by the intermediaries. There may be a lack of end-to-end visibility at times because each intermediary may possess information only about the leg of the transaction in which it was involved. This limitation is addressed by SWIFT's Global Payments Innovation (GPI) initiative. Under SWIFT GPI and universal confirmation, a tracker is provided to track payments right from initiation to credit confirmation. Corporates using this facility can check the status of the payment and get to know about the charges and FX rates levied by the intermediary banks.

(iv) **Blockchain/smart contracts**: Several IT companies have developed blockchain-based solutions for corporates in collaboration with banks. Corporates can access the blockchain platform via their banks. Blockchain technology serves as a shared and immutable ledger that facilitates the process of recording transactions and tracking assets. Further, smart contracts have gained popularity due to the ease of their execution/decision making without any manual intervention.

2.3 Risk Trading

In finance, risk refers to the degree of uncertainty and/or potential financial loss inherent in an investment decision. In general, as investment risks rise, investors seek higher returns to compensate themselves for taking such risks.

The major elements of risk are defined as below:

- **Systematic Risk**: Interest Risk, Inflation Risk, Market Risk, etc.
- **Unsystematic Risk**: Business Risk and Financial Risk.

Types of Risk

(i) **Operational Risk:** This refers to any risk incurred as a result of failure in people, internal processes and policies, and systems.

(ii) **Market Risk:** Also known as systematic risk, market risk refers to any losses resulting from changes in the global financial market. Sources of market loss include economic recessions, natural disasters, political unrest, and changes in interest.

(iii) **Liquidity Risk:** This refers to inability to meet its obligations, thereby jeopardizing its financial standing or even its very existence. Liquidity risks effectively prevent a bank from being able to convert its assets into cash without sacrificing capital due to insufficient interest.

(iv) **Compliance Risk:** Any risk incurred as a result of failure to comply with laws or industry regulations. Compliance risk can lead to financial forfeiture, reputational damage, and legal penalties.

(v) **Reputational Risk:** As its name implies, reputational risk refers to any potential damage to brand or reputation of an institution.

(vi) **Credit Risk:** Credit risk is the possibility that a borrower (individual, company, or government) will not be able to repay a loan or meet other financial obligations.

(vii) **Business Risk:** This refers to any risk that stems from a bank's long-term business strategy and affects the bank's profitability. Common sources of business risk to banks include closures and acquisitions, loss of market share, and inability to keep up with competitors.

Risk-taking comes naturally to banks. Banks engage themselves in the process of financial intermediation by taking risks to earn more than what they pay to the depositors.

There is a direct relationship between risk and reward and the quest for profit maximization has given rise to accelerated risk-taking for enhanced rewards. Whatever be the type of risk, the impact is primarily financial. Ultimately risk manifests in the form of loss of income and reputation.

Each bank as well as every banker needs to understand and appreciate that risk is unavoidable. The existence and quantum of risk associated with each transaction cannot be ascertained with certainty.

Whatever models have been developed for risk management, are primarily based on observed occurrences of the past, which may or may not be repeated in the future. Risk is inherent to the business. Since it cannot be eliminated, it has to be managed.

Credit Risk in Business

Credit risk is the potential loss a lender faces when a borrower defaults on their debt obligations, meaning they fail to repay the principal and interest as agreed.

(a) Consequences for Lenders: If a borrower defaults, the lender risks losing the principal amount, interest payments, and incurring additional costs associated with debt recovery.

(b) Factors Contributing to Credit Risk:

(i) **Borrower's Financial Situation:** A borrower's income, debt levels, credit history, and overall financial stability all play a role in assessing credit risk.

(ii) **Economic Conditions:** Economic downturns, recessions, or other economic shocks can increase the likelihood of borrowers defaulting.

(iii) **Industry and Sector:** Certain industries or sectors may be more vulnerable to economic downturns and therefore present higher credit risk.

(iv) **Loan Terms:** Factors like loan amount, interest rate, repayment schedule, and collateral can influence the level of credit risk.

Credit Risk Management:

Lenders employ various strategies to assess and mitigate credit risk, including:

(i) **Credit Scoring:** Using credit scores and other data to assess a borrower's creditworthiness.

(ii) **Credit Analysis:** Evaluating a borrower's financial statements, credit history, and other relevant information.

(iii) **Collateral:** Requiring borrowers to pledge assets as collateral to secure the loan.

(iv) **Credit Limits:** Setting limits on the amount of credit extended to borrowers.

(v) **Diversification:** Spreading lending activities across different borrowers and sectors to reduce concentration risk.

Risk and Insurance

Insurance plays a crucial role in risk management by providing financial protection against unforeseen events, transferring the risk of potential losses from the insured to the insurer, and enabling businesses and individuals to mitigate the impact of unexpected events.

How Insurance Addresses Risk:

(i) **Risk Transfer:** Insurance works by transferring the risk of potential losses from the insured (the individual or business) to the insurance company (the insurer).

(ii) **Financial Protection:** By paying premiums, the insured receives a guarantee of financial compensation in the event of a covered loss.

(iii) **Mitigation of Uncertainty:** Insurance helps individuals and businesses to cope with uncertainty and reduce the financial impact of unexpected events.

Risk -taking or bearing Institutions

In India, risk-bearing institutions include financial institutions like banks, insurance companies, and investment firms, as well as organizations involved in disaster risk financing and insurance, such as the National Disaster Management Authority (NDMA) and the Insurance Institute of India.

(i) **Banks:** Commercial banks (both public and private sector) and cooperative banks play a crucial role in lending and managing financial risks.

(ii) **Insurance Companies:** Insurance companies, both general and life, are primarily focused on managing and transferring risks to others.

(iii) **Investment Firms:** Investment banks, asset management companies, and other financial institutions are involved in managing investment risks.

(iv) **Development Financial Institutions:** Institutions like IFCI Limited, IDBI, EXIM Bank, IIBI Limited, TFCI Limited, IDFC Limited, NABARD, NHB and SIDBI also play a role in risk bearing.

(v) **Deposit Insurance:** The Deposit Insurance and Credit Guarantee Corporation (DICGC) insures deposits in banks, mitigating the risk of loss for depositors.

Organizations Involved in Disaster Risk Financing and Insurance:

(i) **National Disaster Management Authority (NDMA):** The NDMA is responsible for disaster risk management and works with various stakeholders to implement disaster risk financing and insurance schemes.

(ii) **Insurance Institute of India:** This institute plays a role in promoting insurance education and research, contributing to the development of a robust insurance sector for disaster risk financing.

(iii) **GIC Re:** The General Insurance Corporation of India (GIC Re) is a reinsurer that plays a crucial role in managing and transferring risks related to natural disasters.

(iv) **World Bank:** The World Bank provides financial and technical assistance to developing countries, including India, for disaster risk financing and insurance.

(v) **Reinsurance Companies:** Companies like Swiss Re and Munich Re are involved in providing reinsurance, which helps insurance companies manage large-scale risks.

(vi) **Other Organizations:** Organizations like Lloyds, AXA XL India, Oriental Insurance Co. Ltd, General Insurance Council, Bajaj Allianz, ICICI, and IRDAI are also involved in disaster risk financing and insurance.

3. Interest rates and Exchange Rate

In this section, we shall learn interest rates and exchange rates.

3.1 Interest Rates

Interest is the price the borrowers must pay to lenders to obtain the use of money for a period of time. As all the other prices are determined in different markets, the equilibrium rate of interest is also determined by the forces of supply and demand in the financial market.

In finance, "interest" refers to the cost of borrowing money (for borrowers) or the return earned on investments or savings (for lenders/investors), typically expressed as a percentage of the principal amount.

In the banking context, "interest" refers to the cost of borrowing money (for loans) or the reward for lending money (for deposits), typically expressed as a percentage of the principal amount.

For Borrowers (Loans):

When you take out a loan from a bank, you agree to pay back not only the principal amount borrowed but also an additional amount, which is the interest. This interest is the fee the bank charges for lending you the money.

For Depositors (Savings/Investment Accounts):

When you deposit money in a savings or investment account, the bank pays you interest on that money. This is the reward the bank gives you for allowing them to use your money

Terms used in Interest

(i) **Borrowing:** When you borrow money (e.g., through a loan, credit card, or mortgage), you pay interest on top of the principal amount you borrowed.

(ii) **Lending/Investing:** When you lend money (e.g., through a savings account, or investment), you earn interest on the principal amount.

(iii) **Interest Rate:** The interest rate is the percentage used to calculate the interest amount.

Interest is of two types: *Pure interest* and *gross interest.*

The **pure interest** is the payment for the use of money as capital when there is neither inconvenience, risk nor any other management problem.

Whereas, ***gross interest*** is the gross payment which the lender gets from the borrower. It includes not only net interest but also payment for other elements, which have been outlined below.

Elements of Gross interest

(i) **Payment for risk:** Every loan, if not secured fully, involves risk of non- payment due to the inability or unwillingness of the borrower to pay back the debt. The lender charges something extra for taking such risk.

(ii) **Payment for inconvenience:** The moneylender may add extra charges for the inconvenience caused to him. The greater the inconvenience involved, the higher will be such charge and consequently the gross interest. For instance, the borrower may repay at a very inconvenient time to the lender or the borrower may invest the capital for a period longer than the one for which loan has been given.

(iii) **Payment for management:** The lender expects to be compensated for the additional work he has to do in connection with lending e.g., the form of keeping accounts, sending notices and reminders and other incidental work.

(iv) **Payment for exclusive use of money, i.e. pure interest:** It is the payment for the use of money which is in addition to payments for the above-mentioned risks, inconvenience and management.

Interest Rate in Bond Market

Bond yield or interest rate is the return an investor expects to receive each year over the bond's term to maturity, and it's influenced by the interest rate environment.

Bond prices and interest rates move in opposite directions. When interest rates rise, new bonds are issued with higher yields, making existing bonds with lower yields less attractive, thus pushing down their prices. Conversely, if interest rates fall, existing bonds become more attractive, driving up their prices.

Factors Affecting Bond Yields:

Several factors influence bond yields, including:

(i) **Inflation:** Higher inflation expectations can lead to higher interest rates and bond yields.

(ii) **Economic Growth:** Strong economic growth can lead to higher interest rates and bond yields.

(iii) **Central Bank Policies:** Central banks play a significant role in setting short-term interest rates, which can influence long-term bond yields.

(iv) **Creditworthiness of the Issuer:** The risk of default by the bond issuer also impacts yields; bonds issued by entities with higher credit risk typically offer higher yields to compensate investors for the increased risk.

Yield to Maturity (YTM) in Bond Market

Yield to Maturity (YTM) represents the total return an investor can expect from a bond if held until it matures, considering all coupon payments and the difference between the bond's current price and face value.

YTM is a comprehensive measure of a bond's potential profitability, taking into account:

- **Current market price:** The price at which the bond is currently being traded.
- **Face value:** The amount the bondholder will receive at maturity.
- **Coupon rate:** The interest rate the bond pays.
- **Time to maturity:** The remaining years until the bond matures.

How to compute YTM

Step 1: Calculate the annual coupon payment (C) by multiplying the coupon rate by the face value (FV).

Step 2: Calculate the numerator: C + (FV - PV) / n.

Step 3: Calculate the denominator: (FV + PV) / 2.

Step 4: Divide the numerator (from Step 2) by the denominator (from Step 3) to get the YTM.

$$\text{Yield to Maturity (YTM)} = \frac{C + \frac{FV - PV}{n}}{\frac{FV + PV}{2}}$$

Variables

C (Coupon Payment): The annual interest payment the bondholder receives.

FV (Face Value): The amount the bondholder will receive when the bond matures.

PV (Current Market Price): The current price of the bond in the market.

n (Number of Years to Maturity): The remaining time until the bond matures.

Example:

Following information is available to a bond:

(i) Face Value (FV) of a bond: Rs.1,000

(ii) Coupon Rate: 5% (meaning the annual coupon payment is Rs.50)

(iii) Current Market Price (PV): Rs.900

(iv) Years to Maturity (n): 10 years

Calculate YTM.

Calculation:

- **Step 1:** C = Rs.50 (5% of Rs.1,000)
- **Step 2:** Numerator: Rs.50 + (Rs.1,000 – Rs.900) / 10 = Rs.50 + Rs.10 = Rs.60
- **Step 3:** Denominator: (Rs.1,000 + Rs.900) / 2 = Rs.950
- **Step 4:** YTM = Rs.60 / Rs.950 = 0.0632 or 6.32%

3.2 Exchange Rate

The **Foreign Exchange Market** (Forex, FX, or currency market) is a form of exchange for the global decentralized trading of international currencies. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies. The foreign exchange market assists international trade and investment by enabling currency conversion.

Characteristics of Foreign Exchange Market

The foreign exchange market is unique because of the following characteristics:

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, i.e., trading from 20:15 GMT on Sunday until 22:00 GMT Friday;
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins and with respect to account size.

The Foreign Exchange Market has the following major sectors:

(a) Spot Market
(b) Forward and Futures Market, and
(c) Currency Options Market.

Exchange Rate

In the foreign exchange (forex) market, an exchange rate is the price of one currency expressed in terms of another, representing the value of one currency relative to another.
In finance, an **exchange rate** is the rate at which one currency will be exchanged for another currency. An exchange rate is the rate at which one currency can be converted into another. It's essentially the price of one country's currency in terms of another country's currency.
If the exchange rate between the US dollar and the INR is 88, it means that 1 US dollar can be exchanged for 88 INRs.

Equilibrium Exchange Rate

Equilibrium Exchange Rate is the one that balances the value of nation’s imports and exports. It is based on the flow of goods and services. Equilibrium Exchange Rate is also called as Trade Approach or Elasticity’s Approach to determination of exchange rate.

Bid-Ask Rate

The bid price is the highest price that someone is willing to pay for buying an asset at that moment. The foreign exchange market is nothing more than an ongoing auction to buy and sell. Just as with any auction, buyers place bids.
The asking price is the lowest price at which someone is willing to sell at that moment. Think of it as when you sell a house or other item, you are “asking” a certain price for it. Seller’s place asking prices.

Therefore, if you are interested in buying dollars, you should look at the asking price of a seller. You would have a buyer matched with a seller and the trade could be executed.

Spread

Spread is the difference between the dealer's Ask Rate and Bid Rate.

If the exchange rate is expected to be stable, the spread will be narrow. If the exchange rate is volatile, the spread will be wider.

Where volume of transactions is very high, the Bid-Offer Spread will be very low. In case of a thinly-traded currency, the spread will be wider.

Different Rate and Quotes Used in a Foreign Exchange Market

(i) **Exchange Rate:** It is the price of one currency quoted in terms of another currency.

(ii) **Spot Rate:** It is the exchange rate applicable for an immediate settlement, i.e. the exchange rate prevailing now.

(iii) **Forward Rate:** It is the exchange rate contracted today for exchange of currencies at a future date.

(iv) **Direct Quote:** It refers to the expression of exchange rate where one unit of foreign currency is expressed in terms of number of units of local / domestic currency. Example $1 = INR 88.00 [in India]

(v) **Indirect Quote:** It refers to quoting per unit of Local / Domestic Currency in terms of number of units of Foreign Currency. Example: Rs.1 = $0.025.

(vi) **Two Way Quote:** Two Way Quote refers to quoting Exchange Rates by an Exchange Dealer in terms ofBuying (Bid) Rate and Selling (Ask) Rate

4. Money Market

The money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than one year. It is not a physical location (like the stock market), but an activity that is conducted over the telephone. The money market constitutes a very important segment of the Indian financial system.

Characteristics of money market

The characteristics of the money market are as follows:

(i) It is not a single market but a collection of markets for several instruments.

(ii) It is a wholesale market of short-term debt instruments.

(iii) Its principal feature is honour where the creditworthiness of the participants is important.

(iv) It is a need-based market wherein the demand and supply of money shape the market.

(v) Transactions in the money market can be both secured and unsecured, i.e., without collaterals.

Organized Sector of Indian Money Market

(i) **RBI:** The central bank plays a crucial role in regulating and managing the money market.

(ii) **Commercial Banks:** Scheduled commercial banks, including public and private sector banks, foreign banks, and cooperative banks (excluding Land Development Banks) participate in the money market as both lenders and borrowers.

(iii) **Primary Dealers (PDs):** These financial institutions are authorized to deal in government securities and are also active in the money market.

(iv) **Non-Bank Financial Institutions (NBFI):** Insurance companies, mutual funds, and other financial institutions can participate in the money market, often indirectly through banks.

(v) Corporations and other institutional investors.

Unorganized Sector of Indian Money Market

(i) This sector includes indigenous moneylenders, chit funds, and other informal financial entities.

(ii) These entities are not regulated by the RBI and operate outside the formal financial system.

Participants of Money Market

The main participants of money market are:

- Reserve Bank of India (RBI)
- Discount and Finance House of India (DFHI)
- Mutual funds
- Insurance companies
- Banks
- Corporate investors
- Non-banking finance companies (NBFCs)
- State governments
- Provident funds
- Primary dealers
- Securities Trading Corporation of India (STCI)
- Public sector undertakings (PSUs), and
- Non-resident Indians.

Instruments Traded in Money Market

The instruments traded in the Indian money market are:

1. Call/notice money market—Call (overnight) and short notice (up to 14 days);
2. Treasury Bills (T-bills)
3. Commercial Papers (CPs)
4. Certificates of Deposits (CDs)
5. Commercial Bills (CBs)
6. Inter Bank Participation Certificate
7. Collateralized Borrowing and Lending Obligation (CBLO)

These are discussed below:

1. Call Money Market

Call/Notice money is an amount borrowed or lent on demand for a very short period. If the period is more than one day and upto 14 days, then it is called **notice** money. If the period is more than 14 days, then it is known as **call** money**.**

Banks borrow in this money market for the following purposes:

(i) To fill the gaps or temporary mismatches in funds.

(ii) To meet the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) mandatory requirements as stipulated by RBI.

(iii) To meet sudden demand for funds arising out of large outflows.

Participants of call money:

(a) Borrows and Lenders: Participants in call/notice money market currently include banks (excluding RRBs) and Primary Dealers (PDs), both as borrowers and lenders

(b) Lenders: In the Indian money market, lenders include the Reserve Bank of India (RBI), commercial banks, cooperative banks, primary dealers, and non-bank financial institutions like insurance companies and mutual funds.

2. Treasury Bills Market

Treasury bills are short-term instruments issued by the Reserve Bank of India (RBI) on behalf of the government to tide over short-term liquidity shortfalls. This instrument is used by the government to raise short-term funds to bridge seasonal or temporary gaps between its receipts (revenue and capital) and expenditure. They form the most important segment of the money market not only in India but all over the world as well.

T-bills are repaid at par on maturity. The difference between the amount paid by the tenderer at the time of purchase (which is less than the face value) and the amount received on maturity represents the interest amount on T-bills and is known as the discount. Tax deducted at source (TDS) is not applicable on T-bills.

Types of Treasury Bills

At present, there are 91-day, 182-day, and 364-day T-bills in vogue.

Features of T-bills

(i) They are negotiable securities.

(ii) They are highly liquid as they are of shorter tenure and there is a possibility of inter-bank repos in them.

(iii) There is an absence of default risk.

(iv) They have an assured yield, low transaction cost, and are eligible for inclusion in the securities for Statutory Liquidity Ratio (SLR) purposes.

(v) Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples thereof.

Issue Price: Treasury Bills are issued at a discount and redeemed at face value.

Auction Method: The 91 days T-Bills are auctioned under uniform price auction method (every Friday by the RBI) whereas 364 days T-Bills are auctioned on the basis of multiple price auction method (every alternate Wednesday i.e., the Wednesday preceding the reporting Friday).

Participants in the Treasury Bills Market: The Reserve Bank of India, banks, mutual funds, financial institutions, primary dealers, provident funds, corporates, foreign banks, and foreign institutional investors are all participants in the T-bills market. The state governments can invest their surplus funds as non-competitive bidders in T-bills of all maturities.

Yield in Treasury Bills: It is calculated as per the following formula:

$$\text{Yield} = \frac{100-P}{P} \times \frac{365}{D} \times 100$$

Where,

P = Purchase price

D= Days to maturity

Day Count for Treasury Bill: Actual number of days to maturity/ 365

Example

Assuming that the price of a 91 -Day Treasury Bill issues at Rs.98.20, the yield on the same would be-

$$\text{Yield} = \frac{Rs.100 - Rs.98.20}{Rs.98.20} \times \frac{365}{91} \times 100$$

= 7.3521%

3. Commercial Paper Market

The commercial paper (CP) market is a short-term, unsecured debt market where corporations issue promissory notes, or CP, to raise funds for short-term needs, typically up to 270 days, and are attractive to investors seeking short-term, relatively low-risk investments.

Features of Commercial Paper

(i) **Short-Term Debt Instrument:** Commercial paper (CP) is a short-term, unsecured debt instrument issued by corporations to raise funds for immediate needs, such as financing working capital, inventories, or meeting short-term liabilities.

(ii) **Unsecured:** Unlike bonds or loans, CP is not backed by collateral, meaning investors rely solely on the issuer's creditworthiness.

(iii) **Maturity:** CP typically has a maturity of up to 270 days, but the average maturity is around 30 days.

(iv) **Issuers:** Corporations, financial institutions, and other eligible entities issue CP.

(v) **Investors:** Investors include money market funds, institutional investors, and sometimes, high-net-worth individuals.

(vi) **Liquidity:** The CP market is generally considered to be liquid, meaning it is easy to buy and sell CP.

Who are eligible to issue of CP?

(a) Companies, PDs and FIs are permitted to raise short-term resources through CP.

(b) A company would be eligible to issue CP provided:

  (i) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs.4 crore;

  (ii) the company has been sanctioned working capital limit by bank/s or FIs; and

  (iii) the borrowal account of the company is classified as a standard asset by the financing bank/institution.

Buyback of CP

(i) Issuers may buy-back the CP, issued by them to the investors, before maturity.

(ii) Buy back of CP shall be through the secondary market and at prevailing market price.

(iii) The CP shall not be bought back before a minimum period of 7 days from the date of issue.

(iv) Issuer shall intimate the IPA of the buy-back undertaken.

(v) Buy-back of CPs should be undertaken after taking approval from the Board of Directors.

4. Certificate of Deposits

Certificates of Deposits (CDs) (introduced since June 1989) are unsecured, negotiable, short-term instruments in bearer form, issued by a Commercial Bank(s)/Financial Institution(s) at discount to face value at market rates, with maturity ranging from 15 days to one year. CDs are generally considered high-cost liabilities and banks have recourse to them only under tight liquidity conditions.

Features of Certificate of Deposits

(i) CDs can be issued to individuals, corporations, companies, trusts, funds, associates, etc.
(ii) NRIs can subscribe to CDs on non-repatriable basis.
(iii) CDs attract stamp duty as applicable to negotiable instruments.
(iv) Banks have to maintain SLR and CRR on the issue price of CDs. no ceiling on the amount to be issued.
(v) the minimum issue size of CDs is rs1 lakh and in multiples thereof.
(vi) CDs are transferable by endorsement and delivery.
(vii) The minimum lock-in-period for CDs is 15 days.

Investors in CD:

CDs can be issued to Individuals, Corporations, Companies, Trusts, Funds, Associations, etc. Non-resident Indians (NRIs) may subscribe to CDs, but only on non-repatriable basis which should be clearly stated on the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

Maturity Period:

(a) **CD's issued by Banks:** Not less than 7 days and not more than 1 year from the date of issue.
(b) **CD's issued by FIs:** Not less than 1 year and not exceeding 3 years from the date of issue.

5. Commercial Bills Market

Commercial bill is an important tool to finance credit sales. Commercial bills are negotiable instruments drawn by the seller on the buyer which are, in turn, accepted and discounted by commercial banks.

Types of Commercial Bills:

It may be a demand bill or a usance bill. A demand bill is payable on demand, i.e., immediately at sight or on presentation to the drawee. A usance bill is payable after a specified time. If the seller wishes to give some time for payment, the bill would be payable at a future date. These bills can either be clean bills or documentary bills. In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which it becomes clear. In the case of a documentary bill, documents are delivered against payment accepted by the drawee and documents of the file are held by bankers till the bill is paid.

Commercial bills can be inland bills or foreign bills.

Inland bills must:

(i) be drawn or made in India and must be payable in India: or
(ii) drawn upon any person resident in India

Foreign bills, on the other hand, are:

(i) drawn outside India and may be payable and by a party outside India, or may be payable in India or drawn on a party in India or
(ii) it may be drawn in India and made payable outside India A related classification of bills is export bills and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by exporters abroad.

6. Inter Bank Participation Certificate

Inter Bank Participation Certificates (IBPC) are short-term instruments to even out the short-term liquidity within the Banking system particularly when there are imbalances affecting the maturity mix of assets in Banking Book.

Objective: To provide a degree of flexibility in the credit-portfolio of Banks. It can be issued by Scheduled commercial Bank and can be subscribed by any commercial Bank.

Types: There are two types of participation certificates-

Aspect	Without risk to lender	With risk to lender
Period	Period not exceeding 90 Days	91 Days to 180 Days
Disclosure	Issuing Bank: Disclose as Liability under Borrowing from Banks. participating Bank: Advances to Bank	Issuing Bank: Reduce from Advances Outstanding. Participating Bank: Under Advances

Other Features:

(i) Interest rate on IBPC is freely determined in the market, i.e., negotiable.

(ii) Certificates are neither transferable nor prematurely redeemable by the Issuing Bank.

(iii) Issuing Bank can secure funds against advances without actually diluting its asset-mix.

7. Collateralized Borrowing and Lending Obligation (CBLO)

A Collateralized Borrowing and Lending Obligation (CBLO) is a short-term money market instrument that allows entities to borrow and lend funds against collateral, typically government securities, for managing liquidity and short-term funding requirements.

It facilitates short-term borrowing and lending, helping financial institutions manage their liquidity and funding needs.

Participants in CBLO

CBLO is used by financial institutions to manage their short-term funding and investment needs.

How it works?

The borrower sells the CBLO to the lender, and the lender buys it, effectively lending money to the borrower. The CBLO includes terms and conditions, including maturity, which can range from overnight to about one week.

5. Capital Market

Capital market is a market for equity shares and long-term debt. In this market, the capital funds comprising of both equity and debt are issued and traded. Capital market includes financial instruments with more than one year maturity.

Capital market is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets (e.g., the money market).

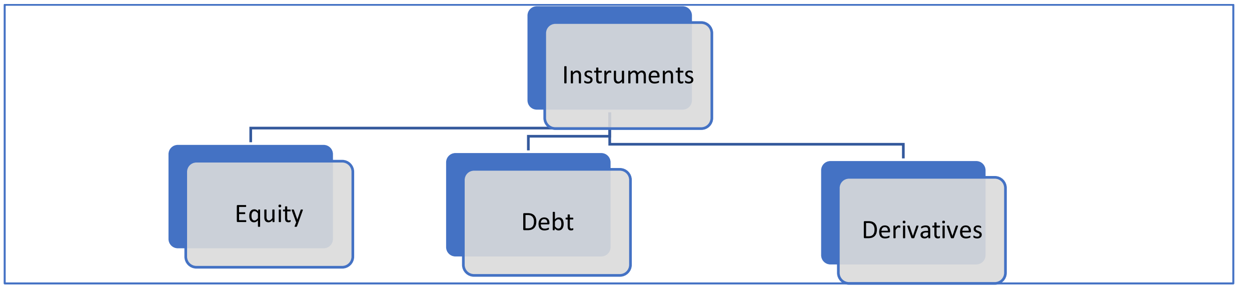
The capital market is characterized by a large variety of financial instruments:

Equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc.

A capital market can be classified into primary and secondary markets.

The primary market is meant for new issues and the secondary market is one where outstanding issue are traded. In other words, the primary market creates long-term instruments for borrowings, whereas the secondary market provides liquidity through the marketability of these instruments.

The secondary market is also known as the stock market. Following types of instruments are traded in the capital market.



(a) Domestic Equity issues by — Corporates (primary issues) — Financial intermediaries (secondary issues)

(b) Debt instruments by — Government (primary issues) — Corporates (primary issues) — Financial intermediaries (secondary issues)

External issues

(a) External Equity issues through issue of — Global Depository Receipts (GDR) and American Depository Receipts (ADR)

(b) Debt instruments through — External Commercial Borrowings (ECB)

(c) Other External Borrowings Foreign Direct Investments (FDI) — in equity and debt form Foreign Institutional Investments (FII) — in the form of portfolio investments Non-resident Indian Deposits (NRI) — in the form of short-term and medium-term deposits.

Functions of Capital Market

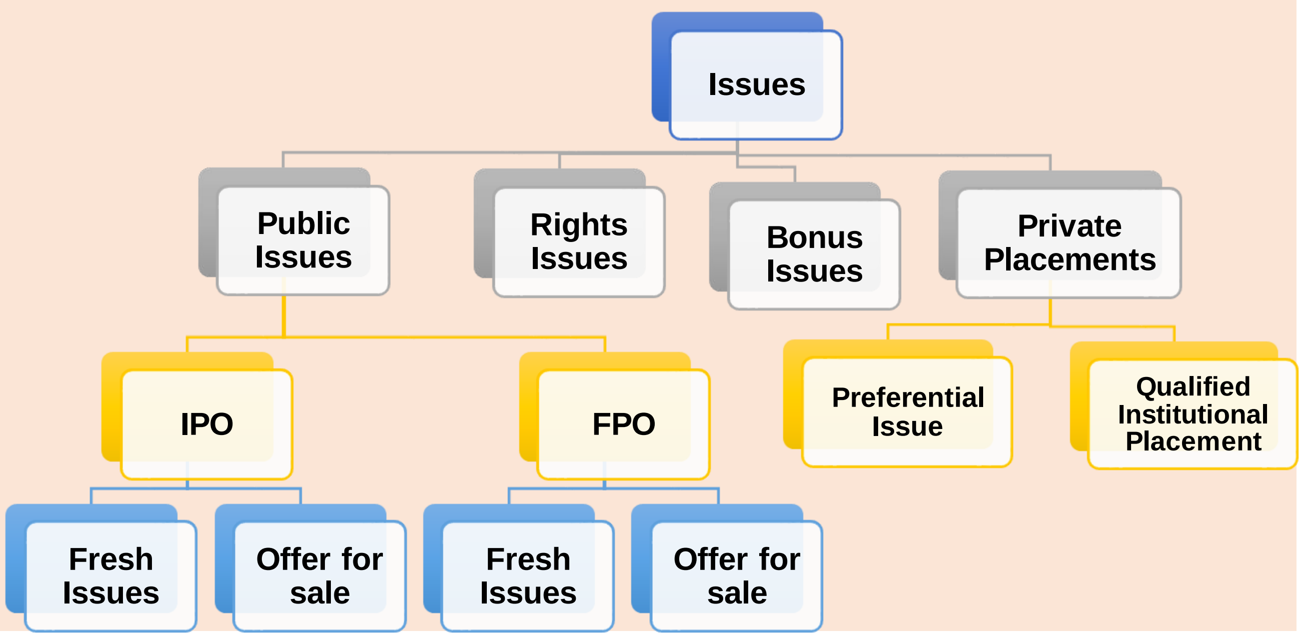
The functions of an efficient capital market are as follows:

(i) Mobilises long-term savings to finance long-term investments.
(ii) Provide risk capital in the form of equity or quasi-equity to entrepreneurs.
(iii) encourage broader ownership of productive assets.
(iv) Provide liquidity with a mechanism enabling the investor to sell financial assets.
(v) lower the costs of transactions and information.
(vi) Improve the efficiency of capital allocation through a competitive pricing mechanism.
(vii) Enable quick valuation of financial instruments-both equity and debt.
(viii) Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund.

5.1 Primary Market

The primary market is a market for new issues. It is also called the new issues market. Funds are mobilized in the primary market through prospectus, rights issues, and private placement.
Initial Public Offering (IPO) refers to the process where private companies sell their shares to the public to raise equity capital from the public investors. The process of IPO transforms a privately-held company into a public company. This process also creates an opportunity for smart investors to earn a handsome return on their investments.

Types of Issues in Primary Market



(i) **Public Issue:** Initial Public offering (IPO)- this is the offer of sale of securities of an unlisted company for the first time. Follow-on Public Offering (FPO)-This is the offer of sale of securities by listed Company.

(ii) **Rights Issue:** If a company issue share in the market to raise additional capital, the existing members are given the first preference to apply for new shares in proportion to their existing share holdings. this is known as right issue mentioned in sec 62(1) of the Companies act 2013.

(iii)**Bonus Issue:** Bonus issues are made by the company when it has huge number of accumulated reserves and wants to capitalize the reserves. Bonus shares are issued on fully paid-up shares only, to the existing shareholders free of cost. sec 63 of companies act states this.

(iv) **Private placement:** When an issuer makes an issue of shares or convertible securities to a select group of persons not exceeding 49, and which is neither a rights issue nor a public issue, it is called a private placement. Private placement of shares or convertible securities by listed issuer can be of three types:

(a) **Preferential allotment**: When a listed issuer issues shares or convertible securities, to a select group of persons in terms of provisions of Chapter VII of SEBI (ICDR) Regulations, 2009, it is called a preferential allotment. The issuer is required to comply with various provisions which inter-alia include pricing, disclosures in the notice, lock-in etc., in addition to the requirements specified in the Companies Act.

(b) **Qualified institutions placement (QIP):** When a listed issuer issues equity shares or non-convertible debt instruments along with warrants and convertible securities other than warrants to Qualified Institutions Buyers only, in terms of provisions of Chapter VIII of SEBI (ICDR) Regulations, 2009, it is called a QIP.

(c) **Institutional Placement Programme (IPP):** When a listed issuer makes a further public offer of equity shares, or offer for sale of shares by promoter/promoter group of listed issuers in which the offer, allocation and allotment of such shares is made only to qualified institutional buyers in terms Chapter VIII A of SEBI (ICDR) Regulations, 2009 for the purpose of achieving minimum public shareholding, it is called an IPP.

(v) **Bought out deals:** When the new issued shares of an unlisted company are bought large by investor or by small investors in group it is known as the bought-out deal.

(vi) **Depository Receipts:** issue of negotiable equity instruments by Indian companies for rising capital from the international capital market. Example- ADRs, GDRs.

Intermediaries to an Issue of Shares in Primary Market

(i) Merchant Bankers

(ii) Bankers to an issue

(iii) Registrar to an issue

(iv) Underwriters to the issue

(v) Debenture Trustees

(vi) Investment Banks

(vii) Depositories

(viii) Portfolio Managers

(ix) Custodians

(x) Investment banks

Initial Public Offering (IPO)

In the primary market, securities are directly issued by companies to investors. Securities are issued either by an Initial Public Offer (IPO) or a Further Public Offer (FPO).

Initial Public Offering (IPO) refers to the process where private companies sell their shares to the public to raise equity capital from the public investors. The process of IPO transforms a privately-held company into a public company. This process also creates an opportunity for smart investors to earn a handsome return on their investments.

The institutional investors, high net worth individuals (HNIs) and the public can access the details of the first sale of shares in the prospectus. The prospectus is a lengthy document that lists the details of the proposed offerings.

The SEBI has laid down eligibility norms for entities raising funds through an IPO and an FPO. The entry norms for making an IPO of equity shares or any other security which may be converted into or exchanged with equity shares at a later date are as follows:

- ✓ Entry Norm I- Profitability Route
- ✓ Entry norm II- QIB Route
- ✓ Entry norm III- appraisal route

However, the SEBI has exempted the following entities from entry norms:

- ❖ Private sector banks.
- ❖ Public sector banks.
- ❖ An infrastructure company whose project has been appraised by a PFI or IDFC or IL&FS or a bank which was earlier a PFI and not less than 5 per cent of the project cost is financed by any of these institutions.
- ❖ Rights issue by a listed company.

The IPO process in India consists of the following steps:

- ❖ Appointment of merchant banker and other intermediaries
- ❖ Registration of offer document
- ❖ Marketing of the issue
- ❖ Post- issue activities

Eligibility of the Issuer

An issuer cannot make a public issue or rights issue of equity shares and convertible securities under the following conditions:

(a) If the issuer, any of its promoters, promoter group or directors or selling shareholders are debarred from accessing the capital market by SEBI, or of any other company which is debarred from accessing the capital market under the order or directions made by SEBI.

(b) Unless an application is made to one or more stock exchanges for “in principle” approval of listing of equity shares and convertible securities on such stock exchanges and has chosen one of them as a designated stock exchange. In case of an initial public offer, the issuer should make an application for listing in at least one recognised stock exchange having nationwide trading terminals.

(c) Unless it has entered into an agreement with a depository for dematerialisation of equity shares and convertible securities already issued or proposed to be issued.

(d) Unless all existing partly paid-up equity shares of the issuer have either been fully paid up or forfeited.

(e) Unless firm arrangements of finance through verifiable means towards 75% of the stated means of finance, excluding the amount to be raised through the proposed public issue or rights issue or through existing identifiable internal accruals, have been made.

(f) Promoter’s holding is in dematerialised form prior to filing of offer document.

(g) The amount for general corporate purposes as mentioned in the objects of the issue in the draft offer document shall not exceeds 25% of the amount raised by the issuer.

(h) A public issue of equity securities, if the issuer or any of its promoters or directors is a wilful defaulter; or

(i) Issue shall be open for at least 3 days and not more than 10 days.

(j) Minimum subscription shall be 90% of the issuer size failing which the application money has to be refunded within 15 days of closure of the issue.

Appointment of Merchant banker and other intermediaries

The issuer shall appoint one or more merchant bankers, and at least one of whom should be a lead merchant banker. The issuer should also appoint SEBI registered intermediaries, in consultation with the lead merchant banker, to carry out the obligations relating to the issue. Where the issue is managed by more than one merchant banker, the rights, obligations and responsibilities, relating, inter alia to disclosures, allotment, refund and underwriting obligations, if any, of each merchant banker should be predetermined and disclosed in the offer document.

(1) The issuer shall, in case of an issue made through the book building process, appoint syndicate member(s) and in the case of any other issue, appoint bankers to issue, at various centres.

(2) The issuer shall appoint a Registrar to the issue, registered with the Board, which has connectivity with all the depositories:

(3) The issuer shall appoint a compliance officer who shall be responsible for monitoring the compliance of the securities laws and for redressal of investors

Other conditions for Initial Public Offer

(a) An issuer may make an initial public offer only in following cases

  (1) The issuer has net tangible assets of at least Rs. 3 crores in each of the preceding 3 years (of 12 months each) of which not more than 50% are held in monetary assets. If more than 50% of the net tangible assets are held in monetary assets, then the issuer has to make firm commitment to utilize such excess monetary assets in its business or project. The 50% criteria will not apply in case of IPO entirely through offer for sale.

  (2) It has a minimum average pre-tax operating profit of Rs.15 crores, calculated on a restated and consolidated basis, during the 3 most profitable years out of the immediately preceding 5 years.

  (3) The issuer company has a net worth of at least Rs.1 crore in each of the preceding 3 full years (of 12 months each).

  (4) In case of change of name by the issuer company within last one year, at least 50% of the revenue for the preceding 1 year should have been earned by the company from the activity indicated by the new name.

(b) Any issuer not satisfying any of the conditions stipulated above may make an initial public offer if:

The issue is made through the book building process and the issuer undertakes to allot at least 75% of the net offer to public to qualified institutional buyers and to refund full subscription monies if it fails to do so.

(c) An issuer may make an initial public offer of convertible debt instruments without making a prior public issue of its equity shares and listing, provided company has not defaulted payment of principal/ interest for a period of 6 months.

(d) An issuer cannot make an allotment pursuant to a public issue if the number of prospective allottees are less than one thousand.

(e) No issuer can make an initial public offer if there are any outstanding convertible securities or any other right which would entitle any person any option to receive equity shares after the initial public offer.

(f) If the issue size is more than Rs.100 crores, a Bank/PFI shall monitor and report on quarterly basis till 95% utilisation of the proceeds.

(g) the issuer may obtain grading for its IPO from one or more Credit Rating Agencies (CRA)s registered with SEBI.

Pricing of shares in Public Issues

The issuer determines the price of the equity shares and convertible securities in consultation with the lead merchant banker or through the book building process. In case of debt instruments, the issuer determines the coupon rate and conversion price of the convertible debt instruments in consultation with the lead merchant banker or through the book building process. The issuer may mention a price or price band in offer document and a floor price in red running prospectus. The issue price shall not be less than the face value.

Differential Pricing

An issuer may offer equity shares and convertible securities at different prices, subject to the following condition:

(a) The retail individual investors/shareholders or employees entitled for reservation making may be offered equity shares at a price which is not lower than 10% the price at which net offer is made to other categories of applicants.

(b) In case of a book-built issue, the price of the equity shares and convertible securities offered to an anchor investor cannot be lower than the price offered to other applicants.

(c) In case the issuer opts for the alternate method of book building, the issuer may offer specified securities to its employees at a price lower than the floor price. However, the difference between the floor price and the price at which equity shares and convertible securities are offered to employees should not be more than 10% of the floor price.

(d) Face value may be less than 10 but not less than Rs.1 if the issue price is Rs.500 or more per share. If issue price is less than Rs. 500 the face value shall be Rs.10 per share.

Promoters' Contribution

In case of an initial public offer, the minimum contribution should not be less than 20% of the post issue capital.

Lock-in of specified securities held by promoters.

(a) minimum promoters' contribution is locked-in for a period of 3 years from the date of commencement of commercial production or date of allotment in the public issue, whichever is later.

(b) promoters' holding in excess of minimum promoters' contribution is locked-in for a period of 1 year. However, excess promoters' contribution in a further public offer are not subject to lock-in.

Book Building process

Book Building means a process undertaken to elicit demand and to assess the price for determination of the quantum or value of specified securities.

(a) In an issue made through the book building process, the allocation in the net offer to public category is made as follows:

(1) Not less than 35% to retail individual investors.

(2) Not less than 15% to non- institutional investors i.e. investors other than retail individual investors and qualified institutional buyers.

(3) Not more than 50% to Qualified Institutional Buyers; 5% of which would be allocated to mutual funds; provided that in addition to 5% allocation available in terms of clause (3), mutual funds shall be eligible for allocation under the balance available for qualified institutional buyers.

In an issue made through the book building process under sub-regulation (2) of regulation 6, the allocation in the net offer to public category shall be as follows:

(1) not more than 10% to retail individual investors;

(2) not more than 15% to non-institutional investors;

(3) not less than 75% to qualified institutional buyers, 5% of which shall be allocated to mutual funds:

In an issue made through the book building process, the issuer may allocate up to 60% of the portion available for allocation to qualified institutional buyers to an anchor investor in accordance with the conditions specified.

(b) In an issue made other than through the book building process, allocation in the net offer to public category will be made as follows:

(1) minimum 30% to retail individual investors, and

(2) remaining to individual applicants other than retail individual investors and other investors including corporate bodies or institutions, irrespective of the number of equity shares and convertible securities applied for.

(3) the unsubscribed portion in either of the categories specified above (point 1 and 2) may be allocated to applicants in the other category.

If the retail individual investor category is entitled to more than 50% on proportionate basis, the retail individual investors will be allocated that higher percentage.

Follow on Public Offer (FPO):

A follow-on offering (FPO) is an offer of sale of securities by a listed company. A follow-on offering can be either of two types (or a mixture of both): dilutive and non-dilutive.

For example, Google's initial public offering (IPO) included both a primary offering (issuance of Google stock by google) and a secondary offering (sale of google stock held by shareholders, including the founders).
In the case of the dilutive offering, the company's board of directors agrees to increase the share float for the purpose of selling more equity in the company. This new inflow of cash might be used to pay off some debt or used for needed company expansion. When new shares are created and then sold by the company, the number of shares outstanding increases and this causes dilution of earnings on a per share basis. Usually, the gain of cash inflow from the sale is strategic and is considered positive for the longer-term goals of the company and its shareholders. some owners of the stock however may not view the event as favorably over a more short-term valuation horizon.

One example of a type of follow-on offering is an at-the-market offering (ATM offering), which is sometimes called a controlled equity distribution in an atm offering, exchange-listed companies incrementally sell newly issued shares into the secondary trading market through a designated broker-dealer at prevailing market prices. the issuing company is able to raise capital on an as-needed basis with the option to refrain from offering shares if unsatisfied with the available price on a particular day.

The non-dilutive type of follow-on offering is when privately held shares are offered for sale by company directors or other insiders (such as venture capitalists) who may be looking to diversify their holdings. Because no new shares are created, the offering is not dilutive to existing shareholders, but the proceeds from the sale do not benefit the company in any way. Usually however, the increase in available shares allows more institutions to take non-trivial positions in the company.

As with an IPO, the investment banks who are serving as underwriters of the follow-on offering will often be offered the use of a green shoe or over-allotment option by the selling company.

A non-dilutive offering is also called a secondary market offering. Follow on Public offering is different from initial public offering.

- IPO is made when company seeks to raise capital via public investment while FPO is subsequent public contribution.
- First issue of shares by the company is made through IPO when company first becoming a publicly traded company on a national exchange while Follow on Public Offering is the public issue of shares for an already listed company.

SEBI has introduced fast track issues (FTI) in order to enable well-established and compliant listed companies satisfying certain specific entry norms/conditions to raise equity through follow-on and rights issues. These norms reduce the process of issue and thereby the time period thus enabling issuers a quick access to primary capital market. Such companies can proceed with follow-on public offers (FPOs)/right issues by filing a copy of Red Herring Prospectus (RHP)/prospectus with the registrar of companies (RoC) or the letter of offer with designated stock exchange (SE), SEBI and stock exchanges. Moreover, such companies are not required to file draft offer document for SEBI comments and to stock exchanges as the relevant information is already in the public domain.

5.2 Secondary Market

The secondary market is a market in which existing securities are resold or traded. This market is also known as the stock market. In India, the secondary market consists of recognized stock exchanges operating under rules, by-laws and regulations duly approved by the government.

Functions of Secondary Market

(i) The secondary market is a platform where investors buy and sell securities (like stocks and bonds) that have already been issued in the primary market.

(ii) The secondary market allows investors to easily convert their investments into cash by selling their securities.

(iii) The interaction of buyers and sellers in the secondary market determines the price of securities.

(iv) The secondary market enables the transfer of ownership of securities from one investor to another.

Difference between Primary and Secondary Market:

Basis of difference	**Primary Market**	**Secondary Market**
Nature of Securities	It deals with new securities, i.e. securities which were not previously available, and are offered for the first time to the investors.	It is a market for old securities which have been issued already and granted stock exchange quotation.
Sale/Purchase	Securities are acquired from issuing companies themselves.	Securities are purchased and sold by the investors without any involvement of the companies.
Nature of Financing	It provides funds to new enterprises & also for expansion and diversification of the existing one and its contribution to company financing is direct.	It does not supply additional funds to company since the company is not involved in transaction.
Liquidity	It does not lend any liquidity to the securities.	The secondary market provides facilities for the continuous purchase and sale of securities, thus lending liquidity and marketability to the securities.

Types of Secondary Market

The two main types of secondary markets are exchange-traded markets (like stock exchanges) and over-the-counter (OTC) markets.

(i) **Exchange-Traded Markets:** These are centralized platforms, like stock exchanges (e.g., National Stock Exchange (NSE), Bombay Stock Exchange (BSE), New York Stock Exchange (NYSE)), where securities are traded.

(ii) **Over-the-Counter (OTC) Markets:** These are decentralized networks where trading happens directly between buyers and sellers, without a centralized exchange. Examples include the bond market.

In India, the Securities and Exchange Board of India (SEBI) regulates the stock market. SEBI ensures that listed companies comply with regulations and disclosure requirements.

5.3 Stock Exchange

A stock exchange, also known as a securities exchange or bourse, is a marketplace where investors can buy and sell shares of publicly traded companies, bonds, and other financial instruments.

A stock exchange is defined under Section 2(3) of the Securities Contracts (Regulation) Act, 1956, 'as anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.'

Functions of Stock Exchange

(1) **Marketplace for Securities:** Stock exchanges provide a platform for investors to buy and sell shares of publicly traded companies.

(2) **Price Discovery:** They facilitate the determination of market prices for securities through the interaction of buyers and sellers.

(3) **Liquidity:** Stock exchanges enhance liquidity, making it easier for investors to buy and sell securities quickly and efficiently.

(4) **Capital Raising:** Companies can raise capital by issuing shares on the stock exchange, which funds investment and growth.

(5) **Investment Channel:** The stock exchange provides a platform for investors to allocate their capital towards potentially profitable companies.

(6) **Economic Growth:** By facilitating capital formation and investment, stock exchanges contribute to overall economic growth.

(7) **Transparency and Fair Dealing:** Stock exchanges are regulated to ensure fair and transparent trading practices, protecting investors from fraud and manipulation.

(8) **Risk Management:** They implement measures to manage market risks and ensure the stability of the financial system.

(9) **Surveillance:** Stock exchanges monitor trading activity to detect and prevent illegal or unethical behavior.

(10) **Attracting Foreign Investment:** A well-regulated and transparent stock exchange can attract foreign investors, boosting capital inflows and economic growth.

(11) **Promoting Savings and Investment:** Stock exchanges encourage savings and investment by providing a platform for individuals to invest in the stock market.

(12) **Education and Awareness:** They can play a role in educating the public about investing and the stock market.

Stock Exchanges in India

At present, in India there are 7 stock exchanges operating in India.

1. BSE Ltd.
2.Calcutta Stock Exchange Ltd.
3. Indian Commodity Exchange Limited
4. Metropolitan Stock Exchange of India Ltd.
5. Multi Commodity Exchange of India Ltd.
6. National Commodity & Derivatives Exchange Ltd.
7. National Stock Exchange of India Ltd.
(Source: SEBI Website)

Leading stock exchanges

1. **Bombay Stock Exchange (BSE):**

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

2. **National Stock Exchange (NSE):**

Founded in 1992, it's India's first dematerialized electronic exchange. It's also located in Mumbai and is known for its efficient trading platform. The NIFTY 50 index, a benchmark index, represents the performance of the top 50 large-cap stocks listed on the NSE. The National Stock Exchange (NSE) has around 2,671 listed companies, with 2,084 on the mainboard and 587 on the NSE Emerge platform as on 31st March 2025.

The products on the Exchange are organized into 3 asset classes for trading: Capital market for the listing and trading of equities, fixed income securities and the derivatives market.

Equity and equity-linked products available for trading in the cash market include stocks, IDRs, ETFs (including those benchmarked the NIFTY indices) and units of closed-ended mutual fund schemes, as well as a segment devoted to the growth of the SME's listed on EMERGE.

Under the Derivatives segment, NSE offers derivative contracts on Equity, Indices, Currency, Interest Rates and Commodities.

The fixed income securities and Debt products include Negotiated Trade Reporting in Government securities, Corporate Bonds, Sovereign Gold Bonds and other debt securities traded on multiple platforms.
(Source: NSE)

3. **Metropolitan Stock Exchange (MSEI):**

It is a recognized stock exchange by the Securities and Exchange Board of India (SEBI). It facilitates trading in the capital market, futures & options, currency derivatives and debt market segments.

4. **India International Exchange (India INX):**

A wholly-owned subsidiary of BSE, it is India's first international exchange.

5. **Multi Commodity Exchange (MCX):**

India's first listed commodity exchange, offering commodity derivatives.

6. **National Commodity and Derivatives Exchange (NCDEX):**

A commodity exchange, particularly popular for agro commodities.

7. Calcutta Stock Exchange (CSE):

While it was established in 1863, there hasn't been any trading on the CSE platform since 2013.

Segments of Stock Exchange

There are three segments in stock market.

(i) Equity Segment:

The equity segment of the stock market is where shares of publicly traded companies are bought and sold, allowing companies to raise capital and investors to potentially profit from the growth of those companies. Investors purchase shares with the expectation that the value of those shares will increase over time, allowing them to sell them later at a higher price for a profit.

Key Participants:

(a) **Companies:** Companies list their shares on stock exchanges to raise capital from investors.

(b) **Investors:** Individuals and institutions who buy and sell shares in the market.

(c) **Stock Exchanges:** Platforms like the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) facilitate the trading of shares.

Types of trading:

(a) **Spot/Cash Market:** Stocks are traded for immediate delivery and payment.

(b) **Futures Market:** Stocks are traded with a contract to buy or sell at a predetermined price and date in the future.

Important Considerations:

(a) **Risk:** Equity investments involve risk, as the value of shares can fluctuate, and investors could lose money.

(b) **Regulation:** The equity market is regulated by financial watchdogs to ensure fair and transparent trading practices.

(ii) Derivative Segments:

Derivatives are financial contracts whose value is derived from (or "derivative" of) an underlying asset, a group of assets, or a benchmark.

Examples of Derivatives: Common types of derivatives include futures, options, forwards, and swaps.

Futures: Contracts obligating the buyer to purchase and the seller to sell an underlying asset at a predetermined price and future date.

Options: Contracts giving the holder the right, but not the obligation, to buy (call option) or sell (put option) an underlying asset at a specified price before or on a specific expiration date.

Why use Derivatives?

(a) **Hedging:** Derivatives can be used to protect against potential losses in the underlying asset's price.

(b) **Speculation:** Investors can bet on the future price movements of an underlying asset.

Who uses Derivatives?

(a) **Hedgers:** Individuals or businesses who use derivatives to reduce their exposure to price fluctuations.

(b) **Speculators:** Investors who bet on the future price movements of the underlying asset, aiming to profit from those movements.

Where to trade Derivatives?

(a) **Exchange-Traded Derivatives:** These are standardized contracts traded on organized exchanges, like the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) in India.
(b) **Over-the-Counter (OTC) Derivatives:** These are privately negotiated contracts between two parties and are not traded on an exchange

(iii) Debt Segment

In the stock market, the "debt segment" (also known as the debt market) is a platform where investors buy and sell debt securities, or fixed-income instruments, such as bonds and treasury bills, issued by governments, corporations, and financial institutions.

Who uses it:

(a) **Issuers:** Governments, corporations, financial institutions, and public sector units use the debt market to raise funds by issuing debt securities.
(b) **Investors:** Individuals and institutions invest in these debt securities to earn a fixed income or capital appreciation.

Types of debt instruments traded:

(a) **Government securities: Treasury bills, government bonds.**
(b) **Corporate bonds: Bonds issued by companies.**
(c) **Other debt instruments: Commercial papers, certificates of deposit, corporate debentures, floating rate bonds, zero-coupon bonds.**

How it works:

(a) Issuers offer debt securities to investors, promising to repay the principal amount along with interest payments.
(b) Investors purchase these securities, effectively lending money to the issuers.
(c) The debt market provides a platform for trading these securities, allowing investors to buy and sell them among themselves.

Examples of Debt Segment in India

(a) **BSE (formerly Bombay Stock Exchange):** The BSE has a debt segment where various debt instruments are traded.
(b) **NSE (National Stock Exchange):** The NSE also has a debt segment for trading debt securities.
(c) **Wholesale Debt Market (WDM):** A formal trading platform for trading a wide range of debt securities.

6. Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India was constituted as a non-statutory body on April 12, 1988 through a resolution of the Government of India.

The Securities and Exchange Board of India (SEBI), is a statutory regulatory body established in the year 1992 to protect investor interests, promote the development of the securities market, and regulate its functioning to ensure transparency and fairness.

Objectives of SEBI

(A) Investor Protection:

(i) **Ensuring fair practices:** SEBI aims to prevent unfair or fraudulent practices in the securities market, such as insider trading, price manipulation, and misleading statements.

(ii) **Promoting transparency:** SEBI mandates that companies disclose information accurately and transparently to investors, enabling them to make informed investment decisions.

(iii) **Providing investor education and awareness:** SEBI conducts investor education programs and produces educational materials to empower investors with knowledge and skills to make informed decisions.

(iv) **Addressing investor grievances:** SEBI provides a platform for investors to lodge complaints and facilitates their resolution.

(B) Regulation of the Securities Market:

(i) **Regulating intermediaries**: SEBI regulates the activities of various intermediaries in the securities market, such as stockbrokers, merchant bankers, and investment advisors, to ensure they adhere to ethical standards and regulations.

(ii) **Regulating takeovers**: SEBI regulates the takeover of companies to ensure that takeovers are done in a fair and transparent manner and that investors' interests are protected.

(iii) **Preventing market manipulation:** SEBI monitors the market for any signs of manipulation and takes action against those involved in such activities.

(C) Promoting Sustainable Market Growth:

(i) **Developing a robust secondary market:** SEBI plays a crucial role in developing a robust secondary market by introducing reforms and initiatives to enhance liquidity, transparency, and efficiency in trading.

(ii) **Fostering innovation**: SEBI encourages innovation in the financial technology realm while maintaining the stability and fairness of the securities market.

(iii) **Promoting financial literacy**: SEBI promotes financial literacy among the general public to encourage informed investment decisions.

Functions of SEBI

(A) Regulatory Functions:

(i) **Protecting Investor Interests:** SEBI's primary goal is to safeguard investors in the securities market by preventing fraud, ensuring fair practices, and providing redressal mechanisms.

(ii) **Regulating Market Participants:** SEBI regulates various market participants, including stock exchanges, brokers, mutual funds, and other intermediaries, ensuring they adhere to regulations and guidelines.

(iii) **Monitoring and Preventing Unfair Practices:** SEBI monitors the market for any signs of malpractices, such as insider trading, market manipulation, and fraudulent activities, and takes action to prevent them.

(iv) **Formulating Regulations and Guidelines:** SEBI formulates regulations and guidelines that govern the securities market, ensuring a fair, transparent, and efficient environment for investors.

(v) **Enforcing Regulations:** SEBI has the power to investigate violations of regulations and take enforcement actions against those who violate them.

(vi) **Regulating Takeovers:** SEBI regulates and oversees the process of corporate takeovers, ensuring fair and transparent procedures.

(vii) **Regulating Mutual Funds:** SEBI regulates the operations of mutual funds, ensuring that they operate in a fair and transparent manner.

(viii) **Regulating Credit Rating Agencies:** SEBI regulates the operations of credit rating agencies, ensuring that they provide accurate and reliable credit ratings.

(ix) **Regulating Depositories:** SEBI regulates the operations of depositories, ensuring that they operate in a fair and transparent manner.

(x) **Regulating Securities Market Intermediaries:** SEBI regulates the operations of various intermediaries in the securities market, including brokers, portfolio managers, and investment advisors.

Developmental Functions:

(i) Promoting Financial Literacy: SEBI conducts research and training programs to promote financial literacy among investors, helping them make informed decisions.

(ii) Developing the Securities Market: SEBI takes measures to promote the development of the securities market, including promoting new products and services, and improving market infrastructure.

(iii) Training Intermediaries: SEBI organizes training programs for intermediaries to enhance their skills and knowledge.

(iv) Promoting Self-Regulatory Organizations: SEBI encourages the formation of self-regulatory organizations to promote ethical and responsible conduct in the market.

Powers of SEBI

The SEBI has three main powers:

(i) Quasi-Judicial: SEBI can issue rulings against fraud and other unethical behaviour in the securities industry. This powerful authority allows SEBI to promote and encourage fairness, transparency, and accountability easily.

(ii) Quasi-Executive: SEBI has the authority to enforce the rules and rulings imposed as well as to pursue legal action against those who violate them. SEBI can review and analyse your books of accounts and relevant documents if it finds any rule violations.

(iii) Quasi-Legislative: SEBI retains the authority to enact laws and regulations to safeguard investors' interest and prevent misconduct.

Since inception, SEBI issued time to time Acts, Rules, Regulations, Guidelines, Master Circulars, General Orders and Circulars

SEBI Regulations

1. Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2021 [Last amended on August 3, 2021]
2. Securities and Exchange Board of India (Issue and Listing of Non-Convertible Securities) Regulations, 2021

3. Securities and Exchange Board of India (Share Based Employee Benefits and Sweat Equity) Regulations, 2021
4. Securities and Exchange Board of India (Underwriters) (Repeal) Regulations, 2021
5. Securities and Exchange Board of India (Vault Managers) Regulations, 2021
6. Securities and Exchange Board of India (Portfolio Managers) Regulations, 2020
7. Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2019
8. Securities and Exchange Board of India (Appointment of Administrator and Procedure for Refunding to the Investors) Regulations, 2018
9. Securities and Exchange Board of India (Buy-back of Securities) Regulations 2018
10. Securities and Exchange Board of India (Depositories and Participants) Regulations, 2018
11. Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2018
12. Securities and Exchange Board of India (Settlement Proceedings) Regulations, 2018
13. Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018
14. SEBI (Procedure for Search and Seizure) Repeal Regulations, 2015
15. Securities and Exchange Board of India (Issue and Listing of Municipal Debt Securities) Regulations, 2015
16. Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015
17. Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015
18. Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014
19. Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014
20. Securities and Exchange Board of India (Research Analysts) Regulations, 2014
21. Securities and Exchange Board of India (Investment Advisers) Regulations, 2013
22. Securities and Exchange Board of India (Issue and Listing of Non-Convertible Redeemable Preference Shares) Regulations, 2013
23. Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012
24. Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
25. Securities and Exchange Board of India {KYC (Know Your Client) Registration Agency} Regulations, 2011
26. SEBI (Investor Protection and Education Fund) Regulations, 2009

27. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009
28. Securities and Exchange Board of India (Intermediaries) Regulations, 2008
29. Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008
30. Securities and Exchange Board of India (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008
31. SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007
32. SEBI (Regulatory Fee on Stock Exchanges) Regulations, 2006
33. SEBI (Self-Regulatory Organisations) Regulations, 2004 [last amended on March 6, 2017]
34. SEBI (Ombudsman) Regulations, 2003
35. SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003
36. SEBI (Procedure for Board Meetings) Regulations, 2001
37. Securities and Exchange Board of India (Employees' Service) Regulations, 2001
38. Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000
39. Securities and Exchange Board of India (Collective Investment Scheme) Regulations, 1999
40. Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999
41. SEBI (Buy Back Of Securities) Regulations, 1998 [Last amended on on March 6, 2017]
42. Securities and Exchange Board of India (Custodian) Regulations, 1996
43. Securities and Exchange Board of India (Mutual Funds) Regulations, 1996
44. Securities and Exchange Board of India (Bankers to an Issue) Regulations, 1994 [
45. Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993
46. Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993
47. Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992
48. Securities and Exchange Board of India (Stock Brokers) Regulations, 1992

Multiples Choice Questions (MCQs)

1. Which of these is not a fundamental objective of Indian Financial System?
    (a) To give time value to money
    (b) Offer Services that reduce risk of loss
    (c) Issuing Bank Notes
    (d) Provide a payment System

Answer: (c)

2. Which of the following is not a function performed by a financial system?
    (a) Saving function
    (b) Liquidity function
    (c) Social function
    (d) Risk function

Answer: (c)

3. Financial assets permit all of the following except ____________.
    (a) Consumption timing
    (b) Allocation of risk
    (c) Separation of ownership and control
    (d) Elimination of risk.

Answer: (b)

4. Which of these is not a type of Financial Assets?
    (a) Cheque
    (b) Call Money
    (c) Notice Money
    (d) Treasury Bills

Answer (a)

5. Which of the following is a type of Capital Market?
   (a) Corporate Securities Market
   (b) Government Securities Market
   (c) Long Term Loan Market
   (d) All of the Above

Answer: (d)

6. Which of the following is/are financial intermediaries?
   (a) Commercial banks
   (b) Insurance companies
   (c) Investment companies
   (d) All of the above.

Answer (d)

7. Financial intermediaries exist because small investors cannot efficiently-
   (a) Diversify their portfolios
   (b) Gather all relevant information
   (c) Assess credit risk of borrowers
   (d) All of the above

Answer (d)

8. The means by which individuals hold their claims on real assets in a well-developed economy are -.
   (a) Investment assets
   (b) Depository assets
   (c) Derivative assets
   (d) Financial assets

Answer (d)

9. When you purchase shares of corporate stock, then:
   (a) You have loaned money to the corporation
   (b) You own part of the corporation
   (c) You have made new funds available to the corporation
   (d) All of the above

Answer (b)

10. Which of the following is a short-term financial instrument?

(a) Treasury bill

(b) Share of Tata Finance Ltd.

(c) Government bond with a maturity of 2 years

(d) Residential mortgage

Answer (a)

11. All of the following are financial intermediaries except __________.

(a) Commercial banks

(b) Insurance companies

(c) Treasury

(d) Mutual funds

Answer (c)

12. A bond that is registered in the owner's name by the issuing company is called a _____________bond.

(a) Certified

(b) Coupon

(c) Registered

(d) Zero-coupon

Answer (c)

13. Gilt edged securities are the bonds issued by _____________.

(a) Big corporate

(b) Multinational corporate

(c) Global corporations

(d) Central government

Answer (d)

14. Which of the following is not a financial asset?

(a) Secured premium notes

(b) National defence gold bond

(c) Bullion

(d) Capital investment bond

Answer (c)

15. The following one is kind of fee-based activity of a financial intermediary.

(a) Hire purchase financing.

(b) Leasing

(c) Capital issue management

(d) Underwriting of shares

Answer (c)

16. Which of the following is /are not regulatory institutions?

(a) RBI

(b) SEBI

(c) IRDA

(d) IFCI

Answer (d)

17. Which of the following is a fee-based service?

(a) Hire purchase

(b) Leasing

(c) Capital issue management

(d) Underwriting

Answer (c)

18. RBI is the lender of last resort for ——————.

(a) Central Government
(b) State Governments
(c) Stock markets
(d) Commercial Banks

Answer (d)

19. Assets Management company is formed

(a) To manage bank's assets

(b) To manage mutual funds investments

(c) To construct infrastructure projects

(d) To run a stock exchange

Answer (b)

20. Prime duty of a merchant banker is

a) Maintaining records of clients

b) Giving loans to clients

(c) Working as a Capital Market Intermediary

(d) None of the above

Answer (c)

21. Which of the following is not regulated by SEBI?

(a) Foreign Institutional Investors

(b) Foreign Direct Investment

(c) Mutual Funds

(d) Depositories

Answer (b)

22. In India, Commercial Papers are issued as per the lines issued by

(a) Securities and Exchange Board of India

(b) Reserve Bank of India

(c) Forward Market Commission

(d) RBI

Answer (b)

23. Which of the following is the benefit of Depositories?

(a) Reduction in the share transfer time to the buyer

(b) Reduced Risk of stolen, fake, forged shares

(c) No Stamp duty on transfer of shares in dematerialized form

(d) All of the above

Answer (d)

24. The first computerised online stock exchange in India was

(a) NSE

(b) OTCEI

(c) BSE

(d) MCX

Answer (b)

25. Commercial paper is a type of

(a) Fixed coupon Bond

(b) Unsecured short-term debt

(c) Equity share capital

(d) Government Bond

Answer (b)

26. Secondary Market in India is regulated by

(a) Reserve Bank of India

(b) Ministry of Finance

(c) Forward Market Commission

(d) Securities and Exchange Board of India

Answer (d)

27. Certificate of Deposits can be issued for a minimum period of

(a) 45 days (b) 3 months

(c) 6 months (d) 1 year

Answer (b)

28. Registrar to an issue is an intermediary in:

(a) Primary market
(b) Secondary market
(c) Capital market
(d) Money market

Answer (a)

29. The primary function of Stock Exchange is to:

(a) mobilize savings from the public for long-term investment
(b) offer a secondary market for shares and other securities
(c) facilitate barter deals between buyer and seller holding different securities
(d) enable Reserve Bank of India to trade in Government securities in their efforts to control money supply in the economy

Ans: (b)

30. The term structure of interest rates is:

(a) the relationship between the rates of interest on all securities

(b) The relationship between the interest rate on a security and it's time to maturity

(c) The relationship between the yield on a bond and its default rate

(d) All of the above

Ans: (b)

31. Intermediaries who are agents of investors and match buyers with sellers of securities are called:

(a) Investment bankers
(b) Traders
(c) Brokers
(d) Dealers
Ans: (c)

32. If market interest rates rise ____________.

(a) Bond prices must rise.
(b) Bond prices must fall.
(c) Bond prices cannot fall.
(d) Bond prices will either rise or fall.
ANSWER: (b)

Unit 2:
Financial Intermediaries

Syllabus:

a. Banks
b. NBFCs
c. RBI
d. Other Financial Institutions

Objectives of this unit:

This Unit will enable you to develop an understanding of the following:

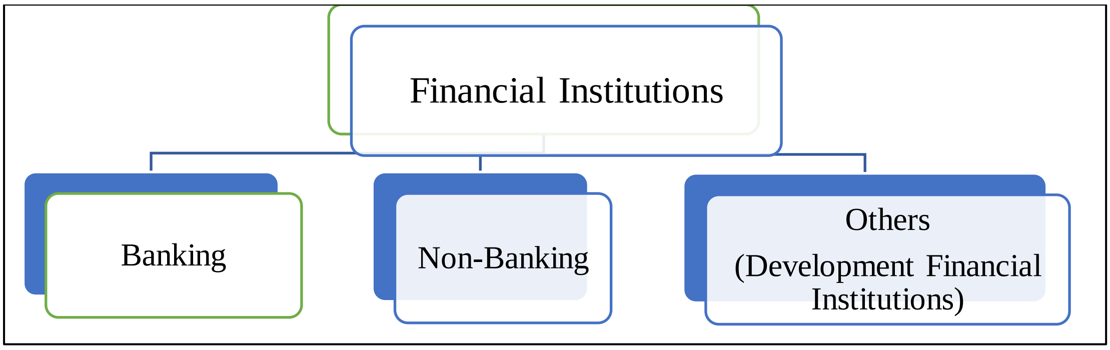
- Structure of Indian Banking system, types, functions
- Meaning and Types of NBFCs,
- Differences between Banks and NBFCs
- Role and Functions of RBI, Credit control mechanism
- Types of other financial institutions in India

Introduction

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund. Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in banking and asset management. Although in certain areas, such as investing, advances in technology threaten to eliminate the financial intermediary, disintermediation is much less of a threat in other areas of finance, including banking and insurance.

- Financial intermediaries serve as middlemen for financial transactions, generally between banks or funds.
- These intermediaries help create efficient markets and lower the cost of doing business.
- Intermediaries can provide leasing or factoring services, but do not accept deposits from the public.
- Financial intermediaries offer the benefit of pooling risk, reducing cost, and providing economies of scale, among others.

Types of Financial Institutions (FIs)



1. Banks or Banking Institutions

Banking institutions are those institutions, which participate in the economy's payment system, i.e., they provide transaction services. Their deposits liabilities constitute a major part of the national money supply and they can, as a whole, create deposits or credit, which is money.

Definition of Banks

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

"Banking company" means any company which transacts the business of banking in India.

Role of Banking Institutions

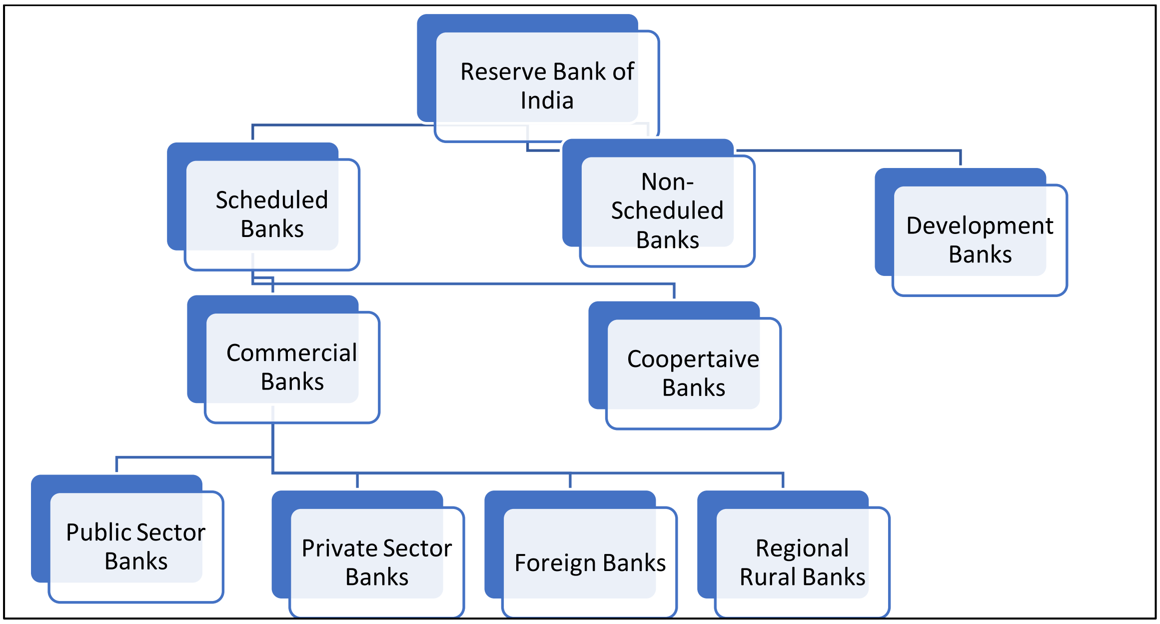
- Banking institutions mobilize the savings of the people.
- They provide a mechanism for the smooth exchange of goods and services.
- They extend credit while lending money.
- They not only supply credit but also create credit.

Characteristics of the Banking Business

As per Section 5(b) of the Banking Regulation Act,1949 are as follows:

(a) Acceptance of deposits from the public
(b) For the purpose of lending or investment
(c) Repayable on demand or otherwise
(d) Withdrawable by means of any instrument whether a cheque or otherwise

Structure of Indian Banking System



The structure of the banking system of India can be broadly divided into scheduled banks, non-scheduled banks and development banks. Banks that are included in the second schedule of the Reserve Bank of India Act, 1934 are considered to be scheduled banks. Presently, 135 scheduled commercial banks are providing banking services in India. In addition, co-operative banks and local area banks are also providing banking services in various segments in different locations of the country. For the purpose of lending to specific sectors / segments, around 9,306 Non-Banking Financial Companies (registered with RBI as on 30.6.2024) and 5 All India Financial Institutions are also catering the needs of the borrowers.

I. Commercial Banks:

Commercial banks are joint stock companies dealing in money and credit that accept demand deposits from public which are withdraw able by cheques and use these deposits for lending to others. Deposits are accepted from large group of people in forms of money and deposits are withdrawable on demand.

Commercial banks mobilize savings in urban and rural areas and make them available to large & small industrial units and trading units mainly for working capital requirements. Commercial banks provide various types of financial services to customers in return of fees.

Functions of Commercial Banks

Functions of commercial banks can be divided in two groups–Banking functions (primary functions) and non-banking functions (secondary functions).

(i) Banking Functions (primary functions): Most of banking functions are of commercial banks are discussed below:

(a) **Acceptance of deposits from public**: Bank accepts following deposits from publics: -

- (i) Demand deposits can be in the form of current account or savings account. These deposits are withdrawable any time by depositors by cheques. Current deposits have no interest or nominal interest. Such accounts are maintained by commercial firms and business man. Interest rate of saving deposits varies with time period. Savings accounts are maintained for encouraging savings of households.
- (ii) Fixed deposits are those deposits which are withdrawable only after a specific period. It earns a higher rate of interest.
- (iii) In recurring deposits, people deposit a fixed sum every month for a fixed period of time.

(b) **Advancing loans**: It extends loans and advances out of money deposited by public to various business units and to consumers against some approved. Usually, banks grant short-term or medium-term loans to meet requirements of working capital of industrial units and trading units. Banks discourage loans for consumption purposes. Loans may be secured or unsecured. Banks do not give loan in form of cash. They make the customer open account and transfer loan amount in the customer's account.

Banks grant loan in following ways: –

- (i) **Overdraft: -** Banks grant overdraft facilities to current account holder to draw amount in excess of balance held.
- (ii) **Cash credit**: - Banks grant credit in cash to current account holder against hypothecation of goods.
- (iii) **Discounting trade bills**: The banks facilitate trade and commerce by discounting bills of exchange.
- (iv) **Term loan**: Banks grant term loan to traders and to agriculturists against some collateral securities.
- (v) **Consumer credit**: Banks grant credit to households in a limited amount to buy durable goods.
- (vi) **Money at call or short-term advances**: Banks grant loan for a very short period not exceeding 7 days to dealers / brokers in stock exchange against collateral securities.

(c) **Credit creation**: Credit creation is another banking function of commercial bank. i.e., it manufactures money.

(d) **Use of cheque system:** Banks have introduced the cheque system for withdrawal of deposits. There are two types of cheques – bearer & cross cheque. A bearer cheque is encashable immediately at the bank by its possessor. A crossed cheque is not encashable immediately. It has to be deposited only in the payee's account. It is not negotiable.

(e) **Remittance of funds**: Banks provides facilities to remit funds from one place to another for their customers by issuing bank drafts, mail transfer etc.

(f) **Corporate Functions of Banks:**

(i) **Project Finance & Infrastructure Finance:** Bank provides fund based and non-fund base credit facilities for New Project as well as expansion, diversification and modernisation of existing projects in Infrastructure and Non- Infrastructure Sector. For funding large infrastructure projects, banks also syndicate loans-in which different banks come forward to share the loan amount.

(ii) **Working Capital Finance:** Banks extend credit facility by way of working capital finance, term loan, project loan, subscription to bonds and debentures/ preference shares/equity shares acquired as a part of the project finance package which is treated as 'deemed advance' and any other form of funded or non-funded finance facility.

(iii) **Export Finance:** Export Finance at pre-shipment and post shipment stage to exporters in various types of funds based and non-fund-based credit facility.

(iv) **Bill Financing:** Advances against Inland Bills in the form of limit for purchase of bills, discount of bills or advance against bills sent for collection to borrowers for their genuine trade transactions. Bills facilities are also allowed to the borrowers against bills accompanied by Railway Receipts (RRs), Motor Transport Receipts (MTRs), Govt. Supply Bills, third party DDs and cheques etc.

(ii) Non-Banking Functions (secondary functions):

Non-banking functions are (a) Agency services (b) General utility services

(a) **Agency services:** - Banks perform following functions on behalf of their customers: -

(i) It makes periodic payments of subscription, rent, insurance premium etc as per standing

(ii) orders from customers.

(iii) It collects bill, cheques, demand drafts, etc on behalf of their customers

(iv) It acts as a trustee for property of its customers.

(v) It acts as attorney. It can help in clearing and forwarding goods of its customers.

(vi) It acts as correspondents, agents of their clients.

(b) **General utility services**: General utility services of commercial banks are as follows: -

(i) Lockers are provided by bank to its customers at nominal rate.

(ii) Shares, wills, other valuables documents are kept in safe custody. Banks return them when demanded by its customers.

(iii) It provides travellers cheque and ATM facilities.

(iv) Banks maintain foreign exchange department and deal in foreign exchange.

(v) Banks underwrites issue of shares and debentures of concerns.

(vi) It compiles statistics and business information relating to trade & commerce.

(vii) It accepts public provident fund deposits.

Types of Commercial Banks

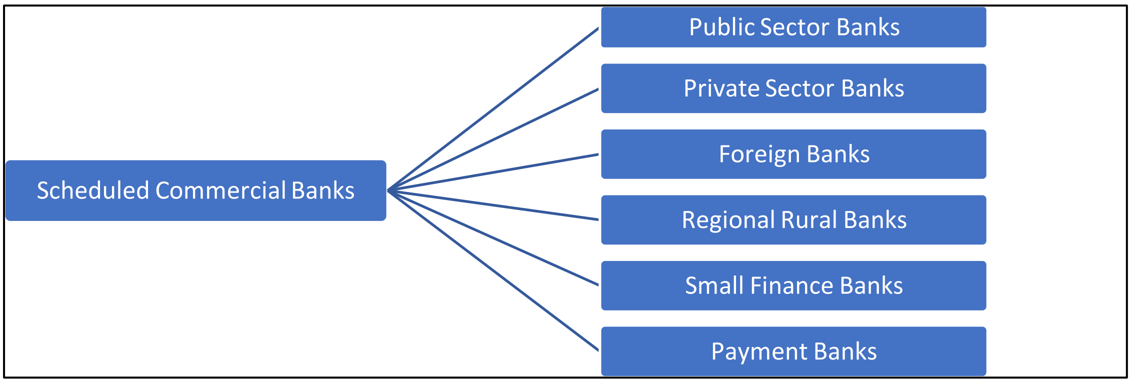
Commercial Banks refer to both scheduled and non-scheduled commercial banks which are regulated under the Banking Regulation Act, 1949.

(A) Scheduled Commercial Banks

A scheduled bank is so called because it has been included in the Schedule-II of the Reserve Bank of India Act, 1934. To be eligible for this inclusion, a bank must satisfy the following three conditions:
(i) It must have a paid-up capital and reserves of an aggregate value of at least Rs. 5.00 lakh.
(ii) It must satisfy the RBI that its affairs are not conducted in a manner damaging to the interests of its depositors; and
(iii) It must be a corporation and not a partnership or a single-owner firm.
Scheduled banks enjoy certain advantages: - (i) Free / concessional remittance facilities through the offices of the RBI and its agents. (ii) Borrowings facilities from the RBI by depositing necessary documents. In return, the scheduled banks are under obligation to: -

(i) maintain an average daily balance of cash reserves with the RBI at rates stipulated by it; and
(ii) submit periodical returns to the RBI under various provisions of the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 (as amended from time to time).

Scheduled Commercial Banks are grouped under following categories:



Scheduled Commercial Banks comprise of Public Sector Banks, Regional Rural Banks, Private Sector Banks, Small Finance Banks (SFBs), Scheduled Payments Banks and Foreign Banks. Public Sector banks comprise of State Bank of India (including erstwhile associate banks and Bharatiya Mahila Bank of period prior to April 1, 2017) and Nationalized banks. IDBI Bank Limited which was classified as" Public Sector Banks" before January 21, 2019, is now classified as "Private Sector Banks".

1. **Public Sector Banks:** State Bank of India and 11 Nationalised Banks are established under the State Bank of India Act, 1955 and Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, respectively.

List of Public Sector Banks

(i) Bank of Baroda
(ii) Bank of India
(iii) Bank of Maharashtra
(iv) Canara Bank
(v) Central Bank of India
(vi) Indian Bank

(vii) Indian Overseas Bank
(viii) Punjab National Bank
(ix) Punjab & Sind Bank
(x) State Bank of India
(xi) Union Bank of India
(xii) UCO Bank

2. **Private Sector Banks:** Private Sector Banks are banking companies licensed to operate under Banking Regulation Act, 1949.

   New Private Sector Banks

   (i) Axis Bank Ltd
   (ii) Development Credit Bank Ltd
   (iii) HDFC Bank Ltd
   (iv) ICICI Bank Ltd
   (v) IndusInd Bank Ltd
   (vi) Kotak Mahindra Ltd
   (vii) Yes Bank Ltd
   (viii) IDFC Bank
   (ix) Bandhan Bank Ltd.

   Old Private sector Banks

   (i) City Union Bank Ltd.
   (ii) Dhanlaxmi Bank Ltd.
   (iii) Karnataka Bank Ltd.
   (iv) Nainital bank Ltd.
   (v) South Indian Bank Ltd.
   (vi) Catholic Syrian bank Ltd.
   (vii) Federal Bank Ltd
   (viii) Jammu & Kashmir Bank Ltd
   (ix) Karur Vysya Bank Ltd
   (x) Lakshmi Vilas Bank Ltd
   (xi) RBL Bank Ltd.
   (xii) Tamilnad Mercantile Bank Ltd.

3. **Foreign Banks:** Foreign Bank is a bank that has its headquarters outside the India but runs its offices as a private entity at any other locations in India. Such banks are under an obligation to operate under the regulations provided by RBI as well as the rule prescribed by the parent organization located outside India.
4. **Regional Rural Banks (RRB):** Regional Rural Banks (RRB) are the banks established under the Regional Rural Banks Act, 1976 with the aim of ensuring sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area notified by the Central Government. RRBs are owned jointly by the Government of India, the State Government and Sponsor Banks.
5. **Small Finance Banks:** Small Finance Banks licensed under Banking Regulation Act, 1949 and created with an objective of furthering financial inclusion by primarily undertaking basic banking activities to un-served and underserved sections including small business

units, small and marginal farmers, micro and small enterprises and other underserved sections.

On 27 November 2014, the Reserve Bank of India issued the required guidelines that have to be followed for licensing of small finance banks in the private sector. The small finance bank shall primarily undertake basic banking activities of acceptance of deposits and lending to the unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities.

List of Small Finance Banks (2015)

(i) Au Financiers (India) Ltd., Jaipur
(ii) Capital Local Area Bank Ltd., Jalandhar
(iii) Disha Microfin Private Ltd., Ahmedabad
(iv) Equitas Holdings Private Limited, Chennai
(v) ESAF Microfinance and Investments Private Ltd., Chennai
(vi) Janalakshmi Financial Services Private Limited, Bengaluru
(vii) RGVN (North East) Microfinance Limited, Guwahati
(viii) Suryoday Micro Finance Private Ltd., Navi Mumbai
(ix) Ujjivan Financial Services Private Ltd., Bengaluru
(x) Utkarsh Micro Finance Private Ltd., Varanasi

6. **Payment Banks:** Payment Banks are public limited companies licensed under Banking Regulation Act, 1949, with specific licensing conditions restricting its activities mainly to acceptance of demand deposits and provision of payments and remittance services.

The Reserve Bank of India issued the guidelines for licensing of payments banks on27 November 2014. The objectives of setting up of payment banks will be to process further the financial inclusion by providing (i) small savings accounts and (ii) payments/remittance services to migrant labour workforce, low-income households, small businesses, other unorganized sector entities and other users.

List of Payment Banks

(i) Aditya Birla Nuvo Limited
(ii) Airtel M Commerce Services Limited
(iii) Cholamandalam Distribution Services Limited
(iv) Department of Posts
(v) Fino PayTech Limited
(vi) National Securities Depository Limited
(vii) Reliance Industries Limited
(viii) Shri Dilip Shantilal Shanghvi
(ix) Shri Vijay Shekhar Sharma
(x) Tech Mahindra Limited
(xi) Vodafone m-pesa Limited
(xii) Tech Mahindra,
(xiii) Cholamandalam Investment and Finance Company
(xiv) IDFC Bank and Telenor Financial Services

7. **Regional Rural Banks (RRBs):** The Government of India promulgated on September 26, 1975, the Regional Rural Bank Ordinance, to set up regional rural banks throughout the country; the Ordinance was replaced by the Regional Rural Banks Act, 1976. The main objective of the regional rural banks is to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in rural areas. There are 43 Regional Rural Banks (RRBs) in India, with 21,856 branches across 26 States and 3 UTs. They are sponsored by 12 Scheduled Commercial Banks (SCBs).

Objectives of RRBs

The following are the main objectives of regional rural banks:

(i) To provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans, small entrepreneurs and other weaker sections.

(ii) To develop agriculture, trade, commerce, industry and other productive activities in the rural areas.

(iii) To provide easy, cheap and sufficient credit to the rural poor and backward classes and save them from the clutches of money lenders.

(iv) To encourage entrepreneurship.

(v) To increase employment opportunities.

(vi) To reconcile rural business aims and social responsibilities.

Functions of RRBs

The functions of Regional Rural Bank are as follows:

(i) Granting of loans and advances to small and marginal farmers and agricultural labourers, either individually or in groups.

(ii) Granting of loans and advances to co-operative societies, agricultural processing societies and co-operative farming societies primarily for agricultural purposes or for agricultural operations and other related purposes.

(iii) Granting of loans and advances to artisans, small entrepreneurs and persons of small means engaged in trade, commerce and industry or other productive activities within a specified region.

(iv) Accepting various types of deposits.

(B) Non-scheduled Banks:

Non-scheduled banks are also subject to the statutory cash reserve requirement. But they are not required to keep them with the RBI; they may keep these balances with themselves. They are not entitled to borrow from the RBI for normal banking purposes, though they may approach the RBI for accommodation under abnormal circumstances.

Features of non-scheduled banks

(i) They are not listed in the Second Schedule of the RBI Act, 1934

(ii) They are unable to protect and serve the interests of depositors
(iii) They must meet cash reserve requirements, but not with reserve banks, but with themselves
(iv) They have a reserve capital of less than 5 lakh rupees
(v) They are typically smaller banks that serve a specific niche market

Examples of non-scheduled banks

1. Andaman and Nicobar State Cooperative Bank Ltd
2. Manipur State Cooperative Bank Ltd
3. Baroda City Co-op. Bank Limited
4. Bardoli Nagrik Sahakari Bank Ltd

Licencing of Banks

The Reserve Bank of India (RBI) issues licences to entities to carry on the business of banking and other businesses in which banking companies may engage, as defined and described in Sections 5 (b) and 6 (1) (a) to (o) of the Banking Regulation Act, 1949, respectively.
The payments bank will be registered as a public limited company under the Companies Act, 2013, and licensed under Section 22 of the Banking Regulation Act, 1949, with specific licensing conditions.

Banking Regulations in India

Indian banks are regulated by the following acts and rules:

1. Reserve Bank of India Act, 1934
2. Banking Regulation Act, 1949
3. Foreign Exchange Management Act, 1999
4. Payment and Settlement Systems Act, 2007
5. Deposit Insurance and Credit Guarantee Corporation Act, 1961

Non-performing Assets (NPA) of Banks

NPA is defined as a credit facility/advance whose:

(i) Interest and/or instalment of principal remain overdue (i.e. an amount due has not been paid on the due date fixed by the bank) for more than 90 days (one quarter) in respect of a term-loan,
(ii) Account remains 'out of order' for more than 90 days in respect of an overdraft (OD)/cash credit (CC).
(iii) Bill remains overdue for more than 90 days in case of bills purchased/discounted.
(iv) Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half-years in case of advances granted for agricultural purposes, and
(v) (v) Amount to be viewed remains overdue for more than 90 days in respect of other accounts.

Types of NPA

There are three types of NPA

(a) Sub-standard assets,

(b) Doubtful assets, and

(c) Loss assets

Sub-standard asset

A sub-standard asset is one which is classified as NPA for a period not exceeding 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure full recovery of bank dues.

Doubtful assets

A doubtful asset is one which has remained NPA for a period exceeding 12 months.

A loan classified as doubtful has all the weaknesses inherent in sub-standard assets, with the added characteristic that the weakness make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss assets

A loss asset is one where loss has been identified by the bank or its internal or external auditors, or by the RBI inspection, though the amount has not been written off wholly.

In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

NPA Management

The mechanism comprises:

(1) DRTs, (2) Recovery officers and (3) Debt Recovery Appellate Tribunals (DRATs).

Corporate debt restructuring (CRD) system

Securitization and reconstruction of Financial Assets and Enforcement of Security Interest (SRFASESI Act 2002)

IBC Code 2016

II. Cooperative Banks

Cooperative banks are financial institutions owned and controlled by their members, who are also their customers, operating on principles of cooperation, mutual aid, and democratic decision-making.

The State Cooperative Bank is a central institution at the State level which works as a final link in the chain between the small and widely scattered primary societies, on the one hand, and the money market, on the other. It balances the seasonal excess and deficiency of funds and equate the demand for and supply of capital. It takes-off the idle money in the slack season and supplies affiliated societies and Central Co-operative Banks with fluid resources during the busy season. It is the vertex of the pyramidal structure in a state for the provision of short and

medium-term credit to agriculturists on co-operative basis. These are formed by joining together all districts central cooperative banks in a particular state.
It collects funds by way of share capital, deposits from public, loan from commercial banks etc.

2. Non-Banking Financial Companies (NBFCs)

The Reserve Bank of India is entrusted with the responsibility of regulating and supervising the Non- Banking Financial Companies by virtue of powers vested in Chapter III B of the Reserve Bank of India Act, 1934.
The regulatory and supervisory objective is to:
(a) ensure healthy growth of the financial companies;
(b) ensure that these companies function as a part of the financial system within the policy framework, in such a manner that their existence and functioning do not lead to systemic aberrations; and that
(c) the quality of surveillance and supervision exercised by the Bank over the NBFCs is sustained by keeping pace with the developments that take place in this sector of the financial system.

Definition of Non-Banking Financial Companies (NBFCs)

According to the Reserve Bank of India (RBI), a Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 or 2013, that is engaged in the business of loans and advances, acquiring securities, or other financial activities, but excluding those of a banking company.
A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/ securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Difference between Banks & NBFCs

NBFCs lend and make investments and hence their activities are akin to that of banks; however, there are a few differences as given below:

(i) NBFC cannot accept demand deposits;

(ii) NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;

(iii) Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

Different Types/ Categories of NBFCs registered with the RBI

NBFCs are categorized (a) in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs, (b) non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and (c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

1. **Asset Finance Company (AFC):** An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general-purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.
2. **Investment Company (IC):** Investment company means any company which is a financial institution carrying on as its principal business the acquisition of securities,
3. **Loan Company (LC):** Loan Company means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.
4. **Infrastructure Finance Company (IFC):** Infrastructure Finance Company is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of ₹ 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.
5. **Systemically Important Core Investment Company (CIC-ND-SI):** CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions: -
   (a) it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
   (b) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
   (c) it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
   (d) it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.
   (e) Its asset size is ₹ 100 crore or above and
   (f) It accepts public funds

6. **Infrastructure Debt Fund:** Non- Banking Financial Company (IDF-NBFC) : IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5-year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.
7. **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI)**: NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:
   (a) loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding ₹1,00,000 or urban and semi-urban household income not exceeding ₹ 1,60,000;
   (b) loan amount does not exceed ₹ 50,000 in the first cycle and ₹ 1,00,000 in subsequent cycles;
   (c) total indebtedness of the borrower does not exceed ₹ 1,00,000;
   (d) tenure of the loan not to be less than 24 months for loan amount in excess of ₹ 15,000 with prepayment without penalty;
   (e) loan to be extended without collateral;
   (f) aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;
   (g) loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower
8. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.
9. Mortgage Guarantee Companies (MGC) - MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is ₹ 100 crore.
10. NBFC- Non-Operative Financial Holding Company (NOFHC) is financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

3. Reserve Bank of India (RBI)

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The RBI is the central bank of India, and regulatory body responsible for regulation of the Indian banking system and Indian currency.

RBI at a Glance

- ❖ Managed by Central Board of Directors
- ❖ India's monetary authority

- ❖ Supervisor of financial system
- ❖ Issuer of currency
- ❖ Manager of foreign exchange reserves
- ❖ Banker and debt manager to government
- ❖ Supervisor of payment system
- ❖ Banker to banks
- ❖ Maintaining financial stability
- ❖ Developmental functions
- ❖ Research, data and knowledge sharing

Functions of the Reserve Bank of India

The Reserve Bank is the umbrella network for numerous activities, all related to the nation's financial sector, encompassing and extending beyond the functions of a typical central bank. Functions of RBI are discussed below:

1. Monetary Authority
2. Issuer of Currency
3. Banker and Debt Manager to Government
4. Banker to Banks
5. Regulator of the Banking System
6. Manager of Foreign Exchange
7. Maintaining Financial Stability
8. Regulator and Supervisor of the Payment and Settlement Systems
9. Developmental Role

1. **Monetary Authority:** The RBI formulates, implements and monitors the monetary policy. Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit. The Reserve Bank's Monetary Policy Department (MPD) formulates monetary policy. The Financial Markets Department (FMD) handles day-to-day liquidity management operations. There are several direct and indirect instruments that are used in the formulation and implementation of monetary policy.
2. **Issuer of currency:** The RBI issues, exchanges and destroys currency notes as well as puts into circulation coins minted by Government of India. The objective of this function is to give the public adequate quantity of supplies of currency notes and coins and in good quality. In consultation with the government, RBI routinely addresses security issues and target ways to enhance security features to reduce the risk of counterfeiting or forgery.
3. **Banker and Debt Management to Government:** Managing the government's banking transactions is a key RBI role. Like individuals, businesses and banks, governments need a banker to carry out their financial transactions in an efficient and effective manner, including the raising of resources from the public. As a banker to the central government, the Reserve Bank maintains its accounts, receives money into and makes payments out of

these accounts and facilitates the transfer of government funds. RBI also act as the banker to those state governments that has entered into an agreement.

4. **Banker to Banks:** Like individual consumers, businesses and organisations of all kinds, banks need their own mechanism to transfer funds and settle inter-bank transactions—such as borrowing from and lending to other banks— and customer transactions. As the banker to banks, the Reserve Bank fulfils this role. In effect, all banks operating in the country have accounts with the Reserve Bank, just as individuals and businesses have accounts with their banks.
5. **Regulator of the Banking System:** The central bank has a critical role to play in ensuring the safety and soundness of the banking system—and in maintaining financial stability and public confidence in this system. As the regulator and supervisor of the banking system, the Reserve Bank protects the interests of depositors, ensures a framework for orderly development and conduct of banking operations conducive to customer interests and maintains overall financial stability through preventive and corrective measures.
6. **Manager of Foreign Exchange:** The RBI manages the Foreign Exchange Management Act, 1999. The objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India. On a given day, the foreign exchange rate reflects the demand for and supply of foreign exchange arising from trade and capital transactions. The RBI's Financial Markets Department (FMD) participates in the foreign exchange market by undertaking sales / purchases of foreign currency to ease volatility in periods of excess demand for/ supply of foreign currency.
7. **Regulator and Supervisor of Payment and Settlement Systems:** The RBI introduces and upgrades safe and efficient modes of payment systems in the country to meet the requirements of the public at large. The objective is to maintain public confidence in payment and settlement system. The Payment and Settlement Systems Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country.
8. **Maintaining Financial Stability:** Pursuit of financial stability has emerged as a key critical policy objective for the central banks in the wake of the recent global financial crisis. Central banks have a critical role to play in achieving this objective. Though financial stability is not an explicit objective of the Reserve Bank in terms of the Reserve Bank of India Act, 1935, it has been an explicit objective of the Reserve Bank since the early 2000s.
9. **Developmental role:** The RBI performs a wide range of promotional functions to support national objectives. This includes ensuring credit availability to the productive sectors of the economy, establishing institutions designed to build the country's financial infrastructure, expanding access to affordable financial services and promoting financial education and literacy.

Monetary Policy of RBI

Monetary policy refers to the policy to control the supply of credit/money in the economy. Its objective is to correct the economy's inflation and deflation situations. It states the use of financial instruments under the control of the Reserve Bank of India to achieve the ultimate objective of economic policy mentioned in the Reserve Bank of India Act, 1934 which is to standardise magnitudes such as availability of credit, interest rates, and money supply.

The primary goal of monetary policy is to maintain price stability while pursuing growth. Price stability is an essential prerequisite to sustainable growth.

The Reserve Bank of India (RBI) uses several instruments of monetary policy, including repo rate, reverse repo rate, cash reserve ratio (CRR), statutory liquidity ratio (SLR), and open market operations (OMOs) to manage liquidity and influence the money supply.

(A) Quantitative Instruments:

(i) Repo Rate: The rate at which RBI lends money to commercial banks for short periods, typically overnight. Present Repo Rate is 6.25%.

(ii) Reverse Repo Rate: The rate at which RBI absorbs liquidity from commercial banks by lending to them. Current Reverse Repo Rate is 3.35%.

(iii) Cash Reserve Ratio (CRR): The percentage of a bank's deposits that it is required to hold with RBI. The present CRR is 4.00%.

This means that banks must keep 4.00% of their Net Demand and Time Liabilities (NDTL) with the RBI as liquid cash reserves.

NDTL (Net Demand and Time Liabilities)

- "Demand liabilities" means liabilities which must be met on demand, and
- "Time liabilities" means liabilities which are not demand liabilities;
- This includes the sum of demand and time deposits held by the bank. Demand deposits are those that can be withdrawn anytime, whereas time deposits have a fixed maturity date.

(iv) Statutory Liquidity Ratio (SLR): The percentage of a bank's deposits that it is required to hold in liquid assets. The SLR is the minimum percentage of deposits that banks must keep in cash, gold, and other liquid assets. The RBI can change the SLR limit as needed, and the maximum limit is 40%. As of March 30, 2025, the Statutory Liquidity Ratio (SLR) of the Reserve Bank of India (RBI) is 18%. This means that for every ₹100 of deposits a bank holds, it must keep at least ₹18 in liquid assets.

SLR Requirement

The following lending institutions are liable to maintain an SLR, per the Banking Regulation Act 1949:

- Scheduled Commercial Banks
- Local Area Banks
- Primary (Urban) Co-operative Banks
- State Co-operative Banks
- Central Co-operative Banks

Calculation of SLR

SLR = {(Liquid assets held by the bank) / (Net demand and time liabilities (NDTL) }×100

Liquid assets such as cash, gold, and government securities. The total of these liquid assets

(v) Open Market Operations (OMOs): Buying or selling government securities by RBI in the open market to influence liquidity.

(B) Qualitative Instruments:

(i) **Liquidity Adjustment Facility (LAF):** A mechanism used by RBI to adjust liquidity in the system, including repo and reverse repo operations.
(ii) **Fine-tuning Operations:** These are small adjustments to liquidity in the market to keep the weighted average call rate (WACR) close to the policy rate.
(iii) **Marginal Standing Facility (MSF):** A facility where banks can borrow from RBI overnight against the security of government securities, at a rate higher than the repo rate.
(iv) **Standing Deposit Facility (SDF):** A facility where banks can deposit funds with RBI at a rate lower than the reverse repo rate.
(v) **Bank Rate:** The rate at which RBI lends to commercial banks as a last resort, typically used as a signal for the overall interest rate environment. The present bank rate is 6.50%.

4. Other Financial Institutions

"Other development financial institution" means a development financial institution licensed under Section 29 of the National Bank for Financing Infrastructure and Development Act, 2021.

(1) NABARD
(2) SIDBI
(3) SFCs
(4) EXIM Bank

These are discussed below:

(1) National Bank for Agriculture and Rural Development (NABARD)

NABARD is India's apex development bank, established in 1982 to promote sustainable and equitable agriculture and rural development through financial and technical support.

Role and Functions:

(a) **Apex Development Bank:** NABARD serves as the apex development bank for India, providing financial and technical support to promote rural development.
(b) **Supervisory Body:** It acts as an apex supervisory body for Regional Rural Banks, State Cooperative Banks, and District Central Cooperative Banks.
(c) **Refinance Support:** NABARD provides refinance support to financial institutions for lending to rural areas.
(d) **Infrastructure Development:** It plays a crucial role in building rural infrastructure.
(e) **Credit Planning:** NABARD prepares district-level credit plans and guides the banking industry in achieving credit targets.

Areas of Focus:

(a) **Agriculture and Related Sectors:** NABARD focuses on promoting sustainable agriculture and rural development through various initiatives.
(b) **Natural Resource Management:** It supports projects in natural resources management, including water management and watershed development.

(c) **Rural Livelihood Improvement:** NABARD works towards improving rural livelihoods through microfinance, skill development, and entrepreneurship.
(d) **Climate Change:** A significant portion of NABARD's disbursements are related to climate change adaptation and mitigation activities.

Key Initiatives:

(a) **SHG Bank Linkage Project:** NABARD is at the forefront of promoting Self-Help Groups (SHGs) and Joint Liability Groups (JLGs) for microfinance.
(b) **Watershed Development Programme:** NABARD supports projects aimed at improving land and water management, enhancing agricultural productivity, and ensuring livelihood security in rural areas.
(c) **Digitalization of Cooperatives:** NABARD is actively involved in the digitalization of Primary Agricultural Credit Societies (PACS) to enhance their efficiency and transparency.
(d) **AgriSURE:** NABARD promotes Agri-tech startups and encourages investment in the agriculture and rural sector.

(2) Small Industries Development Bank of India (SIDBI)

SIDBI, or the Small Industries Development Bank of India, is a principal financial institution mandated to promote, finance, and develop the Micro, Small, and Medium Enterprise (MSME) sector in India, established under an Act of Parliament in 1990.

Functions of SIDBI

(a) **Promotion, Financing, and Development of MSMEs:** SIDBI's primary mandate is to foster the growth and development of the Micro, Small, and Medium Enterprise (MSME) sector.
(b) **Coordination:** SIDBI coordinates the activities of various institutions involved in promoting, financing, and developing the MSME sector.
    (i) **Financial Assistance: Indirect Lending:** SIDBI provides refinance facilities to banks and financial institutions, enabling them to extend credit to MSMEs.
    (ii) **Direct Lending:** SIDBI also offers direct loans to MSMEs to address credit gaps and support their growth.
    (iii) **Fund of Funds:** SIDBI manages a fund of funds to provide equity support to startups and emerging businesses.
(c) **Promotion and Development:** SIDBI promotes entrepreneurship and provides handholding support to budding entrepreneurs, focusing on holistic development of the MSME sector through credit-plus initiatives.
(d) **Facilitator:** SIDBI acts as a facilitator, including serving as a Nodal Agency for MSME-oriented schemes of the government.
(e) **Marketing Support:** SIDBI assists MSMEs in expanding their marketing channels, both domestically and internationally.
(f) **Technology Upgradation:** SIDBI supports the modernization and technological upgradation of MSME units.
(g) **Employment Generation:** SIDBI promotes employment-oriented industries, particularly in semi-urban areas, to create jobs and prevent migration to cities.

(h) **Venture Funding:** SIDBI promotes venture funds and works with state-level venture funds to support innovation and growth.
(i) **Infrastructure Development:** SIDBI supports infrastructure development in MSME clusters through the SIDBI Cluster Development Fund (SCDF).
(j) **Green Financing:** SIDBI is launching initiatives under green financing for projects involving renewable energy, climate change, electric vehicles, and energy efficiency.
(k) **Promotion and Development:** SIDBI promotes entrepreneurship and provides handholding support to budding entrepreneurs through credit-plus initiatives.
(l) **Facilitator:** SIDBI plays a facilitator role, including serving as a Nodal Agency for MSME-oriented schemes of the Government.

Financial Assistance

(a) **Indirect Lending:** SIDBI provides financial assistance to banks, SFBs, NBFCs, MFIs, and New Age Fintechs, which in turn extend credit to MSMEs.
(b) **Direct Lending:** SIDBI offers demonstrative and innovative lending products to directly address credit gaps in the MSME sector.
(c) **Fund of Funds:** SIDBI manages the Fund of Funds to support emerging startups through equity support.

(3) State Financial Corporations (SFCs)

The State Financial Corporations Act, 1951, empowered state governments to set up SFCs. State Financial Corporations (SFCs) are the financial institutions that were set up by the state governments in India, post-Independence.

There are 18 SFCs in India, with 17 established under the State Financial Corporations Act, 1951, and the Tamil Nadu Industrial Investment Corporation Ltd. established under the Companies Act, 1949.

The objective was to provide credit and other support services to small businesses and farmers.

The important functions of State Finance Corporations are:

(i) The SFCs grant loans mainly for acquisition of fixed assets like land, building, plant and machinery.
(ii) The SFCs provide financial assistance to industrial units whose paid-up capital and reserves do not exceed Rs. 3 crore (or such higher limit up to Rs. 30 crore as may be specified by the central government).
(iii) The SFCs underwrite new stocks, shares, debentures etc., of industrial concerns.
(iv) The SFCs provide guarantee loans raised in the capital market by scheduled banks, industrial concerns, and state co-operative banks to be repayable within 20 years.

(4) Export-Import Bank of India (EXIM Bank)

The EXIM Bank is a government-owned financial institution established in 1982 to promote, finance, and facilitate India's international trade, supporting exporters and importers with financial assistance.

Different aspects of EXIM Bank are discussed below:

(a) **Objectives:** Exim Bank's primary function is to finance, facilitate, and promote India's international trade, integrating foreign trade and investment with the country's economic growth.
(b) **Establishment:** It was established in 1982 under the Export-Import Bank of India Act, 1981.
(c) **Ownership:** The bank is wholly owned by the Government of India and operates as a statutory corporation.
(d) **Services:** EXIM Bank provides a wide range of financial services to Indian exporters and importers, including export credit, pre-shipment credit, post-shipment credit, and overseas investment finance.
(e) **Global Presence**: EXIM Bank has offices across India and in select locations worldwide.
(f) **Support for Businesses**: The bank aims to boost the businesses of industries and Small and Medium Enterprises (SMEs).
(g) **Lines of Credit**: EXIM Bank extends lines of credit to various countries to promote Indian projects, products, and services.

Multiple Choice Questions

1. The Definition of 'Banking' is given in
   (a) Negotiable Instrument Act, 1881
   (b) RBI Act, 1934
   (c) The Banking Regulation Act, 1949
   (d) Contract Act
   Answer (c)

2. Which of the following banks are not commercial banks?
   (a) Foreign Banks (b) State Co-operative Banks
   (c) Private Banks (d) Regional Rural Banks
   Answer (b)
3. Cash deposit ratio means:
   (a) The percentage of cash-in-hand-balance with the Central Bank to the aggregate deposits
   (b) The percentage of total cash money received as deposits by banks
   (c) All the above
   (d) None of the above
   Answer (a)

4. A rise in the reserve ratio of banks-
   (a) Will lead to an increase in the money supply

(b) Will lead to a proportionate increase in the money supply
(c) Will lead to a decrease in the money supply
(d) None of these

Answer (c)

5. Bank conducts Government business at its branches as an agent of -

(a) RBI	(b) SBI
(c) Government of India	(d) None of the above

Answer (a)

6. Commercial banks influence money supply through
   (a) Printing of one-rupee notes
   (b) Augmentation of savings and time deposits
   (c) Provision of high denomination notes
   (d) Creation of demand deposits

Answer (d)

7. Open market operations, one of the measures taken by Reserve Bank of India (RBI) in order to control credit expansion in the economy means:
   (a) Sale or purchase of Government Securities
   (b) Issuance of different types of Bonds
   (c) Auction of Gold
   (d) To make available Direct Finance to borrowers

Answer (a)

8. Which one of the following is not a development bank of India?
   (a) Industrial Finance Corporation of India
   (b) Small Industries Development Bank of India
   (c) National Bank for Agriculture and Rural Development
   (d) State Bank of India

Answer (d)

9. The NABARD was set up in

(a) 1982	(b) 1984
(c) 1986	(d) 1991

Answer: (a)

10. Small Industries Development Bank of India is wholly subsidiary of

(a) RBI	(b) Exim Bank
(c) NABARD	(d) IDBI

Answer (d)

11. State Financial Corporation extend financial assistance to
    (a) Proprietory and partnership firms
    (b) Public and private limited companies and co-operative societies
    (c) Hindu undivided family concerns
    (d) All the above

    Answer (d)

12. The Regional Rural Banks were set up in
    (a) January 1, 1975 (b) March 11, 1975
    (c) April 1, 1975 (d) October 2, 1975

    Answer (d)

13. The commercial paper can be issued to raise deposits by-
    (a) Commercial banks (b) Reserve Bank of India
    (c) IDBI (d) Every non-banking company

    Answer: (a)

14. Time deposits mean (a)
    (a) The deposits which are lent to bank for a fixed period
    (b) Time deposits include over due fixed deposits
    (c) Time deposits do not include recurring deposits as well
    (d) Time deposits do not include deposits under Home Loan Account Scheme

    Answer: (a)

15. Which one of the following is not a national level development bank
    (a) Industrial Finance Corporation of India
    (b) Small Industries Development Bank of India
    (c) National Bank for Agriculture and Rural Development
    (d) State Financial Corporation

    Answer: (d)

16. The rate at which the RBI lends shot-term money to the banks?
    a) Prime Lending Rate
    b) Cash Reserve Ratio
    c) Repo Rate
    d) Reverse Repo Rate

    Ans: (c)

17. The rate of which discounting the bills of first class banks is done by RBI is called ______.
    (a) Discounting Rate

(b) Bank Rate
(c) Prime Lending Rate
(d) Loan Rate
ANSWER: (b)

18. The first development financial institution in India that has got merged with a bank is ____.
    (a) IDBI
    (b) ICICI
    (c) IDFC
    (d) UTI
    ANSWER: (b)

Unit 3:
Insurance (General Insurance)

Objectives of this unit:
This unit will enable you to develop an understanding of the following:

- Meaning and importance of insurance
- Principles of insurance
- Types of insurance
- Structure of insurance industry in India
- Life insurance
- General insurance (Products, General Insurance Council)
- Reinsurance
- Insurance Intermediaries
- Insurance Regulation

1. Introduction

In day-to-day life, man is confronted with various risks. However great a genius he may be, it is impossible for him to foresee all the calamities in store for him and provide necessaries for them to advance. Many happy lives are ruined either by the untimely death of the earning member of the family or by other disastrous calamities such as floods, fire, earthquakes, war, accidents, etc., which may take a heavy toll on human life. These risks cannot be known in advance as to when they win happen, and it is physically impossible for an individual to make provision against them by him.

Insurance is a device not to avert these risks but to mitigate their rigor on individuals. Insurance is defined as a cooperative device to spread the loss caused by a particular risk over several persons exposed to it and who agree to insure themselves against that risk.

The risk is the uncertainty of a financial loss. It should not be confused with the chance of loss which is the probable number of losses out of a given number of exposures. It should not be confused with peril which is defined as the cause of the loss, or with a hazard which is a condition that may increase the chance of loss.

Finally, risk must not be confused with the loss itself, which is the unintentional decline in or disappearance of value arising from a contingency.

Wherever there is uncertainty concerning a probable loss, there is a risk.

The risk is the uncertainty of a financial loss. It should not be confused with the chance of loss, which is the probable number of losses out of a given number of exposures.

It should not be confused with "peril," which is defined as the cause of the loss, or with "hazard," which is a condition that may increase the chance of loss.

2. Meaning and Definition of Insurance

Before fully elaborating on the definition of insurance; get familiar with the following terms; The definition of insurance can be made from two points:

- Functional Definition and,
- Contractual Definition.

Let's get a brief idea about the two points;

Functional Definition of Insurance:

Insurance is a cooperative device to spread the loss caused by a particular risk over some persons exposed to it and who agree to insure themselves against the risk. Thus, the insurance is; A co-operative device to spread the risk;

The system to spread the risk over many persons who are insured against the risk;

The principle to share the loss of each member of the society based on the probability of loss to their risk; and

The method to provide security against losses to the insured. Similarly, another definition can be given.

Insurance is a cooperative device for distributing losses falling on an individual or his family over many persons, each bearing a nominal expenditure and feeling secure against heavy loss.

Contractual Definition of Insurance:

Insurance is defined as a form of risk management primary insurance has been defined to be that in which a sum of money as a premium is paid in consideration of the insurance incurring the risk of paying a large sum upon a given contingency.

The insurance, thus, is a contract whereby;

- A certain sum, called premium, is charged in consideration,
- Against the said consideration, a large sum is guaranteed to be paid by the insurer who received the premium,
- The payment will be made in a certain definite sum, i.e., the loss or the policy amount, whichever may be, and
- The payment is made only upon a contingency.

A more specific definition can be given as follows "Insurance may be defined as a consisting one party (the insurer) agrees to pay to the other party (the insurer) or his beneficiary, a certain sum upon a given contingency (the risk) against which insurance is sought."

So, it is clear that every risk involves the loss of one or the other kind. The function of insurance is to spread this loss over many persons through the mechanism of cooperation.

The persons exposed to a particular risk cooperate to share the less caused by that risk whenever it takes place.

Thus, the risk is not averted, but the members share the loss of its occurrence. The Significance of this fact will be clear in the following example.

The legal definition focuses on a contractual arrangement whereby one party agrees to compensate another party for losses.

The financial definition provides for the funding of the losses. In contrast, the legal definition provides for the legally enforceable contract that spells out the legal rights, duties, and obligations of all the parties to the contract.
Every risk involves the loss of one or another kind. The function of insurance is to spread the loss over many persons who agree to co-operate with each other at the time of loss.
The risk cannot be averted, but loss occurring due to a certain risk can be distributed amongst the agreed persons.
They agree to share the loss because the chances of loss, i.e., the time, and amount to a person, are unknown. Anybody may suffer a loss to a given risk, so the rest of the persons who are agreed will share the loss.
The larger the number of such persons, the easier the process of distribution of loss.
The loss is shared by them by payment of premium which is calculated on the probability of loss. In olden times, the contribution by the persons was made at the time of loss.
Insurance is also defined as a social device to accumulate funds to meet the uncertain losses arising through a certain risk to a person insured against the risk.

3. Features of Insurance

From the above explanation, find the following characteristics, which are generally observed in life, marine, fire, and general insurances.

(i) Sharing of Risk:

Insurance is a device to share the financial losses which might befall an individual or his family in the happening of a specified event. The event may be the death of a breadwinner to the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance, and other certain events in general insurance, e.g., theft in burglary insurance, accident in motor insurance, etc. The loss arising from these events, if insured, is shared by all the insured in the form of a premium.

(ii) Co-operative Device:

The most important feature of every insurance plan is the cooperation of a large number of persons who, in effect, agree to share the financial loss arising due to a particular risk that is insured. Such a group of persons may be brought together voluntarily or through publicity or solicitation of the agents. An insurer would be unable to compensate for all the losses from his capital. So, by insuring or underwriting a large number of persons, he can pay the amount of loss. Like all cooperative devices, there is no compulsion here on anybody to purchase the insurance policy.

(iii)Value of Risk:

The risk is evaluated before insuring to charge the share of an insured, herein called, consideration or premium. There are several methods of evaluation of risks. If there is an expectation of more loss, a higher premium may be charged. So, the probability of loss is calculated at the time of insurance.

(iv)Payment at Contingency:

The payment is made at a certain contingency insured. If the contingency occurs, payment is made. Since the life insurance contract is a contract of certainty, because the contingency, the death, or the expiry of the term will certainly occur, the payment is certain. The contingency is that the fire or the marine perils, etc., may or may not occur in other insurance contracts. So, if the contingency occurs, payment is made. Otherwise, no amount is given to the policy-holder. Similarly, in certain policies, payment is not certain due to the uncertainty of a particular contingency within a particular period. For example, in term insurance, payment is made only when the assured death occurs within the specified term, maybe one or two years. Similarly, in Pure Endowment, payment is made only at the survival of the insured at the expiry of the period.

(v) Payment of Fortuitous Losses:

Another characteristic of insurance is the payment of fortuitous losses. A fortuitous loss is unforeseen and unexpected and occurs as a result of chance. In other words, the loss must be accidental. The law of large numbers is based on the assumption that losses are accidental and occur randomly. For example, a person may slip on an icy sidewalk and break a leg. The loss would be fortuitous. Insurance policies do not cover intentional issues.

(vi) Amount of Payment:

The amount of payment depends on the value of loss due to the particular insured risk provided insurance is there up to that amount. In life insurance, the purpose is not to make good the financial loss suffered. The insurer promises to pay a fixed sum on the happening of an event. If the event or the contingency takes place, the payment does fail due if the policy is valid and in force at the time of the event, like property insurance, the dependents will not be required to prove the occurring loss and the amount of loss.

It is immaterial in life insurance what was the amount of loss was at the time of contingency. But in the property and general insurances, the amount of loss and the happening of loss is required to be proved.

(vii) A large number of Insured Persons:

To spread the loss immediately, smoothly, and cheaply, a large number of persons should be insured. The co- operation of a small number of persons may also be insurance, but it will be limited to the smaller area. The cost of insurance for each member may be higher.So, it may be unmarketable. Therefore, to make the insurance cheaper, it is essential to ensure many persons or properties because the lessor would be the cost of insurance, so the lower would be the premium.

4. Benefits of Insurance

Insurance gives benefits to individuals and organizations in many ways. Some of the benefits are discussed below:

(i) The obvious benefit of insurance is the payment of losses.
(ii) It manages cash flow uncertainty when paying capacity at the time of losses is reduced significantly.
(iii) It complies with legal requirements by meeting contractual and statutory requirements, and also provides evidence of financial resources.
(iv) Insurance promotes risk control activity by providing incentives to implement a program of losing control because of policy requirements.
(v) The efficient use of the insured's resources.

(vi) It provides a source of investment funds. Insurers collect the premiums and invest those in a variety of investment vehicles.

(vii) Insurance is support for the insured's credit.

(viii) It facilitates loans to organizations and individuals by guaranteeing the lender payment at the time when collateral for the loan is destroyed by an insured event. Hence, reducing the uncertainty of the lender's default by the party borrowing funds.

(ix) It reduces the social burden by reducing uncompensated accident victims and the uncertainty of society.

5. Principles of Insurance

The contract of insurance between an insurer and insured is based on certain principles, let us know the principles of insurance in detail.

To ensure the proper functioning of an insurance contract, the insurer and the insured have to uphold the seven principles of Insurance mentioned below:

(i) Utmost Good Faith.
(ii) Proximate Cause.
(iii) Insurable Interest.
(iv) Indemnity.
(v) Subrogation.
(vi) Contribution.
(vii) Loss Minimization.

Let us understand each principle of insurance with an example:

(i) Principle of Utmost Good Faith:

The fundamental principle is that both the parties in an insurance contract should act in good faith towards each other, i.e., they must provide clear and concise information related to the terms and conditions of the contract. The Insured should provide all the information related to the subject matter, and the insurer must give precise details regarding the contract.

Example – Mr. X took a health insurance policy. At the time of taking insurance, he was a smoker and failed to disclose this fact. Later, he got cancer. In such a situation, the Insurance company will not be liable to bear the financial burden as Jacob concealed important facts.

(ii) Principle of Proximate Cause:

This is also called the principle of 'Causa Proxima' or the nearest cause. This principle applies when the loss is the result of two or more causes. The insurance company will find the nearest cause of loss to the property. If the proximate cause is the one in which the property is insured, then the company must pay compensation. If it is not a cause the property is insured against, then no payment will be made by the insured.

Example: Due to a fire, a wall of a building was damaged, and the municipal authority ordered it to be demolished. While demolition the adjoining building was damaged. The owner of the adjoining building claimed the loss under the fire policy. The court held that fire is the nearest cause of loss to the adjoining building, and the claim is payable as the falling of the wall is an inevitable result of the fire. In the same example, the wall of the building was damaged due to fire, fell due to a storm before it could be repaired, and damaged an adjoining building. The owner of the adjoining building claimed the loss under the fire policy. In this case, the fire was a remote cause, and the storm was the proximate cause; hence the claim is not payable under the fire policy.

(iii)Principle of Insurable interest:

This principle says that the individual (insured) must have an insurable interest in the subject matter. Insurable interest means that the subject matter for which the individual enters the insurance contract must provide some financial gain to the insured and also lead to a financial loss if there is any damage, destruction, or loss.

Example – The owner of a vegetable cart has an insurable interest in the cart because he is earning money from it. However, if he sells the cart, he will no longer have an insurable interest in it.

To claim the amount of insurance, the insured must be the owner of the subject matter both at the time of entering the contract and at the time of the accident.

(iv)Principle of Indemnity:

This principle says that insurance is done only for the coverage of the loss; hence insured should not make any profit from the insurance contract. In other words, the insured should be compensated the amount equal to the actual loss and not the amount exceeding the loss. The purpose of the indemnity principle is to set back the insured in the same financial position as he was before the loss occurred. The principle of indemnity is observed strictly for property insurance and does not apply to the life insurance contract.

Example – The owner of a commercial building enters an insurance contract to recover the costs for any loss or damage in the future. If the building sustains structural damages from fire, then the insurer will indemnify the owner for the costs to repair the building by way of reimbursing the owner for the exact amount spent on repair or by reconstructing the damaged areas using its authorized contractors.

(v) Principle of Subrogation:

Subrogation means one party stands in for another. As per this principle, after the insured, i.e., the individual has been compensated for the incurred loss to him on the subject matter that was insured, the rights of the ownership of that property go to the insurer, i.e., the company.

Subrogation gives the right to the insurance company to claim the amount of loss from the third party responsible for the same.

Example – If Mr. A gets injured in a road accident, due to reckless driving of a third party, the company with which Mr. A took the accidental insurance will compensate for the loss that occurred to Mr. A and will also sue the third party to recover the money paid as claim.

(vi) Principle of Contribution:

The contribution principle applies when the insured takes more than one insurance policy for the same subject matter. It states the same thing as in the principle of indemnity, i.e. the insured cannot make a profit by claiming the loss of one subject matter from different policies or companies.

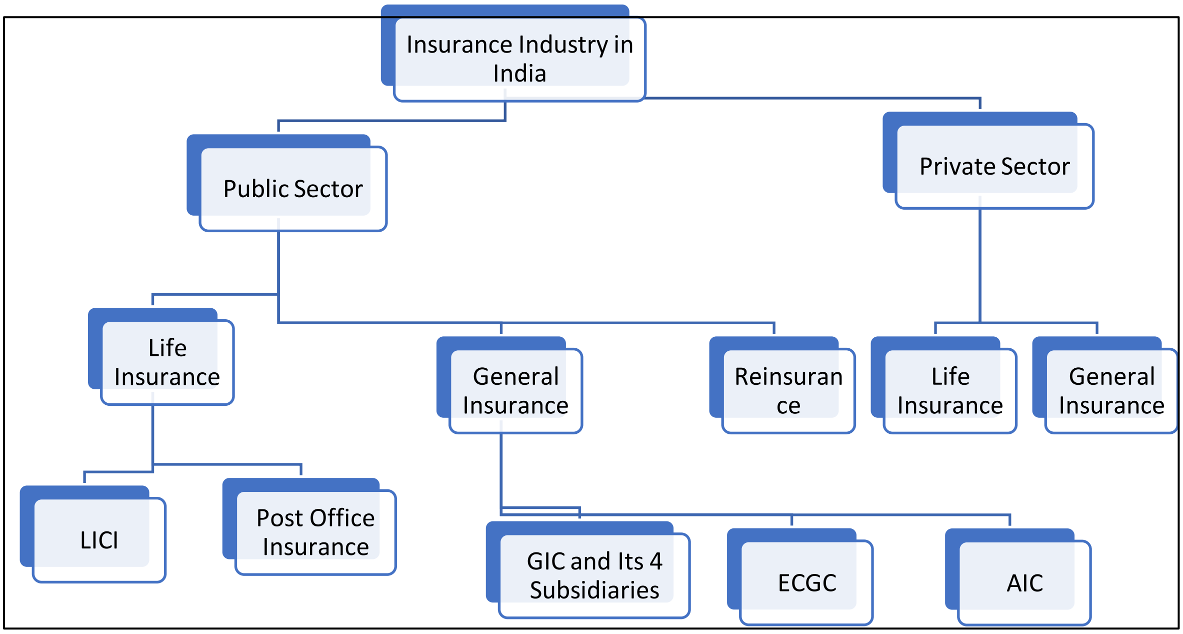
Example – A property worth Rs. 5 Lakhs is insured with Company A for Rs. 3 lakhs and with company B for `1 lakhs. The owner in case of damage to the property for 3 lakhs can claim the full amount from Company A but then he cannot claim any amount from Company B. Now, Company A can claim the proportional amount reimbursed value from Company B.

(vii) Principle of Loss Minimization:

This principle says that as an owner, it is obligatory on the part of the insurer to take necessary steps to minimize the loss to the insured property. The principle does not allow the owner to be irresponsible or negligent just because the subject matter is insured.
Example: If a fire breaks out in Insured factory, Insured should take reasonable steps to put out the fire. Insured cannot just stand back and allow the fire to burn down the factory because Insured know that the insurance company will compensate for it.

6. Structure of Insurance Industry in India

India's Insurance industry is one of the premium sectors experiencing upward growth. This upward growth of the insurance industry can be attributed to growing incomes and increasing awareness in the industry. India is the fifth largest life insurance market in the world's emerging insurance markets, growing at a rate of 32-34% each year. In recent years, the industry has been experiencing fierce competition among its peers which has led to new and innovative products within the industry.
Over the past nine years, the insurance sector has attracted substantial foreign direct investment amounting to nearly Rs. 54,000 crore (US$ 6.5 billion), driven by the government's progressive relaxation of overseas capital flow regulations.
The insurance industry of India has 57 insurance companies - 24 are in the life insurance business, while 34 are non-life insurers. Among the life insurers, Life Insurance Corporation (LIC) is the sole public sector company. There are six public sector insurers in the non-life insurance segment. In addition to these, there is a sole national re-insurer, namely General Insurance Corporation of India (GIC Re).
The insurance industry has undergone numerous transformations in terms of new developments, modified regulations, proposals for amendments and growth in 2022. These developments have opened new avenues of growth for the industry while ensuring that insurers stay relevant with changing times and the latest digital disruptions.
(Source: https://www.ibef.org/industry/insurance-sector-india dated 14.03.2025)
The structure of insurance industry in India is shown below:



There are two broad categories of insurance:

A. Life Insurance

B. General Insurance

These are discussed below:

7. Life Insurance

The insurance policy whereby the policyholder (insured) can ensure financial freedom for their family members after death. It offers financial compensation in case of death or disability. While purchasing the life insurance policy, the insured either pays the lump-sum amount or makes periodic payments known as premiums to the insurer. In exchange, of which the insurer promises to pay an assured sum to the family if insured in the event of death or disability or at maturity.

Depending on the coverage, life insurance can be classified into the below-mentioned types:

(a) **Term Insurance:** Gives life coverage for a specific period.

(b) **Whole life insurance:** Offer life cover for the whole life of an individual

(c) **Endowment policy:** a portion of premiums goes toward the death benefit, while the remaining is invested by the insurer.

(d) **Money back Policy:** a certain percentage of the sum assured is paid to the insured in intervals throughout the term as a survival benefit.

(e) **Pension Plans:** Also called retirement plans are a fusion of insurance and investment. A portion of the premiums is directed towards retirement corpus, which is paid as a lump sum or monthly payment after the retirement of the insured.

(f) **Child Plans:** Provides financial aid for children of the policyholders throughout their lives.

(g) **ULIPS:** Unit Linked Insurance Plans: same as endowment plans, a part of premiums goes toward the death benefit while the remaining goes toward mutual fund investments.

List of Registered Insurance Companies in India—Life Insurance

Public Sector: Life Insurance Corporation (LIC) of India

Private Sector:

1. Aegon Religare Life Insurance Company Ltd.
2. Aviva Life Insurance Company Ltd.
3. Bajaj Allianz Life Insurance Company Ltd.
4. Birla Sun Life Insurance Company Ltd.
5. Bharti AXA Life Insurance Company Ltd.
6. Canara HSBC Oriental Bank of Commerce Life Insurance Company Ltd.
7. DLF Pramerica Life Insurance Company Ltd.
8. Future Generali India Life Insurance Company Ltd.
9. HDFC Standard Life Insurance Company Ltd.

10. ICICI Prudential Life Insurance Company Ltd.
11. IDBI Fortis Life Insurance Company Ltd.
12. ING Vysya Life Insurance Company Ltd.
13. India First Life Insurance Company Ltd.
14. Kotak Mahindra Old Mutual Life Insurance Ltd.
15. Max New York Life Insurance Company Ltd.
16. Metlife India Insurance Company Pvt. Ltd.
17. Reliance Life Insurance Company Ltd.
18. SBI Life Insurance Company Ltd.
19. Sahara India Life Insurance Company Ltd.
20. Shriram Life Insurance Company Ltd.
21. Star Union Dai-ichi Life.
22. TATA AIG Life Insurance Company Ltd.

8. General Insurance

Everything apart from life can be insured under general insurance. It offers financial compensation for any loss other than death. General insurance covers the loss or damages caused to all the assets and liabilities. The insurance company promises to pay the assured sum to cover the loss related to the vehicle, medical treatments, fire, theft, or even financial problems during travel.

The transactions of general insurance business in India are governed by two main statutes, namely:

- The Insurance Act, 1938
- General Insurance Business (Nationalisation) Act, 1972

The Insurance Act was passed in 1938 and was brought into force from 1st July, 1939. This act applies to the GIC and the four subsidiaries. The act was amended several times in the years 1950, 1968, 1988, 1999. This Act specifies the restrictions and limitations applicable as specified by the Central Government under powers conferred by section 35 of the General Insurance Business (Nationalization) Act, 1972. The important provisions of the Act relate to:

Registration: Every insurer is required to obtain a Certificate of Registration from the Controller of Insurance, by making the payment of requisite fees. Registration should be renewed annually.

Accounts and audit: An insurer is required to maintain separate accounts of the receipts and payments in each class of insurance viz. Fire. Marine and Miscellaneous Insurance.

Apart from the regular financial statements, the companies are required to maintain the following documents in respect of each class of insurance:

- Record of Cover notes specifying the details of the risk covered
- Record of policies

- Record of premiums
- Record of endorsements
- Record of Bank guarantees
- Record of claims
- Register of agency force and business procured by each with details of commission
- Register of employees
- Cash Books
- Reinsurance details
- Claims register

General Insurance can cover almost anything, and everything but the five key types of insurance available under it are:

(a) **Health Insurance:** Covers the cost of medical care.

(b) **Fire Insurance:** give coverage for the damages caused to goods or property due to fire.

(c) **Travel Insurance:** compensates the financial liabilities arising out of non-medical or medical emergencies during travel within the country or abroad

(d) **Motor Insurance:** offers financial protection to motor vehicles from damages due to accidents, fire, theft, or natural calamities.

(e) **Home Insurance:** compensates for the damage caused to a home due to man-made disasters, natural calamities, or other threats.

General Insurance Products

General Insurance products are discussed below:

(i) Motor insurance:

Motor insurance policy is a contract between the insured and the insurer in which the insurer promises to indemnify the financial liability in event of loss to the insured.

The Motor Vehicles Act in 1939 was passed to mainly safeguard the interests of pedestrians. According to Section 24 of Motor Vehicles Act, "No person shall use or allow any other person to use a motor vehicle in a public place, unless the vehicle is covered by a policy of Insurance." Insurance of Motor Vehicles are covered under the Motor Vehicles Act 1939. Insurance of motor vehicles against damage is not made compulsory, but the insurance against third party liability arising out of the use of motor vehicles in public places is made compulsory. Insurance Cover against damage is known as "Own Damages" and against injury or death to a third party is known as "Third Party" claim. No motor vehicle can play in a public place without such insurance. Recently, pursuant to a Supreme Court decision, all Insurers are mandated to issue long term policy for Third Party risks- Three years for new private cars and five years for new two wheelers.

Motor insurance is broadly classified as follows:

(i) Private Cars- vehicles used only for social, domestic and pleasure purposes.

(ii) Private Motor cycles and Motor scooters

(iii) Commercial vehicles – sub divided into Goods carrying vehicles, Passenger carrying vehicles and Miscellaneous vehicles.

The risks under motor insurance are of two types:

(1) Legal liability due to bodily injury, death or damage caused to the property of others.

(2) Loss or damage to one's own vehicle\ injury to or death of self and other occupants of the vehicle.

When does claim arise and how to settle?

(i) The insured's vehicle is damaged or any loss incurred.

(ii) Any legal liability is incurred for death of or bodily injury

(iii) Or damage to the third party's property.

The claim settlement in India is done by opting for any of the following by the insurance company:

(a) Replacement or reinstatement of vehicle

(b) Payment of repair charges

(ii) Fire Insurance:

Fire insurance covers: (a) house, building and flats, (b) fixed assets like furniture & fixture, etc, and (c) loss of profit.

It is a comprehensive policy that generally covers loss due to fire, earthquake, riots, floods, strike, etc. This policy can be taken by the owner of the premises only. Usually, the banks, and other lending institutions and housing finance companies insist on the premises being insured against fire.

The fire rates have been revised by the government in two occasions in the years 1979 and 1987. Competition is very severe in this segment among insurance companies as maximum premium comes from corporate clients having large industrial assets. Fire insurance accounts for 20% of the total business of general insurance companies and brings most profits for them.

(iii) Marine Cargo Insurance:

Marine cargo insurance covers: (a) cargo in transit, and (b) cargo declaration policy.

Marine hull insurance covers: (i) Inland vessels, (ii) Ocean going vessels, (iii) Fishing and scaling vessels, (iv) Freight at risk, (v) Construction of ship, (vi) Voyage insurance of various vessels, (vii) Ship breaking insurance, and (viii) Oil and energy in respect of onshore and offshore risks.

With effect from April 2005, IRDA has removed the price control on insuring marine hull. Currently, marine cargos as well as marine hull insurance have come under the purview of 'file and use' regulations, as applicable to non-tariff products. The marine hull insurance represents a business of Rs. 400 crores. The competition in this sector is strong particularly after de-tariffing.

(iv) Personal Accident Insurance:

The Policy provides that, if the insured shall sustain any bodily injury resulting solely and directly from accident caused by external, violent and visible means, then the Insurance company shall pay to the insured or his legal personal representative(s), as the case may be, a Sum assured under the Policy. The Policy covers the contingency of death, loss of body parts and Permanent and Temporary disablements.

(v) Liability Insurance:

The purpose of liability insurance is to provide indemnity in respect of damages payable under law for personal liability of any nature. This legal liability may arise under the common law on the basis of negligence or under statutory law (e.g., Public Liability Insurance Act or workman's Compensation Act) on 'no fault basis', i.e. even when there is no negligence.

(vi) Engineering Insurance:

Engineering insurance covers the various risks in a manufacturing organisation, especially plants. The various categories of Engineering insurance are as follows:

(a) Contractors All Risks Policy – designed to protect the interests of contractors and principals in respect of civil engineering projects like buildings, bridges, tunnels etc.

(b) Erection All Risks Policy – is concerned with erection of electrical plant and machinery and equipment and structures involving no or very little civil engineering work.

(c) Marine-cum-erection Policy – comments with the delivery of the first consignment of plant and machinery at the site of erection.

(d) Machinery breakdown Policy – Insurable property includes boilers, electrical, mechanical and lifting equipment.

(e) Contractors Plant & Machinery Policy – Policy given to a Contractor who may be using his plant and machinery at different projects during the course of the year

(f) Boiler & Pressure Plant Policy.

(g) Machinery Loss of Profits Policy or Machinery insurance indemnify an insured against material damage resulting from breakdown or explosion or collapse of machinery – such damage may also result in business interruption at the Insured's premises.

(h) Advance Loss of Profits Policy – risk of delay of project due to accidental damage to project materials.

(i) Deterioration of Stock Policy – covers loss due to breakdown of refrigeration.

(j) Electronic Equipment Policy - physical loss or damage necessitating repairs or replacement.

(k) External Data Media – covers cost of replacing damaged external storage media.

(l) Increased cost of working – indemnifies against all additional cost incurred to ensure continued data processing on substitute equipment if such costs are incurred as an unavoidable consequence of loss or damage indemnifiable under material damage section of the policy.

(vii) Miscellaneous Insurance:

Miscellaneous Insurance products include the following products:

(a) Burglary insurance

(b) Householders' Insurance

(c) Shopkeepers' Insurance

(d) Bankers' Blanket Policies

(e) Jewellers' Block Policies

(f) Blood Stock (Horse) Insurance

(g) All Risks Insurance Policy – includes jewellery, valuables, antiques, paintings, watches, cameras etc.

(h) Money insurance – covers the risk of loss of money in transit

(i) Fidelity guarantees – covers the risk of arising out of dishonesty of employees
(j) Television insurance
(k) Pedal cycle insurance
(l) Plate Glass insurance – breakage of plain glass
(m) Neon sign insurance

(viii) Rural Insurance:

Rural insurance includes the following categories of products:
(a) Cattle Insurance
(b) Sheep and Goat Insurance
(c) Poultry Insurance
(d) Dog Insurance
(e) Silk Worm Insurance
(f) Honey Bee Insurance
(g) Horticulture/Plantation Insurance Scheme
(h) Comprehensive Floriculture Insurance
(i) Agriculture Pump set Policy
(j) Salt Works Insurance
(k) Cycle Rickshaw Policy
(l) Animal Driven Cart Insurance
(m) Gober Gas Insurance
(n) Hut Insurance
(o) Weather/Crop Insurance

Investments:

Investments of insurance company are usually made in approved investments under the provisions of the Act. The guidelines and limitations are issued by the Central Government from time to time.

Tariff Advisory Committee (TAC)

Tariff Advisory Committee (TAC) is a statutory body set up under the Insurance Act, 1938. TAC looks into the pricing of non-life insurance products. It has been broad-based with representatives from various faculties apart from insurance sector. It has revised fire insurance and engineering tariffs.

TAC determines the tariffs of the insurance industry other than for marine cargo and marine hull covers. It provides floor rates for various insurance products. It assists in preventing uneconomic competition and facilitates classification of risks-based on their characteristics. It controls and regulates the rates, terms and conditions which may be offered by insurers in respect of fire, motor and other covers.

With effect from May 2000, a simplified fire tariff has been introduced with substantial reduction in premium rates.

Large risks in which the threshold limit of probable maximum loss is ? 1,054 crore or above, at any one location, or in which the sum insured at any one location is ? 10,000 crore 01 above, have been de-tariffed. These risks have been considered as the risks beyond the tariff regime and would be guided as per the premium rates existing in international insurance markets which are substantially cheaper than the tariff rates in India. Moreover, these large risks require customisation of products which are not available in the Indian insurance market. Therefore, the insurers can issue comprehensive insurance package policy for large risk on reinsurance-based rates, terms and conditions.

As we have mentioned before that the tariff regime is getting phased out gradually, the IRDA has drafted a vision document for TAG mentioning its future role.

General Insurance Council

The General Insurance Council is an executive committee consisting of (a) nominees of IRDA [viz. member (nonlife) as chairman and executive director (non-life) and the secretary general of the council], and (b) the CEOs of all non-life insurance companies licenced by IRDA. The council organises meetings of the executive committee, chief underwriters, heads of health insurance departments, etc. periodically.

The missions of the council are: (a) Expanding and deepening penetration of non-life insurance in India, (b) Promoting a responsible and disciplined pro-consumer service regime, and (c) Imbibing best global practices by way of a self-regulatory mechanism.

As we have observed from the mission statement, the council concentrates on issues relating to (a) promotion of non-life insurance market, (b) promotion of consumer education and awareness of non-life insurance products, and (c) development of insurance intermediaries, viz. agents and brokers. The council puts forward its opinion about the industry to the government, IRDA, and other policy makers, problems existing in the industry, and cooperation needed. It also deliberates on necessity for level playing field between life and non-life insurers in health portfolio, and adopting best global practices in health management.

List of the Registered Insurance Companies in India—General Insurance

Public Sector:

1. New India Assurance Company Ltd.
2. National Insurance Company Ltd.
3. Oriental Insurance Company Ltd.
4. United India Insurance Company Ltd.
5. Export Credit Guarantee Corporation of India Ltd. (ECGCI)
6. Agricultural Insurance Company of India Ltd. (AIC)

Private Sector:

1. Acko General Insurance Limited
2. Agriculture Insurance Company of India Limited
3. Bajaj Allianz General Insurance Company Ltd.
4. Cholamandalam MS General Insurance Company Ltd.
5. Future Generali India Insurance Company Limited
6. Go Digit General Insurance Limited

7. HDFC ERGO General Insurance Company Limited
8. ICICI LOMBARD General Insurance Company Limited
9. IFFCO TOKIO General Insurance Company Limited
10. Zurich Kotak General Insurance Company (India) Limited (formerly known as Kotak Mahindra General Insurance Company Limited)
11. Kshema General Insurance Limited
12. Liberty General Insurance Limited
13. Magma General Insurance Limited (" Erstwhile Magma HDI General Insurance Company Limited ")
14. Navi General Insurance Limited
15. Raheja QBE General Insurance Company Ltd.
16. Reliance General Insurance Company Limited
17. Royal Sundaram General Insurance Company Limited
18. SBI General Insurance Company Limited
19. Shriram General Insurance Company Limited
20. Tata AIG General Insurance Company Limited
21. Universal Sompo General Insurance Company Limited
22. Zuno General Insurance Ltd. (formerly known as Edelweiss General Insurance Company Limited)

9. Reinsurance

Reinsurance is a risk transfer mechanism whereunder an insurance company passes on the risk on an insurance policy to another entity called Reinsurer for a consideration under a Reinsurance treaty (contract).

Under reinsurance one direct insurance company (also called Ceding company) transfers (cedes) part of the risk to another insurance company (called Reinsurer). This helps in reducing the liability of the direct insurer to a large extent. If there is no reinsurance, it could result in a dent in the financial position of an insurance company, especially when a natural calamity happens.

Some of the global reinsurance companies who have opened reinsurance offices in India include Swiss Re., Munich Re., RGA, Hannover Re. etc. The Indian Reinsurer is GIC Re. (General Insurance Corporation of India).

Reinsurers have their teams which comprise of competent technical professionals who are experts in Actuarial, Claims, Underwriting etc.

Reinsurers take a proportion of the premium paid by the Policyholder and promises to pay the proportionate amount of any claims insured under the Policy.

Reinsurance Companies

1. General Insurance corporation of India
2. General Reinsurance AG - India Branch
3. Munich Re - India Branch
4. RGA Life Reinsurance Co. of Canada – India Branch

5. SCOR SE - India Branch
6. Swiss Reinsurance Company Ltd.-India Branch
7. XL Insurance Co SE - India Reinsurance Branch
8. Hannover Ruck SE - India Branch
9. Lloyd's
10. AXA France VIE – India Reinsurance Branch
11. Allianz Global Corporate & Speciality SE, India Branch

10. Insurance Intermediaries

Insurance is considered a complex product, and it is not easy for the insurer to take care of all the processes involved in sales and administration of related services. An insurance intermediary acts as a bridge between the insurance provider and the end customer. They could be involved in the sales process like an insurance agent or an insurance broker, or the claims process like a surveyor or a third-party administration. Let us look
at each of the intermediaries in some detail below.

(1) Agent:

An agent is an individual or a corporation that is authorised to solicit and procure insurance business for the insurance company they represent. The business could be related to renewal and revival of existing policies or sale of new policies. An agent who represents both a life insurer and a general insurer is known as a Composite Insurance Agent.

(a) Individual Agents:

These are individuals who can be appointed by an insurance company to sell insurance policies on their behalf.

As per Section 42 of the Insurance Act, 1938, an insurer may appoint any person to act as insurance agent for the purpose of soliciting and procuring insurance business.

No person shall act as an insurance agent for more than one life insurer, one general insurer, one health insurer at a time.

Provided that the Authority shall, while framing regulations, ensure that no conflict of interest is allowed to arise for any agent in representing two or more insurers for whom he may be an agent.

(b) **Corporate Agents:**

In the case of a Corporate Agency, a Partnership firm or a Company may apply for doing insurance agency, as against individuals which we saw earlier. However, unlike Individual agent who can work for only 1insurer in a line of business (Life/Non-Life/Standalone health), a corporate agent is allowed to work for upto 3 insurers in each line of business. Therefore, a corporate agent can work up to a maximum of 9 insurers, with a cap of 3 insurers in each line of business.

Following are the key provisions under the IRDAI (Registration of Corporate Agents) Regulations, 2015:

- **Maximum tie ups for a Corporate Agent:** Maximum 3 insurance companies – in life, non-life and Health insurance separately or a Composite licence for all categories.
- **Two types of corporate agencies**: Exclusive & non-exclusive corporate agencies - An exclusive corporate agent is one who does only insurance solicitation and a non-exclusive

corporate agent is one whose primary business is something different and insurance solicitation is a secondary line of business. For example, Banks are Non-exclusive Corporate agents whose primary business is banking and secondary business is insurance solicitation.

- **Minimum capital and net worth requirement**: only for exclusive corporate agents: Rs. 50 lakhs.
- **At least 1 Principal Officer & as many Specified Persons as required to be appointed**: A Principal Officer, an employee of the corporate agent, is the Primary person responsible for the Corporate Agency and shall be accountable to IRDAI for compliance with the Regulations. He may be the CEO for the Corporate agency business. business. A Specified Person is an employee of the corporate agency entity responsible for solicitation of insurance business. Only Specified Persons and Principal Officers are eligible to sell on behalf of the corporate agent.

(2) Insurance Broker:

An insurance broker is an individual licenced by IRDAI to arrange insurance contracts with an insurer on behalf of a client. A broker can represent multiple insurance companies.

Broker Vs. Agent: An agent is permitted to represent only one insurance company within a sector i.e., a general insurer, a life insurer, or both, but not two general insurers. A broker can represent multiple general or life insurers or both. IRDAI licences both agents and brokers for general insurance or life insurance or both. They have to follow the code of conduct laid down by IRDAI under respective regulations.

It is important to remember that neither an agent nor a broker can give a discount on the premiums to be paid for the insurance policy. Any such offer would be against Section 41 of the Insurance Act. Only an insurance company can offer a discount on premium, and it has to be in accordance with the policy's terms and conditions.

(3) Surveyor and Loss Assessors:

A surveyor or a loss assessor plays the role of determining the extent of damage sustained by the insured. When a loss event occurs, the insured and the insurer may not agree on the actual loss. An independent surveyor brings them on the same page. To be a surveyor or loss assessor, the company or the individual has to meet the criteria laid out by IRDAI. The criteria vary based on the kind of surveys to be performed. For example, a surveyor for motor insurance must be either a mechanical engineer or an automobile engineer. On the other hand, a surveyor for marine insurance must be a marine engineer or a naval architect. A surveyor is engaged only if the claimed losses are over Rs. 50,000 in motor insurance or over Rs. 1 lakh in other insurance. These limits are reviewed and revised by IRDAI every three years.

Duties and Responsibilities of a Surveyor and Loss Assessor:

It shall be the duty of every Licensed Surveyor and Loss Assessor to investigate, manage, quantify, validate and deal with losses (whether insured or not) arising from any contingency, and report thereon to the insurer or insured, as the case may be., All Licensed Surveyors and Loss Assessors shall carry out the said work with competence, objectivity and professional integrity and strictly adhere to the code of conduct as stipulated in these.

(i) Declaring whether he has any interest in the subject matter in question or whether it pertains to any of his relatives, business partners, or through material shareholding;

(ii) Bringing to the notice of the Authority, any change in the information or particulars furnished at the time of issuance of the license, within a period not exceeding fifteen days from the date of occurrence of such change that has a bearing on the license granted by the Authority.

(iii) Maintaining confidentiality and neutrality without jeopardizing the liability of the insurer and claim of the insured;

(iv) Conducting inspection and re-inspection of the property in question suffering a loss;

(v) Examining, inquiring, investigating, verifying, and checking upon the causes and the circumstances of the loss in question including the extent of loss, nature of the ownership and insurable interest;

(vi) Conducting spot and final surveys, as and when necessary, and comment upon the franchise, excess/under insurance, and any other related matter;

(vii) Estimating, measuring, and determining the quantum and description of the subject under loss;

(viii) Advising the insurer and the insured about loss minimization, loss control, security, and safety measures, wherever appropriate, to avoid further losses;

(ix) Commenting on the admissibility of the loss as also the observance of warranty conditions under the policy contract;

(x) Surveying and assessing the loss on behalf of an insurer or insured;

(4) Third-Party Administrator:

Third-party administrator or (TPA) is an organisation that has been licensed by IRDAI to process claims and provide cashless facility. Insurance companies outsource claim management or some aspects thereof to TPA with an aim to provide a quick turnaround to end customers. They act as an intermediary between the insurance provider, the policyholder and a service provider (for example, a hospital in the case of health insurance and a mechanic in case of motor insurance). While TPAs can be involved with various aspects of claim processing, their primary responsibility is to provide cashless services, especially cashless hospitalisation. These are the primary insurance intermediaries currently defined by IRDAI. They can add other intermediaries based on the evolution of the insurance industry. Intermediaries help in achieving standardisation of the service provided and allow insurers to achieve greater efficiency. Further, they also help increase insurance penetration in a wide market like India.

(5) Bancassurance:

Bancassurance is a new concept in financial services sector means using the bank's distribution channels to sell insurance products. The philosophy behind Bancassurance is to combine the manufacturing capability sand selling culture of insurance companies with the distribution network and large receptive client base of banks. It is a phenomenon wherein insurance products are offered through the distribution channels of the banking services along with a complete range of banking and investment products and services. To put it simply, Bancassurance tries to exploit synergies between both the insurance companies and banks. Bancassurance if taken in right spirit and implemented properly can be win-win situation for the all the participants' viz., banks, insurers and the customer.

Need for Bancassurance:

The growth of Bancassurance as a distribution channel can be ascribed to the following:

(a) **Conducive environment:** Progressive dismantling of laws relating to undertaking of insurance businesses by banks, increasing use of electronic channels and automation, growing needs for private retirement plans to complement public pensions, the concern for providing total financial services to customers, etc. have paved the way for Bancassurance.

(b) **Cost effectiveness:** Insurers look to Bancassurance as an alternative cost-effective mode of distribution as against the costly agency services. It is estimated that 50% of the insurer's cost structure is directly or indirectly related to distribution

(c) **Fee-based income:** A bank expects to increase its fee-based income and overall productivity by leveraging its branch network, brand image and client base by optimally using its assets/infrastructure and by positioning itself as a one-stop-shop with value-added service for its customers, thereby increasing customer loyalty and retention. Bancassurance enables a bank to satisfy the risk protection needs of its clients without assuming underwriting risk.

(d) **Fund Management:** Life insurance (where premium is about 55% of the insurance premium worldwide) is a savings market. It is one of the methods to increase the deposits of banks. Both life and non-life insurance business provide additional flow of float funds besides fee-based income to banks, through the same channel of distribution and with the same people.

(e) **Innovations and efficiency**: Increased convergence of banking and insurance would lead of melding of their corporate cultures, skill and synergising/innovating the marketing of financial services.

(f) **Models of Bancassurance:** Different Bancassurance business models as given below are prevalent in different countries:

(g) **Distribution agreements:** In simplest form called 'tied agent', the bank's personnel sell the products of one insurer exclusively, either in stand-alone basis or bundled with bank products.

(h) **Strategic alliance:** This is a higher degree of intervention in product development, service provision and channel management by way of bank investing sizably in insurance business without any contingent liability.

(i) **Joint** venture: Here a large bank with a well-developed customer database partner with a large insurer with strong product and channel experience, to develop a powerful new distribution model. Alternatively, a bank and insurance company may agree to have cross holdings between them to share the profits.

(j) Financial service group: Under further integration between a bank and insurer, an insurance company may build/ buy a bank or a bank may build/buy an insurance company.

Thus, banks could associate themselves with insurance companies by becoming a distributor or by being a strategic investor or developing a joint venture or by becoming a promoter. Most of the bancassurance operations fall in the first model.

11. Health Insurance Policies

Health insurance policies in India can be classified in two groups, viz.

(i) Indemnity-based policies such as, (a) mediclaim, (b) health guard, healthwise, etc. and
(ii) Benefit type policies such as, (a) daily allowance, (b) hospital cash, (c) critical illness (standalone), or (d) as a rider with life insurance policy.
Indemnity-based policies provide for reimbursement of expenses incurred for hospitalisation necessitated by a covered diseases, illness, or injury. *Benefit type policies* provide for lumpsum payment on happening of an event insured against by the policy.

In India following types of policies are in vogue:
(1) Standard health insurance policy, (2) Reimbursement and cashless policy, (3) Floater policy, (4) Group mediclaim policy, (5) Cancer medical expenses insurance policy, (6) Health riders with life insurance, and (7) Other health insurance policies, viz. (a) Hospital cash policy, (b) Critical illness policy, (c) Jan arogya bima policy, (d) Community-based universal health insurance scheme, (e) Nagrik suraksha policy, (f) Personal accident policy, and (g) Overseas medical insurance policy.
Health insurance policies are discussed below:

(1) Standard *Health Insurance Policy*

The standard health policy provides cover against the risk of hospitalisation. The operative clause of this policy offers to indemnify the insured against hospitalisation expenses incurred by the insured at a hospital or nursing home on the advice of a duly qualified medical practitioner on account of illness, diseases, injury, etc. Caused during the policy period.

(2) Reimbursement and Cashless Policy

Reimbursement policy is the conventional method of indemnification in all non-life insurance policies. Here, the insured initially bear all expenses which is reimbursed later on by the insurance company, provided the claim is admissible as per the policy. Preliminary notice of claim has to be given by the insured to the insurance company within 7 days from the date of hospitalisation. The notice of claim shall provide particulars, viz. (a) policy number, (b) name of the insured in respect of whom claim has been made, (c) nature of illness/injury, and (d) name and address of attending medical practitioner/hospital/nursing home.
Since the reimbursement claim defeats the very purpose of insurance that is to provide financial support at the time of peril, the insurance companies have introduced an innovative concept called *cashless system* in the mediclaim policy. This system which is in vogue in many western countries has been introduced also in India innovative concept in this country which permits a policy holder to avail of medical treatment at any of the network and listed hospitals of the insurer without any payment of cash. The insurers have a panel of Third Party Administrators (TPAs) who typically offer services in different cities. The TPAs are the contact parties for settlement of claims.
They facilitate smooth operation of health cover by way of functioning as link among the insurance companies, their clients and the hospitals. They enable cashless payment of claims to the insured in which they settle claims with the hospitals. The hospital bills are paid by TPA directly to the hospital, and thereby provide a relief to the insured from the trouble of arranging funds for hospitalisation.

(3) Floater Policy

This policy provides for a common sum insured for the entire family. The sum insured or the amount covered can be used for the principal insured or together for the family members. It implies that the entire family can claim up to the sum insured during the policy period. Technically speaking, this policy recognises the family as a single exposure unit as against the individual family members. Moreover, the premium chargeable for a family floater policy is much less as compared to a standard health insurance policy. More families nowadays prefer to take family floater policy due to reduced premium.

(4) Group Mediclaim *Policy*

The group mediclaim policy is available to any group or association or institution, corporate body provided it has a central point of administration and subject to a minimum number of persons to be covered by this policy. This policy offers the same coverage as available in the individual mediclaim policy, but with the difference, that, in this policy, cumulative bonus and health checkup expenses are not payable. Group discount in premium is however, available. Renewal premium is subject to bonus clause and the maternity benefit is available at extra premium.

(5) Cancer Medical Expenses Insurance Policy

Two types of policies are available to cover medical expenses for treatment of cancer. One such policy is available to the members of Indian Cancer Society and another one for the members of Cancer Patients Aids Association.

(6) Health Riders with Life Insurance

The IRDA has encouraged both life as well as non-life insurance companies to introduce rider policies offering health cover. Riders are add-on benefits attached to the main policy. The salient features of health riders with life insurance policies are as follows:

The rider is added to a life policy in order to protect the insured in case of critical illness. The extra cover is equal to the sum assured on the base policy and is paid on diagnosis of the illness. It is renewable up to the age of 65 years, without any medical examination. The premium is increased once in every 5 years. The illness covered and the premiums vary among insurers. Most of the insurers cover cancer, coronary artery bypass, heart attack, kidney/renal failure, major organ transplant and paralytic stroke under health riders. Generally, the insurers do not terminate the base policy when a claim is made on the rider. The sum of insurance under a critical insurance policy is required to be selected by the insured from among 4 levels, viz. Rs. 5 lakhs, Rs.10 lakh, Rs. 20 lakhs, and Rs. 25 lakhs. The premium paid for the rider qualifies for deduction of tax under Section 80D of the Income Tax Act.

(7) Other Health Insurance Policies

The health insurance products provide only for the expenses incurred due to disease, injury or illness covered under the policy. The cover however, excludes pre-existing diseases and conditions, and limit or restrict the cover for payment of pre-hospitalisation expenses up to 30 days and post-hospitalisation expenses up to 60 days. Even congenital diseases are excluded from the scope of the cover. In order to reduce the gap in expectations of the insured, there are very many other health insurance covers offered by the insurers. We shall mention some of such health insurance policies now.

(a) **Hospital Cash Policy:** The policy provides cover against additional expenses such as, transport, board and lodging, hiring of personal attendant, etc. It provides for cash allowance ranging from Rs. 500 to Rs. 5,000 per day in case of hospitalisation on account of disease, injury, or illness suffered by the insured. For the purpose of the policy, hospitalisation means a continuous stay in the hospital as an in-patient for 24 hours. Some policies have the provisions for paying twice the daily limit per day in case of admission in ICU or ICCU for a period not exceeding 7 days. This policy can be taken for covering entire family, i.e. the proposer, spouse and dependent children in the age bracket of 3 months up to 21 years.

(b) **Critical Illness Policy:** Critical illness policy provides for a lumpsum payment against the listed diseases. The number of diseases covered varies as per the market. Depending on the type of policy the number of diseases covered may vary from 5 to 35 in the policies.

Besides, there are disease specific policies, viz. (a) cancer insurance, (b) diabetes insurance, etc. Available in the market. The basic critical illness policy covers the listed diseases such as: (i) cancer, (ii) coronary artery bypass surgery, (iii) first heart attack, (iv) kidney failure, (v) major organ transplant, and (vi) stroke. The critical illness policy can be taken either on standalone basis or as a rider to the life insurance policy. The standalone critical illness policy is a one-year policy, whereas a rider to the life insurance policy is a long-term policy.

(c) **Jan Arogya Bima Policy:** The general insurance companies introduced jan arogya bima policy in the year 1998. It is a lower version of mediclaim policy. The terms, conditions, and exclusions of this policy is similar to the mediclaim policy. The policy however, does not provide for either the cumulative bonus or the free health checkup feature which are usually available in the mediclaim policy. The policy covers the individual or the entire family on the line of basic policy. The sum insured per person is limited to Rs. 5,000.

There is no agency commission payable. Hence, the policy is generally sold through the NGOs, government agencies, self-help groups, etc. The premium charged for this policy is Rs. 70 per adult person and Rs. 50 per dependent son/ daughter up to the age of 25 years.

(d) **Community-based Universal Health Insurance Scheme:** The community-based universal health insurance scheme was announced in the Union budget 2003—04. It provides health protection and good health services to the weaker sections of the society. The responsibility for implementation of this scheme has been given to the New India Assurance Company Ltd., a public sector insurance company.

Under this scheme, a premium has been fixed in order to be entitled for reimbursement of medical expenses such as: (i) Rs. 1 per day for an individual, (ii) Rs.1.50 per day for a family of 5 (including the first 3 children), and (iii) Rs. 2 per day for a family of 7 (including the first 3 children and dependent parents)

The pattern of medical expenses reimbursement is as follows:

(a) Up to Rs 30,000 for hospitalisation; (b) Up to Rs. 25,000 for death due to accident; and (c) Compensation on account of loss of earnings @ Rs. 50 per day up to a maximum of 15 days, after a waiting period of 3 days. The government contributes? 100 per year towards annual premium for the benefit of the family living below poverty line.

(e) **Nagrik Suraksha Policy:** Nagrik suraksha policy is an accident insurance cover that provides compensation for injuries due to accident and/or reimbursement of expenses incurred in a hospital due to accidental injuries, subject to certain limits.

(f) **Personal Accident Policy:** Personal accident policy provides compensation in case of death, or bodily injury to the insured, directly and exclusively due to accident, by way of external, visible and violent means.

It is a 24 hours cover operating all over the world. It provides comprehensive cover of death, permanent disablement, and temporary total disablement. This policy is available in family package in which the proposer, spouse and dependent children are covered under a single policy. Group personal accident policy is also available for specified groups.

(g) **Overseas Medical Insurance Policy:** Overseas medical insurance policy covers medical expenses of the insured while travelling abroad for business/holiday/study/ employment. The premium under this policy is payable in Rupees and claims are settled abroad in foreign currency.

Rules and Guidelines for Health and Mediclaim Insurance by IRDAI:

The IRDAI is the primary authority in charge of developing new health insurance policies and recommendations. In 2020, the regulator released new IRDAI rules for health and medical insurance, which are as follows:

Claims Rejection: The insurer cannot reject the claim if the policyholder has renewed the policy for eight years without an interruption or lapse. The moratorium period will be in effect throughout this time. Except in fraud cases or when the claim is brought against a policy exclusion, the insurer cannot appeal the claim denial to the IRDAI.

Inclusion of Telemedicine: The medical service has altered with the advent of digitization, and one can now visit a doctor via online consultations. The Insurance Regulatory and Development Authority of India (IRDAI) has ordered insurers to incorporate telemedicine consultations in their policies.

Claim Settlement: If an insurer fails to settle a claim within a reasonable time, the insurer is obligated to pay interest on the claim amount. It should ensure that the claim is settled within 30 to 45 days of the policyholder submitting the final document.

IRDAI is a regulatory body that is responsible for everything right and wrong any insurance company does. Insured can either contact them or let them know about Insured grievances if the insurance company denies to answer. Insured can also raise any queries about the insurance policy and insurer in case of a fraud. In either way, the role of IRDAI is very significant for complete transparency and making changes to the rules and regulations from time to time.

Differences between General Insurance and Life Insurance

General Insurance	Life Insurance

1. It covers non-life assets.	1. It covers life of an individual.
2. It is not a type of savings	2. This insurance helps you accumulate savings for future
3. Annual contract with a lumpsum premium.	3. Long-term contract with the option of installment premiums
4. Pays sum assured in case of an eventuality such as theft or accident.	4. Pays sum assured to the nominee in case of the death of the policyholder

12. Insurance Regulations in India

Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market.

Insurance Sector Reforms

The insurance sector in India has gone through the process of reforms following these recommendations. The Insurance Regulatory & Development Authority (IRDA) Bill was passed by the Indian Parliament in December 1999. The IRDA became a statutory body in April, 2000 and has been framing regulations and registering the private sector insurance companies. The insurance sector was opened upto the private sector in August 2000. Consequently, some Indian and foreign private companies have entered the insurance business now. There are about 33 general insurance and 24 life insurance companies operating in the private sector in India, early in 2022.

Insurance Regulatory and Development Authority of India (IRDAI), is a statutory body formed under an Act of Parliament, i.e., Insurance Regulatory and Development Authority Act, 1999 (IRDA Act, 1999) for overall supervision and development of the Insurance sector in India.

Objectives of IRDAI

- Protect the interests of policyholders.
- Promote the orderly growth of the insurance industry.
- Ensure the financial security of the insurance market.
- Promote fairness and transparency in financial markets.
- Ensure speedy settlement of genuine claims.
- Promote competition to increase consumer choice and lower premiums.

IRDAI's functions

- Register and regulate insurance companies.
- License and establish norms for insurance intermediaries.
- Regulate and oversee premium rates.
- Specify financial reporting norms.

- Regulate investment of policyholders' funds.
- Ensure insurance coverage in rural areas and for vulnerable sections of society
- Issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;
- protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;
- specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents
- specifying the code of conduct for surveyors and loss assessors;

Promotion and Regulation:

- Promoting efficiency in the conduct of insurance business;
- Promoting and regulating professional organisations connected with the insurance and re-insurance business;
- Levying fees and other charges for carrying out the purposes of this Act;
- Calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;
- Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);
- Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;
- Regulating investment of funds by insurance companies;
- Regulating maintenance of margin of solvency;

Other duties:

- Adjudication of disputes between insurers and intermediaries or insurance intermediaries;
- Supervising the functioning of the Tariff Advisory Committee;
- Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);
- Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and
- Exercising such other powers as may be prescribed.

Multiple Choice Questions

1. Contract of insurance is a contract of -

   (a) Agency (b) Indemnity
   (c) Bailment (d) Guarantee

   Answer: (b)

2. ------increases the frequency of loss.

   (a) Peril
   (b) Subjective risk
   (c) Hazard
   (d) Objective risk

   Answer (c)

3. ___ hazard increases the probability of loss due to dishonesty or character defects of an insured person.

   (a) Moral
   (b) Morale
   (c) Legal
   (d) Physical

   Answer (a)

4. Master policy is issued for ______

   (a) Term insurance schemes
   (b) permanent insurance
   (c) individual insurance
   (d) group insurance schemes

   Answer (d)

5. Subrogation means ______

   (a) something of monetary value
   (b) to make good loss
   (c) payment of premium
   (d) transfer of rights of an insured to another person

   Answer (d)

6. _______ risks happen within a stable environment and are constant over an observed period of time.

   (a) Speculative
   (b) Pure
   (c) Static
   (d) Dynamic

   Answer (c)

7. Which among the following is not a pure risk?

   (a) Personal risk
   (b) Property risk
   (c) Loss of income risk
   (d) Strategic risk

   Answer (d)

8. Which of the following method reduces the chance of loss to zero?
   (a) Risk Transferring
   (b) Risk avoidance
   (c) Risk retention
   (d) Risk reduction
   Answer (b)
9. ___ refers to the manner in which the risk control measures that have been implemented shall be financed.
   (a) Risk financing
   (b) Risk retention
   (c) Risk transfer
   (d) Risk sharing
   Answer (a)
10. ___ is the most famous tool of risk management
   (a) Certainty risk
   (b) Insurance
   (c) Loss prevention
   (d) Uncertainty risk
   Answer (b)
11. ___ is still the most leading channel in India for distributing insurance products.
   (a) Brokers
   (b) Agency power
   (c) Insurance market
   (d) National market
   Answer (b)
12. An insurance agent represents the ______.
   (a) Insured
   (b) Insurer
   (c) Government
   (d) Adjustment bureau
   Answer (b)
13. ___ is a whole life policy that insures two lives with the proceeds payable on the second (later) death.
   (a) Survivorship life insurance policy
   (b) Group life insurance
   (c) Joint life insurance
   (d) Prepaid insurance
   Answer (a)

14. The ______ is formed with four subsidiary companies.
    (a) Life insurance Corporation of India
    (b) ICICI Prudential Life Insurance Company
    (c) General Insurance Corporation of India
    (d) Bajaj Allianz General Insurance Company
    Answer (c)

15. the following is not a concern of the insurance regulatory framework?
    (a) It has to safeguard the interests of the customers.
    (b) It has to safeguard the interests of the stakeholders.
    (c) It has to ensure the financial soundness of the insurance industry.
    (d) It has to help in the healthy growth of the insurance market.
    Answer (b)

16. Insurable interest means
    Statement A: Legal right to insure.
    Statement B: Have suffered financial loss.
    (a) Both statements are correct
    (b) Both statements are wrong
    (c) Statement A is correct
    (d) Statement B is correct
    Answer: (a)

17. One of the fundamental principles of life insurance is
    (a) There is an insurer & policyholder
    (b) Utmost good faith
    (c) Insurable interest
    (d) Both b & c
    Answer: (d)

18. Which Insurance policy gives holder the benefits of both Insurance and Investment?
    (a) Term Insurance Policies
    (b) Money-back Policies
    (c) Pension Policies
    (d) Unit-linked Investment Policies

Answer: (d)

19. Which of the following is the proof of contract between the Insurer and the Insured?
    (a) Policy Document
    (b) Proposal-Form
    (c) Claim-Form
    (d) Nomination-Form
    Answer (a)

20. Insurer is a person who has:
    (a) Insured his life on goods
    (b) Helped person to get an insurance policy
    (c) Undertaken to make goods the loss of the subject matter of insurance
    (d) Field of suit in a court of law to recover an insurance claim

    Answer: (c)

21. Insurable interest in a life insurance contract should:
    (a) At the time of the contract
    (b) At the time of maturity
    (c) At the time of claim
    (d) At the time of surrender

Answer: (a)

22. Match List I with List II and select the correct answer by using codes given below the lists:

List- I (Description)	List –II (Micro-insurance)
(I) This model is useful for delivering simple insurance products such as, term life insurance.	1. Full-service Model
(II) This model is useful in managing low severity risks like primary health care.	2. Provider-driven Model
(III) This model is useful for complicated and service intensive covers such as, health and weather insurance.	3. Community-based Model
(IV) This model integrates services like health care with insurance.	4. Partner-Agent Model

Codes:

	(I)	(II)	(III)	(IV)
(a)	1	2	3	1
(b)	2	1	4	3
(c)	3	2	1	3
(d)	4	3	1	2
Answer (d)	**4**	**3**	**1**	**2**

23. Insurance to cover risks arising out of professional negligence is known as
    (a) Business Insurance
    (b) Professional Insurance
    (c) Liability Insurance
    (d) Risk Insurance

    Answer: (c) Liability Insurance

24. Match List I with List II and select the correct answer by using codes given below the lists:

List- I	List -II
A. Evaluation Risk	1. This risk arises due to holding of shares in other weak or sick enterprise by the insurer.
B. Depreciation Risk	1. This risk arises due to investments losing their value on account of non-payment, credit and market risks.
C. Participation Risk	3. This risk arises due to insufficient technical provisions.

Codes:

	A	B	C
(a)	1	2	3
(b)	2	3	1
(c)	3	2	1
(d)	1	3	2
Answer (c)	3	**2**	**1**

25. Consider the following statements:
    (I) Moral hazards are insurable
    (II) Physical hazards are insurable
    Which of the statement(s) given above is/are correct?
    (a) Only (I)
    (b) Only (II)
    (c) Both (I) and (II)
    (d) Neither (I) nor (II)
    Answer: (b) Only (II)

26. Which of the following steps in the risk management process helps in determining sum insured under policies?
    (a) Risk identification
    (b) Risk retention
    (c) Risk transfer
    (d) Risk evaluation
    Answer: (D)

27. Which one of the following is non-technical risk in insurance?
    (a) Growth risk
    (b) Third party guarantee risk
    (c) Liquidity risk

(d) Interest rate risk

Answer: (b)

28. Consider the following statements:

The life insurance contacts are contracts of utmost good faith because:

(I) Only insured knows about his health

(II) Only insured knows about his family history

(III) Insured cannot attempt to make profit out of his health condition

(IV) Insurer’s risk is related to the disclosures made by insured

Which of the statement(s) given above is/are correct?

(a) I, II and III

(b) I, II, III and IV

(c) I, II and IV

(d) II, III and IV

Answer: (b)

29. Floater policy -

(a) provides for a common sum assured for the entire family

(b) provides for a lumpsum payment against the listed diseases

(c) provides cover against additional expenses such as transport, board and lodging, hiring, of personal attendant etc.

(d) is available to any group or association or institution or corporate body subject to a minimum number of persons to be covered by the policy

Answer (a)

30. A kind of insurance which provides for indemnity for loss against health such as loss of time and medical expenses due to sickness is called _________.

(a) Fidelity insurance

(b) Crop insurance

(c) Health insurance

(d) Fire insurance

Answer: (c)

31. Term assurance provides the following benefits _________.

(a) death benefits if the person dies within term.

(b) death and survival benefits.

(c) periodic payments at predictable intervals.

(d) death benefits with bonus.

Answer (a)

32. The process of transfer of risk from one insurer to another insurer is called:

(a) Transfer insurance

(b) Double insurance

(c) Reinsurance

(d) Joint insurance

Answer (c)

33. Which of the following is not a pure risk?
    (a) Personal risk
    (b) Property risk
    (c) Loss of income risk
    (d) Strategic risk

Answer (d)

34. Which of the following is correct for insurance regulation in India?
    (a) The Insurance Act, 1958
    (b) The General Insurance Business (Nationalisation) Act, 1972
    (c) Life Insurance Corporation Act, 1959
    (d) Insurance Regulatory and Development Authority Act, 2001

Answer (b)

35. Which one of the following is a private sector general insurance organisation in India?
    (a) National Insurance Co Ltd.
    (b) The New India Assurance Co. Ltd.
    (c) United India Insurance Co. Ltd.
    (d) ICICI Lombard General Insurance Co. Ltd.

Answer (d)

Unit -4
Mutual Funds

Objectives of this unit:
This unit will enable you to develop an understanding of the following:

- Concept and Definition of Mutual Funds
- History of Mutual Funds in India
- Types of Mutual Funds/ Schemes
- Advantages, limitations of investing in Mutual Funds
- Constituents of mutual funds
- Evaluation of Mutual Fund Schemes

1. Introduction

A mutual fund is a collective investment vehicle that collects & pools money from a number of investors and invests the same in equities, bonds, government securities, money market instruments.
The money collected in mutual fund scheme is invested by professional fund managers in stocks and bonds etc. in line with a scheme's investment objective. The income / gains generated from this collective investment scheme are distributed proportionately amongst the investors, after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. In return, mutual fund charges a small fee.
In short, mutual fund is a collective pool of money contributed by several investors and managed by a professional Fund Manager.
Mutual Funds in India are established in the form of a Trust under Indian Trust Act, 1882, in accordance with SEBI (Mutual Funds) Regulations, 1996.
The fees and expenses charged by the mutual funds to manage a scheme are regulated and are subject to the limits specified by SEBI.

2. History of Mutual Find in India

The mutual fund industry in India started in the year 1963 with the formation of Unit Trust of India, at the initiative of Government of India and Reserve Bank of India with the primary objective was to mobilize the small savings.
The history of mutual fund industry can be divided into five phases.
Phase I: Establishment and Growth of Unit Trust of India 1964-1987
Unit Trust of India was established in the year 1963 by an Act of Parliament. It was set up by RBI and it continued to operate under the regulating control of the RBI until the two were delinked in the year 1978 and the entire control was transferred in the hands of Industrial Development Bank of India.

UTI's first innovative and most successful launch was Unit Scheme 1964 or popularly known as US-64. Other innovative products of UTI include: (a) Unit Linked Investment Plan or ULIP in 1971; (b) Children's Gift Growth Fund and India Fund in 1986; (c) Master share (India's first equity dividend scheme), 1987; (d) Monthly income scheme. From 1964 to 1987, 23 long years, UTI enjoyed the complete monopoly.

Phase II Entry of Public Sector Funds (1987-1993)

In 1986, the Government of India amended banking regulation act and allowed public sector commercial banks to set up mutual funds. This led to SBI, PNB, Canara Bank, Bank of India, Bank of Baroda, etc. commercial banks to set up their own mutual funds.

In 1987, GoI further granted permission to insurance corporations in the public sector to float mutual funds and accordingly LIC and GIC set up their own mutual funds. The period of 1987-1993 can be termed as the period of public sector mutual funds, from a single player in 1985 to 8 players in 1993. However, UTI remained the leader with about 60% market share and asset under management of the industry has increased seven times to `47,100 crores.

Phase III Emergence of Private Sector Banks (1993-1996)

The permission was given to the private sector funds including foreign funds management companies (most of them entering through joint venture with Indian promoter) to enter the mutual fund industry in 1993. In 1993, the first mutual fund regulation came into being under which all mutual funds, except UTI was to be registered. The Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993).

Phase IV Growth and SEBI Regulation (1996-2004)

The mutual fund industry witnessed robust growth and strict regulations from SEBI after 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds.

Investor's interests were safeguarded when SEBI (Mutual Funds) Regulation 1996 was introduced and the Government of India offered tax benefits to investors through their budget proposal in the year 1999 which exempted all divided incomes in the hands of the investors. Various investor awareness programmes were also initiated by SEBI and Association of Mutual Funds in India (AMFI).

Phase V Growth and Consolidation (2004 Onwards)

During this phase, the industry witnessed several mergers and acquisitions, e.g. Alliance Mutual Fund have been taken over by Birla Sun Life. Simultaneously, more international mutual fund players entered India like Fidelity, Franklin Templeton Mutual Fund, etc. During this period excellent performance of the stock market, low interest rate, tax holidays on some schemes have helped for robust growth. Still, the penetration of mutual fund in the retail investors segment is still low at 6% of GDP against 72% in U.S. Active participation of the retail investors will boost the mutual fund industry in India. Today, the mutual fund industry is dominated by urban investors and to some extent semi-urban investor. Mutual fund industry must tap the huge untapped potential particularly in rural areas.

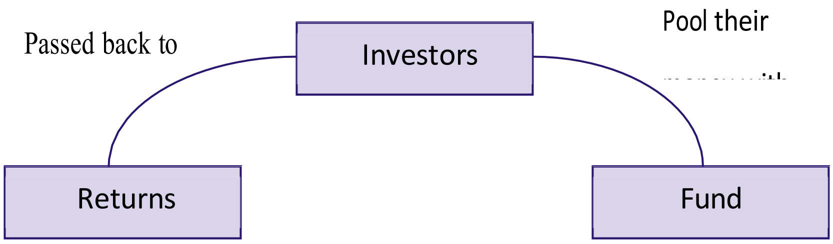
3. How does a mutual fund work?

A mutual fund is a professionally managed investment scheme, usually run by an asset management company that brings together a group of people and invests their money in stock, bonds and other securities. The investors in mutual fund are given the share in its total funds which is proportionate to their investments, and which is evidenced by the unit certificates.

However, unlike shareholders in a company, the shareholders in mutual funds do not have any voting rights. Mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

In India, a mutual fund is required to be registered with the Securities and Exchange Board of India which regulates securities markets before it can collect funds from public.

How does a Mutual Fund Work?



4. Definition of Mutual Fund

Mutual Fund (MF) is a fund established in the form of a Trust, to raise monies through sale of units to the public or a section of the public under one or more schemes for investing in Securities, including Money Market Instruments. [Trust Deed should be duly registered under the Indian Registration Act, 1908.]

5. Who can invest in Mutual Funds?

Anybody with an investible surplus of as little as a few thousand rupees can invest in mutual funds by buying units of a particular mutual fund scheme that has a defined investment objective and strategy.

6. Advantages of investing in Mutual Funds:

(i) **Professional Management**: Investors avail the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

(ii) **Diversification**: MFs invest in a number of companies across a broad cross-section of industries and sectors. Investors achieve this diversification through a MF with less money and risk.

(iii) **Convenient Administration**: Investing in a MF reduces paper work and helps investors to avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies.

(iv) **Return Potential**: Over a medium to long term, MF has the potential to provide a higher return as they invest in a diversified basket of selected securities.

(v) **Low Costs**: MFs are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial & other fees translate into lower costs for investors.

(vi) **Liquidity**: In open ended schemes, investors can get their money back promptly at Net Asset Value (NAV) related prices from the Mutual Fund. With close-ended schemes, investors can sell their units on a stock exchange at the prevailing market price, or avail of the facility of direct repurchase at NAV related prices which some close ended and interval schemes offer periodically.

(vii) **Transparency:** Investors get regular information on the value of their investment in addition to disclosure on the specific investments made by scheme, the proportion invested in each class of assets and the Fund Manager's investment strategy and outlook.

7. Limitations of taking the Mutual Fund route for investment:

Limitations of investing mutual funds are mentioned below:

(i) **No choice of Securities**: Investors cannot choose the securities which they want to invest in.

(ii) **Relying on other's Performance:**

- ❖ Investors face the risk of Fund Manager not performing well. Investors in Mutual Fund have to rely on the fund manager for receiving any earning made by the fund, i.e. they are not automatic.
- ❖ If fund manager's pay is linked to performance of the fund, he may be tempted to perform only on short-term and neglect long-term performance of the fund.

(iii) **High Management Fee**: the management fees charged by the fund reduces the return available to the investors.

(iv) **Diversification**: Diversification minimizes risk but does not guarantee higher return.

(v) **Diversion of Funds:** There may be unethical practices e.g. diversion of mutual fund amounts by mutual fund/s to their sister concerns for making gains for them.

(vi) **Lock-In Period**: Many mutual fund schemes are subject to lock in period and therefore, deny the investors market drawn benefits.

8. Activities involved in Mutual Funds

Following are the activities involved in mutual funds:

(i) **Formulation of Scheme:** A Mutual Fund formulates a scheme with a specified objective to meet the investment needs of various investors i.e. High Return Scheme, Fixed Return Scheme etc. The Scheme should be approved by the Trustees and filed with SEBI.

(ii) **Sale of Units:** Units under the scheme are sold to the investors to collect funds from them.

(iii) **Investment by AMC**: An AMC can invest in any of the schemes of a MF only if full disclosure of its intention to invest has been made in the offer documents. An AMC shall not be entitled to charge any fees on its investment in that scheme.

(iv) **Portfolio Creation**: Resources so received from investors are pooled to create a diversified portfolio of securities by investing the money in instruments, which are in line with the objectives of respective schemes.

(v) **Investment Pattern**: The Investment Pattern of Mutual Funds is governed partly by Government Guidelines and partly by nature and objective of Mutual Fund.

(vi) **Daily Operations**: Daily operations are managed by professionals and Expert Fund Managers who take investment decisions regarding where, when and what to invest and disinvest to get the maximum return as well as higher capital appreciation.

(vii) **Meeting of Expenses**: Expenses like custodial fee, cost of dividend warrants, Registrar's Fee, Asset Management Fee etc., are borne by the respective scheme.

(viii) **Purchase and Repurchase Price**: The purchase and repurchase price of Mutual Funds are generally fixed and also vary in Stock Exchanges if the security is quoted on the basis of its Net Asset Value.

(ix) **Maturity:** Balance remaining in the scheme is returned to the investors upon its maturity on the basis of the Net Assets Value of the scheme on that date.

9. Role of Mutual Fund in Financial Market:

Important role of mutual funds in financial markets are as follows:

(i) **Organized Investments**: Due to participation of Mutual Funds in a large scale, it has transformed the Financial Market Transactions into a much more organized. Individual investors may speculate to the maximum, but under the collective investment scheme (i.e. Mutual Fund), the tendency to speculate greatly reduced at an individual level.

(ii) **Evolution of Stock Markets**: Large scale transactions entered into by Mutual Funds, headed by team professionals, have helped in the evolution of stock markets and financial markets.

(iii) **Household Savings**: They are the ideal route for many a household to invest their savings for a higher return, than normal term deposits with banks.

10.Constituents of Mutual Funds

In India, the mutual funds are under the active supervision of the 'Securities and Exchange Board of India' (*SEBI*). The constituents of mutual funds are as follows:

(i) **Sponsors/Promoters:** Sponsor includes any entity acting alone or in collaboration with a body corporate establishing a mutual fund. For Mutual Fund Registration with SEBI, the fulfillment of the underlined criteria is required: -

(a) Net Worth (Assets- Liabilities) should be positive for the last five years. No loss should be revealed by the sponsor during the last three years as loss disqualifies sponsorship. The Sponsors should contribute 40% share of Net Worth of Asset Management Companies.

(b) The capital contributed towards the Asset Management Company should be less than the net worth of the sponsors in the immediately preceding year in which it applied for sponsorship.

(ii) **Trust or Trustees:** Trustees function under the sponsor for protecting the interest of beneficiaries under a Trust deed. The Trustees are to comply with SEBI (*Mutual Fund Regulations*). Trustees control AMCs and can claim Trusteeship fees if the trust deed is created under the Indian Registration Act, 1908.

(iii)**Asset Management Companies (*AMCs*):** AMCs function under professional fund managers for all activities of the fund. Fund managers get remuneration and are appointed by the Trustees. Assistance is received from brokers, auditors, bankers, and lawyers during the operations of the AMCs. One of the mandatory duties of Amies to disclose the Net Asset Value (*NAV*) of a scheme on day-to-day basis.

(iv)**Custodian:** Custodian operates under the Board of Trustees and safeguards the assets of Mutual Fund. SEBI registration of Custodian is mandatory and Custodian is different from sponsors.

(v) **Registrar and Transfer Agents (RTAs):** RTA provides support function to mutual funds with respect to investment records, disbursal of dividends and communication with investors regarding various reports. In case of In-house functioning of RTA, funds can charge service charges at competitive market rate.

(vi) **Auditors:** To perform the important task of audit of accounts of Asset Management Company and that of each separate mutual fund scheme, auditors are appointed by the Trustee. System audit is also conducted for mutual fund. Audit report increases transparency and integrity.

(vii) **Brokers:** Brokers help the mutual fund investors in transacting unit of mutual fund, through online platform and they also provide research reports to the fund managers. However, the cost is likely to increase because of brokerage.

(viii) **Distributors:** Distributors may include individuals or institutions (banks, post office, financial organisations etc.). Functioning of distributors in Tier-I, Tier-II and Tier –III cities of India has resulted in growth of Asset Under Management of Indian Mutual Fund Industry.

(ix) **Banks:** Bank appointed by AMCs provide support services with respect to transactions of mutual fund schemes.

11. Types of Mutual Fund Schemes

Mutual funds come in many varieties, designed to meet different investor goals. Mutual funds can be broadly classified based on:

1. Organisation Structure: Open ended, Close ended, Interval
2. Management of Portfolio: Actively or Passively
3. Investment Objective: Growth, Income, Liquidity
4. Underlying Portfolio: Equity, Debt, Hybrid, Money market instruments, Multi Asset
5. Thematic / solution oriented: Tax saving, Retirement benefit, Child welfare, Arbitrage
6. Exchange Traded Funds
7. Overseas funds
8. Fund of funds

These are discussed below:

1. Scheme Classification by Organization Structure

(i) **Open-ended schemes** are perpetual, and open for subscription and repurchase on a continuous basis on all business days at the current NAV.

(ii) **Close-ended schemes** have a fixed maturity date. The units are issued at the time of the initial offer and redeemed only on maturity. The units of close-ended schemes are mandatorily listed to provide exit route before maturity and can be sold/traded on the stock exchanges.

(iii) **Interval schemes** allow purchase and redemption during specified transaction periods (intervals). The transaction period has to be for a minimum of 2 days and there should be at least a 15-day gap between two transaction periods. The units of interval schemes are also mandatorily listed on the stock exchanges.

Differences between open-ended and close-ended funds

Aspect	Open End Funds	Closed End Funds
Initial Subscription	Open-End Fund is one which is available for subscription all through the year.	Fund is open for subscription only during a specified period.

Maturity	Do not have a fixed maturity.	Stipulated maturity period (3 to 15 Years)
Subsequent Transactions	Investors can buy and sell units at Net Asset Value related prices.	Investors can invest at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where they are listed.
Repurchase	Any time.	Basedon terms of the fund. Periodic repurchase at NAV related price.

2. Scheme Classification by Portfolio Management

(i) **Active Funds**

In an Active Fund, the Fund Manager is 'Active' in deciding whether to Buy, Hold, or Sell the underlying securities and in stock selection. Active funds adopt different strategies and styles to create and manage the portfolio.

- The investment strategy and style are described upfront in the Scheme Information document (offer document)
- Active funds expect to generate better returns (alpha) than the benchmark index.
- The risk and return in the fund will depend upon the strategy adopted.
- Active funds implement strategies to 'select' the stocks for the portfolio.

(ii) **Passive Funds**

Passive Funds hold a portfolio that replicates a stated Index or Benchmark e.g. –

- Index Funds
- Exchange Traded Funds (ETFs)

In a Passive Fund, the fund manager has a passive role, as the stock selection / Buy, Hold, Sell decision is driven by the Benchmark Index and the fund manager / dealer merely needs to replicate the same with minimal tracking error.

Active v/s Passive Funds

Active Fund –

- Rely on professional fund managers who manage investments.
- Aim to outperform Benchmark Index
- Suited for investors who wish to take advantage of fund managers' alpha generation potential.

Passive Funds –

- Investment holdings mirror and closely track a benchmark index, e.g., Index Funds or Exchange Traded Funds (ETFs)
- Suited for investors who want to allocate exactly as per market index.
- Lower Expense ratio hence lower costs to investors and better liquidity

3. Classification by Investment Objectives

Mutual funds offer products that cater to the different investment objectives of the investors such as –

(a) Capital Appreciation (Growth)
(b) Capital Preservation
(c) Regular Income
(d) Liquidity
(e) Tax-Saving

Mutual funds also offer investment plans, such as Growth and Dividend options, to help tailor the investment to the investors' needs.

(a) Growth funds

- Growth Funds are schemes that are designed to provide capital appreciation.
- Primarily invest in growth-oriented assets, such as equity
- Investment in growth-oriented funds require a medium to long-term investment horizon.
- Historically, Equity as an asset class has outperformed most other kind of investments held over the long term. However, returns from Growth funds tend to be volatile over the short-term since the prices of the underlying equity shares may change.
- Hence investors must be able to take volatility in the returns in the short-term.

(b) Income funds

- The objective of Income Funds is to provide regular and steady income to investors.
- Income funds invest in fixed income securities such as Corporate Bonds, Debentures and Government securities.
- The fund's return is from the interest income earned on these investments as well as capital gains from any change in the value of the securities.
- The fund will distribute the income provided the portfolio generates the required returns. There is no guarantee of income.
- The returns will depend upon the tenor and credit quality of the securities held.

(c) Liquid / Overnight /Money Market Mutual Funds

- Liquid Schemes, Overnight Funds and Money market mutual fund are investment options for investors seeking liquidity and principal protection, with commensurate returns.
  – The funds invest in money market instruments* with maturities not exceeding 91 days.
  – The return from the funds will depend upon the short-term interest rate prevalent in the market.
- These are ideal for investors who wish to park their surplus funds for short periods.
  – Investors who use these funds for longer holding periods may be sacrificing better returns possible from products suitable for a longer holding period.

  * Money Market Instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time.

4. Classification by Investment Portfolio

Mutual fund products can be classified based on their underlying portfolio composition.

(i) The first level of categorization will be on the basis of the asset class the fund invests in, such as: Equity / debt / money market instruments or gold.

(ii) The second level of categorization is on the basis of strategies and styles used to create the portfolio, such as, Income fund, Dynamic Bond Fund, Infrastructure fund, Large-cap/Mid-cap/Small-cap Equity fund, Value fund, etc.

The portfolio composition flows out of the investment objectives of the scheme.
Funds are classified into Equity Funds, Debt Funds and Special Funds.

(a) Equity Funds: Equity funds invest primarily in stocks. A share of stock represents a unit of ownership in a company. If a company is successful, shareholders can profit in two ways:

- the stock may increase in value, or
- the company can pass its profits to shareholders in the form of dividends.

If a company fails, a shareholder can lose the entire value of his or her shares; however, a shareholder is not liable for the debts of the company.

Equity Funds are of the following types viz.

(i) **Growth Funds:** They seek to provide long term capital appreciation to the investor and are best to long term investors.

(ii) **Aggressive Funds:** They look for super normal returns for which investment is made in start-ups, IPOs and speculative shares. They are best to investors willing to take risks.

(iii) **Income Funds:** They seek to maximize present income of investors by investing in safe stocks paying high cash dividends and in high yield money market instruments. They are best to investors seeking current income.

(b) Debt Funds

Debt Funds are of two types viz.

(i) **Bond Funds**: They invest in fixed income securities e.g. government bonds, corporate debentures, convertible debentures, money market. Investors seeking tax free income go in for government bonds while those looking for safe, steady income buy government bonds or high-grade corporate bonds. Although there have been past exceptions, bond funds tend to be less volatile than stock funds and often produce regular income. For these reasons, investors often use bond funds to diversify, provide a stream of income, or invest for intermediate-term goals. However, like stock funds, bond funds also have following risks and can lose money.

(ii) **Gilt Funds**: They are mainly invested in Government securities.

(c) Special Funds

Special Funds are of four types viz.

(i) **Index Funds:** Every stock market has a stock index which measures the upward and downward sentiment of the stock market. Index Funds are low cost funds and influence the stock market. The investor will receive whatever the market delivers.

(ii) **International Fund**s: A mutual fund located in India to raise money in India for investing globally.

(iii) **Offshore Funds:** A mutual fund located in India to raise money globally for investing in India.

(iv) **Sector Funds:** They invest their entire fund in a particular industry e.g. utility fund for utility industry like power, gas, public works.

5. Thematic / solution oriented: Tax saving, Retirement benefit, Child welfare, Arbitrage

A Thematic fund focuses on trends that are likely to result in the ‘out-performance’ by certain sectors or companies. The theme could vary from multi-sector, international exposure, commodity exposure etc. Unlike a sector fund, theme funds have a broader outlook.

However, the downside is that the market may take a longer time to recognize views of the fund house with regards to a particular theme, which forms the basis of launching a fund.

(a) Tax Saving Schemes:

Object: Provide tax rebates to the investors under specific provisions of the Indian Income Tax laws as the Government offers tax incentives for investment in specified avenues.

For Whom? For persons who seek to park their otherwise taxable income in funds for a moderate income, to reduce their tax liability.

(b) Equity Linked Savings Scheme (ELSS)

ELSS is one of the options for investors to save taxes under Section 80 C of the Income Tax Act. They also offer the perfect way to participate in the growth of the capital market, having a lock-in-period of three years. Besides, ELSS has the potential to give better returns than any traditional tax savings instrument.

Moreover, by investing in an ELSS through a Systematic Investment Plan (SIP), one can not only avoid the problem of investing a lump sum towards the end of the year but also take advantage of "averaging".

(c) Arbitrage Funds

Typically, these funds promise safety of deposits, but better returns, tax benefits and greater liquidity. Pru-ICICI is the latest to join the list with its equities and derivatives funds.

instruments and lower volatility in comparison to equity.

This fund is aimed at an investor who seeks the return of small savings instruments, safety of bank deposits, tax benefits of RBI relief bonds and liquidity of a mutual fund.

Arbitrage fund finally seeks to capitalize on the price differentials between the spot and the futures market.

The other schemes in the arbitrage universe are Benchmark Derivative, JM Equity and Derivatives, Prudential ICICI Balanced, UTI Spread and Prudential ICICI Equity and Derivatives.

6. Exchange Traded Funds

Exchange Traded Funds (ETFs) are hybrids product that combine the features of listed stocks and index fund. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETFs can be bought and sold like any other stock on an exchange. In other words, ETFs can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. Therefore, one can invest at real time prices as against the end of the day prices as is the case with open-ended schemes.

Index Funds attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50

7. Overseas Funds or International Funds

A mutual fund located in India to raise money globally for investing in India.

An international mutual fund, also known as a foreign or global fund, is a type of investment vehicle that pools money from multiple investors to invest in a diversified portfolio of stocks or bonds from companies and governments outside of the investor's home country.

- **Global Funds:** Invest in companies from around the world, including the investor's home country.
- **International Funds:** Invest in companies from countries outside the investor's home country.
- **Regional Funds:** Focus on specific regions or countries, such as a fund focused on emerging markets or a fund focused on the US market.

8. Fund of Funds

Fund of Funds (FoF) as the name suggests are schemes which invest in other mutual fund schemes. It is a Mutual Fund Scheme, where the subscription proceeds are invested in other Mutual Funds, instead of investing in Equity or Debt Instruments.

These funds offer and achieve a greater diversification than traditional mutual funds.

Expense/Fees on such funds are higher than those on regular funds because they include part of the expense fees charged by the underlying funds.

Indirectly, the proceeds of Fund of Funds may be invested in its own funds, and can be difficult to keep track of overall holdings.

12. Systematic Investment Plan (SIP) and Systematic Withdrawal Plan (SWP):

Systematic Investment Plan (SIP):

(i) **Nature:** Under a SIP, an investor can invest in the units of mutual funds at periodic intervals (monthly or quarterly) prevailing unit price of that time. This fund is for those investors who do not want to accumulate their savings and invest in one go. this fund permits them to accumulate their savings by directly investing in the mutual fund**.**

(ii) **Feature:** Investors can save a fixed amount of rupees every month or quarter, for the purchase of additional units.

Systematic Withdrawal Plan (SWP):

(i) **Nature**: SWP permits the investor to make an investment at one go and systematically withdraw at periodic intervals, at the same time permitting the balance funds to be re-invested.

(ii) **Features:**

- ❖ Investors can receive regular income while still maintaining their investment's growth potential.
- ❖ SWP includes convenient payout options and has several tax advantages.
- ❖ Withdrawal can be done either on a monthly basis or on a quarterly basis, based on needs and investment goals of an investor.
- ❖ Tax is not deducted, & dividend distribution tax is not applicable. There are no entry or exit loads.

13. Factors Affecting selection of Mutual Funds:

(i) **Past Performance**: The Net Asset Value is the yardstick for evaluating a Mutual Fund. An increase in NAV means a capital appreciation of the investor. While evaluating the performance of the fund, the dividends distributed is to be considered as the same signifies income to the investor. Dividends distributed during a period go on to reduce the Net Asset Value of the fund to the extent of such distribution.

(ii) **Timing:** The timing when the mutual fund is raising money from the market is vital. In a bullish market, investment in mutual fund falls significantly in value whereas in a bearish market, it is the other way round where it registers growth.

(iii) **Size of Fund:** Managing a small sized fund and managing a large sized fund is not the same as it is not dependent on the product of numbers. Purchase through large sized fund may by itself push prices up while sale may push prices down. Medium sized funds are generally preferred.

(iv) **Age of Fund:** Longevity of the fund in business needs to be determined and its performance in rising, falling and steady markets have to be checked for consistency.

(v) **Largest Holding**: It is important to note where the largest holdings in mutual fund have been invested in order to identify diversion of funds to Group Concerns.

(vi) **Fund Manager**: One should have an idea of the person handling the fund management. A person of repute gives confidence to the investors. His performance across varying market scenarios should also be evaluated.

(vii) **Expense Ratio**: SEBI has laid down the upper ceiling for Expense Ratio. A lower Expense Ratio will give a higher return which is better for an investor.

(viii) **PE Ratio**: The ratio indicates the weighted average PE Ratio of the stocks that constitute the fund portfolio with weights being given to the market value of holdings. It helps to identify the risk levels in which the mutual fund operates.

(ix) **Portfolio Turnover**: The fund manager decides as to when he should enter or quit the market. A very low portfolio turnover indicates that he is neither entering nor quitting the market very frequently. A high ratio, on the other hand, may suggest that too frequent moves have led the fund manager to miss out on the next big wave of investments. A simple average of the portfolio turnover ratio of a peer group updated by mutual fund tracking agencies may serve as a benchmark. The ratio is annual purchase plus annual sale to average value of the portfolio.

14. Net Asset Value (NAV) in relation to a Mutual Fund:

Net asset Value (NAV) of a mutual fund (mf) scheme is the market Value per unit of all the assets of the scheme. It is the value of each unit of the scheme. it includes dividends, interest accruals and reduction of liabilities and expenses.

For example, if the market value of securities of a mutual fund scheme is ₹200 lakh and the mutual fund has issued 10 lakh units of ₹ 10 each to the investors, then the NAV per unit of the fund is ₹ 20 (i.e., ₹200 lakh/10 lakh).

Since market value of securities changes every day, NAV of a scheme also varies on day-to-day basis. NAVs of mutual fund schemes are published on respective mutual funds' websites as well as AMFI's website daily.

Unlike stocks, where the price is driven by the stock market and changes from minute-to-minute, NAVs of mutual fund schemes are declared at the end of each trading day after markets are closed, in accordance with SEBI Mutual Fund Regulations. Further, Units of mutual fund schemes under all scheme (except Liquid & Overnight funds) are allotted only at prospective NAV, i.e., the NAV that would be declared at the end of the day, based on the closing market value of the securities held in the respective schemes.

A mutual fund may accept applications even after the cut-off time, but you will get the NAV of the next business day. Further, the cut-off time rules apply for redemptions too.

There are three aspects which need to be highlighted:

(i) It is the net value of all assets less liabilities. NAV represents the market value of total assets of the Fund less total liabilities attributable to those assets.

(ii) NAV changes daily. The value of assets and liabilities changes daily. NAV today will not be NAV tomorrow or day later.

(iii) NAV is computed on per unit basis i.e. dividing the Net Asset Value by number of Outstanding Units.

(A) **Ascertainment:**

(i) The investors' subscription is treated as the capital in the Balance sheet of the fund, and the investments on their behalf are treated as assets.

(ii) NAV per Unit = Net asset Value of the fund ÷ No. of Units Outstanding.

(iii) It reflects the realizable value that the investor will get for each unit that he is holding if the scheme is liquidated on that date.

(iv) Net Assets = Market Value of Investments + Receivables + Accrued Income + Other Assets - Accrued Expenses - Payables - Other Liabilities

(B) **Utility:**

(i) The performance of a particular scheme of a mutual fund is denoted by NAV.

(ii) NAV plays an important part in investors' decisions to enter or to exit the Scheme.

(iii) Analysts use the NAV to determine the yield on the schemes. investors' rights & Obligations under the Mutual Fund Regulations.

Investors' Rights & Obligations under the Mutual Fund Regulations

(A)Rights:

(i) Unit holder has a proportionate right in the beneficial ownership of the scheme assets, as well as any dividend or income declared under the scheme.

(ii) Unit holder is entitled to receive dividend warrant within 42 days.

(iii) AMC can be terminated by 75% of the unit holders.

(iv) Unit Holder has the right to inspect major documents i.e., material contracts, Memorandum of Association and Articles of Association of the AMC, Offer Document, etc.

(v) 75% of the unit holders have the right to approve any changes in the close-ended scheme.

(vi) Every unit holder have right to receive copy of the annual statement.

Limitations to Investors' Rights:

(i) No right against Trust: Unit holders cannot sue the Trust, but they can initiate proceedings against the Trustees, if they feel that they are being cheated.

(ii) No right to sue for lower returns: Except in certain circumstances, AMC cannot assure a specified level of return to the investors. AMC cannot be sued to make good any shortfall in such schemes.

Investors' Obligations:

(i) Study of risk factors: An investor should carefully study the risk factors and other information provided in the Offer Document. Failure to study will not entitle him for any rights thereafter.

(ii) Monitoring schemes: It is the responsibility of the investor to monitor his schemes, by studying the Reports and other Financial Statements of the Funds.

Sale Price

Sale Price is the price payable per unit by an investor for purchase of units (subscription) and/or switch-in from other schemes of a mutual fund.
SEBI vide circular no. SEBI / IMD / CIR No. 4 / 168230 / 09 dated June 30, 2009 has abolished Entry Load for all mutual fund schemes.
Hence, during the New Fund Offer (NFO), the Sale Price per unit is at Face Value per unit specified in the respective Scheme Information Document (SID) and Key Information Memorandum (KIM)
During the 'Ongoing Offer' period (i.e., the date from which the scheme re-opens for subscriptions/redemptions after the closure of the NFO period.), the units may be purchased at NAV i.e., the Sale Price per unit is equivalent to applicable NAV on the date of subscription

Repurchase/Redemption Price

The Repurchase/Redemption Price is the price per Unit at which a Mutual Fund would 'repurchase' the units (i.e., buys back units from the investor) upon redemption of units or switch-outs of units to other schemes/plans of the Mutual Fund by the investors, and includes Exit Load, if / wherever applicable.

Redemption price is calculated as follows:

Redemption Price = Applicable NAV*(1- Exit Load, if any)
For Example: If the Applicable NAV is ₹10 and Exit Load is 2%, then the Redemption Price will be = ₹10* (1-0.02) = ₹9.80
It may be noted that an AMC / Trustee has the right to modify existing Exit Load structure and/or to introduce Exit Loads subject to a maximum limit prescribed under the Regulations.
Any change in Load structure will be effective on prospective basis and will not affect the existing mutual fund units in any manner.
As per SEBI (Mutual Funds) Regulations, 1996, in respect of Open-Ended Schemes, Repurchase Price (commonly referred to as Redemption price) shall not be lower than 95% of NAV.
It may be noted that units of Closed Ended Schemes cannot be Repurchased prematurely.
(Source: https://www.amfiindia.com/investor-corner/knowledge-center/net-asset-value.html#accordion3)

Entry and Exit Load in Mutual Funds

Some Asset Management Companies (AMCs) have sales charges, or loads, on their funds (entry load and/or exit load) to compensate for distribution costs. Funds that can be purchased without a sales charge are called no-load funds.
Entry load is charged at the time an investor purchases the units of a scheme. The entry load percentage is added to the prevailing NAV at the time of allotment of units.
Exit load is charged at the time of redeeming (or transferring an investment between schemes). The exit load percentage is deducted from the NAV at the time of redemption (or transfer between schemes). This amount goes to the Asset Management Company and not into the pool of funds of the scheme. In simple terms, therefore, Entry and Exit Load in Mutual Fund are the charges one pays while buying and selling the fund respectively.

15. Methods for evaluating the performance of Mutual Fund

Following are the methods for evaluating the performance of Mutual Fund

1. **Sharpe Ratio:**

(a) Nature: Sharpe Ratio is a composite measure to evaluate the performance of Mutual Funds by comparing the reward to risk ratio of different funds. This formula uses the volatility of portfolio return.

(b) Basis: The reward, i.e. portfolio return in excess of the average risk-free rate of return, is divided by standard deviation. Since it considers standard deviation as a measure of risk, it takes into account both Systematic and Unsystematic Risk.

(c) Risk Premium: This measure indicates the risk premium return per unit of total risk. Excess return earned over the risk-free return on portfolio to the portfolio's total risk measured by the standard deviation.

(d) Computation:

Sharpe Ratio = $(R_P - R_F) \div \sigma_P$

Where,

R_P = Return on Portfolio

R_F = Risk Free Return

σ_P = Standard Deviation of Portfolio

(e) Use: Sharpe Ratio is an appropriate measure of performance for an overall portfolio when it is compared with another portfolio. The result on its own cannot lead to any comparison. It has to be compared with returns from another portfolio for making any meaningful conclusion.

2. Treynor's Ratio:

(a) Nature: Treynor Ratio is a measure to evaluate the performance of mutual funds by comparing the reward to volatility ratio of different funds. Risk considered here is only Systematic Risk, and not Total Risk.

(b) Assumption: It assumes a completely diversified portfolio, i.e. that the investor would have eliminated all the unsystematic risk by holding a diversified portfolio.

(c) Basis: Excess return earned over the risk-free return on portfolio to the portfolio's total risk measured by the Beta of Portfolio. The ratio expresses the portfolio's risk premium per unit of beta.

(d) Computation:

Treynor's Ratio = $(R_P - R_F) \div \beta_P$

Where, R_P = Return on Portfolio

R_F = Risk Free Return

β_P = Beta of Portfolio

(e) Use: It is appropriate only in case of comparison with completely diversified portfolio. As in the case of Sharpe Ratio, Treynor's measure cannot be used in an isolated manner. It should be compared with such results of other portfolio to draw conclusions.

3. Jensen's Alpha:

(a) Nature: It is an absolute measure of evaluating a fund's performance. It compares desired performance (based on benchmark portfolio) with actual performance.

(b) Benchmark Performance: Benchmark Performance is computed using Capital Asset Pricing Model (CAPM), i.e. by factoring the sensitivity of the portfolio return to that the Market Portfolio.

(c) Computation:

Jensen's Alpha [α] = Actual Return Less Return under CAPM

(d) Evaluation and Appropriateness:

- If Jensen's Alpha is positive, it reflects that the Mutual Fund has exceeded the expectations and outperformed the Market Portfolio and vice-versa.
- Alpha would give meaningful results only if its used to compare two portfolios of similar beta factor
- It is used for measuring performance of a portfolio and to identify the part of the performance that can be attributed solely to the portfolio.
- This model considers only systematic risk and not the total risk.

Different kinds of expenditure incurred by a Mutual Fund and the way to treat them in computing the net asset value:

(i) **Initial Issue Expenses:** AMC incur some expenses when a scheme is launched. The benefits of these expenses accrue over many yea₹ Therefore, they cannot be charged to any single year. SEBI permits amortization of initial expenses as follows —

(a) **Close End Scheme:** Such schemes floated on a load basis; the initial issue expense shall be amortized on a weekly basis over the period of the scheme.

(b) **Open Ended Scheme:** Initial issue expenses may be amortized over a period not exceeding 5 years Issue expenses incurred during the life of an open-end scheme cannot be amortized.

(ii) **Recurring Expenses:** It includes the followings:

(a) Marketing and selling expenses including agent's commission
(b) Brokerage and transaction costs
(c) Registrar services for transfer of units sold or redeemed.
(d) Audit fees
(e) Custodian charges
(f) Costs related to investor communication
(g) Cost of fund transfers from location to location
(h) Cost of providing accounts statements and dividend/ redemption cheques and warrants
(i) Insurance Premium paid by the Fund
(j) Winding up costs for terminating a fund or a scheme
(k) Cots of statutory advertisements.
(l) Other costs as approved by SEBI.

(iii) **Total Expenses:** Total Expenses of the scheme as charged by the AMC excluding issue or redemption expenses but including investment management and advisory fees, are subject to the following limits-

(a) On the first Rs.100 Crores of the average weekly Net Assets - 1.5%
(b) On the next Rs. 300 Crores of the average weekly Net Assets - 2.25%
(c) On the next Rs.300 Crores of the average weekly Net Assets - 2.0%
(d) On the balance of the assets 1.75%

16. Value of Traded Securities and Non-Traded Securities of Mutual Fund

Traded Securities:

(a) Last Quoted Closing Price: Traded Securities should be valued at the last quoted closing price on the Stock Exchange.

(b) **More than One Stock Exchange:** If the securities are traded on more than one Stock Exchange then the valuation should be as per the last quoted closing price on the Stock Exchange where the security is principally traded.

(c) **No Trading on Principal Stock Exchange:** When on a particular valuation day, a security has not been traded on the selected Stock Exchange, the value at which it is traded on another Stock Exchange may be used.

Non-Traded Securities:

(a) **Meaning:** If a security is not traded on any Stock Exchange for a period of 60 days prior to the
valuation date, the scrip must be valued as a non-trade scrip.

(b) **Valuation:** Non-Traded Scrips should be valued in good faith by the AMC on the basis of valuation methods approved by the AMC.

(c) **General** Principles in Valuation:

- **Equity Instruments:** Valued on the basis of capitalization of earnings solely or in combination with the Net Asset Value. Price Earnings Ratios of comparable traded securities, with an appropriate discount for lower liquidity, should be used for the purpose of capitalization.
- **Debt Instruments:** Valued on YTM (Yield to Maturity) basis. Capitalization factor being determined for comparable traded securities with an appropriate discount for lower liquidity.
- **Government Securities:** Valued at YTM based on the prevailing market rate.
- **Money Market Instruments:** Valued at Cost Plus Accruals.
- **Convertible Debentures/Bonds:** Non-convertible component should be valued as a debt Instrument, and Convertibles as any Equity Instrument.

17. Rating of Mutual Funds Scheme in India

In India, Mutual funds schemes are evaluated by independent institutions amongst which CRISIL, Value Research India and Economic Times are most popular.

CRISIL: This rating shows how likely a particular MF is going to deliver the returns on time and within the policy framework. Their calculations include: (a) superior return scope; (b) portfolio concentration analysis; (c) mean return and volatility; (d) quality of assets; (e) exposure to sensitive sector; (f) liquidity analysis; (g) tracking error for index funds. It indicates how much a fund's performance can fluctuate regarding the index that it tracks. A lower tracking error is a positive indicator. It covers the schemes and ranks in the following five categories equity, debt, balanced, gilt and liquid.

CRISIL rating starts from 1 star to 5 star. Top 10% funds get 5-star ratings (very good), the next 20% good, the next 40% average, the next 20% below average and the last 10% poor.

Value Research India: Value research fund rating (risk-adjusted rating) is a metric that can be defined as a composite measure of both the returns and risk associated with a particular fund. The rating is almost in line with CRISIL. Each scheme is assigned a risk grade and a return grade and composite measure of performance is calculated by subtracting the risk grade form the return grade. Within each category, the top 10%, are considered 5 star, the next 22.5% four star the next 35% three star, the next 22.5% two star, and the last 10% one star.

Economic Times: It evaluates MF schemes on a quarterly basis and uses a risk-adjusted tracker for the measurement of performance known as Sortino ratio. It assesses the fund performance under five categories: equity diversified, ELSS, balanced, MIP and debt. The top 10% of funds in each category are classified as platinum, the next 20% as gold and balance 70% as silver.

Morningstar Ratings

One of the best-known and widely used by the investors regarding mutual fund performance today is the rating system developed by Morningstar. Investors quickly search the ratings made by Morningstar when they wish to invest in mutual fund. They feel that such a rating is a likely predictor of future success. However, it is important to note that this rating system is measuring historical risk-adjusted performance of funds that have at least a three- year history.

When both the risk and return measures are put together, a raging can be determined for all fund in a set. Top 10% receive 5 stars, next 22.5% receive for stars, next 35% receive three stars, next 22.5 two stars and balance 10% one star.

The Morningstar raking system, using one to five stars, remains a popular measure of mutual fund performance. Although not perfect even now, it is a sound, well-regarded tool for investors if used properly. Morningstar itself has always urged investors to use its star system of rakings as a starting point in selecting funds, not as the bottom line. This is a good advice to remember.

Illustrations

Illustration 1

A mutual fund has a net asset value of Rs.50 at the beginning of the year. During the year, a sum of Rs.4 was distributed as income (dividend) besides Rs.3 as capital gains distribution. At the end of the year, NAV was Rs.55. Calculate total return for the year. Suppose the aforesaid mutual fund in the next year declared a dividend of Rs.5 as income distribution and no capital gains distribution and NAV at the end of second year was Rs.50, what is the return for the second year?

Name of the Scheme	ABC
Size of the Scheme	Rs.100 lakhs
Face Value of the Share	Rs.10
Number of the outstanding shares	10 lakhs

Market value of the fund's investments Receivables	Rs.180 lakhs
Accrued Income	Rs.1 lakh
Receivables	Rs.1 lakh
Liabilities	Rs.50,000
Accrued expenses	Rs.50,000

Find NAV per unit?

Answer:

NAV per unit = (Investment + Recoverable + Accrued Income – Liabilities – Accrued expenses)/No of units (mutual fund) = (180 lakhs + 1 lakh + 1 lakh – 0.50 lakh – 0.50 lakh)/10 lakhs = 18.1 lakhs.

Illustration 2

A mutual fund made an issue of 20,00,000 units of ₹10 each on January 01, 2024. No entry load was charged. It made the following investments:

Particulars	Amount (₹)
1,00,000 Equity shares of ₹100 each @₹160	160,00,000
8% Government Securities	16,00,000
11% Debentures (unlisted)	10,00,000
10% Debentures (listed)	10,00,000
Total	1,96,00,000

During the year, dividends of ₹24,00,000 were received on equity shares. Interest on all types of debt securities was received as and when due. At the end of the year equity shares and 11% debentures (unlisted) are quoted at 180% and 85% respectively. Other investments are at par.

Find out the Net Asset Value (NAV) per unit given that operating expenses paid during the year amounted to ₹10,00,000. Also find out the NAV, if the mutual fund had distributed a dividend of ₹0.75 per unit during the year to the unitholders.

Answer:

Calculation of NAV

Particulars	Amount (₹)
Cash Balance in the Beginning	4,00,000.00
(Rs.200 Lakh -196 Lakh)	
Dividend Received	24,00,000.00
Interest on 8% Govt. Securities	1,28,000.00
Interest on 11% Debentures (unlisted)	1,10,000.00
Interest on 10% Debentures (listed)	1,00,000.00
	31,38,000.00
Less; Operating Expenses	10,00,000.00
Net Cash Balance at the end	21,38,000.00
Calculation of NAV _	
Cash Balance	21,38,000.00
8% Government Securities	16,00,000.00

11% Debentures (unlisted)	8,50,000.00
10% Debentures (listed)	10,00,000.00
1,00,000 Equity shares @ Rs.180	1,80,00,000.00
Total Assets	2,35,88,000.00
No of Units	20,00,000
NAV per Unit	11.79

Calculation of NAV, if dividend of Re.0.75 is paid

Particulars	Amount (₹)
Total Assets	2,35,88,000.00
Less: Dividend (Re.0.75 per unit)	15,00,000.00
Net Assets	2,20,88,000.00
No of Units	20,00,000
NAV per Unit	11.04

Illustration 3

Moon Light Mutual Fund Co. has the following assets under it on the close of business as on:

Company	No. of Shares	1st March 2024 Market price per share (₹)	2nd March 2024 Market price per share (₹)
A Ltd.	20,000	20.00	20.40
B Ltd.	30,000	315.50	363.00
C Ltd.	20,000	360.30	381.20
D Ltd.	60,000	507.20	505.80

Total number of units is 600,000.

Calculate the Net Asset Value (NAV) per unit of the Fund on 1st March 2024.

Answer:

NAV of the fund currently is the market value of securities divided by the outstanding number of units
Market Value of Securities as on 1st March 2024

Company	No. of Shares	1st March 2022 Market Price of Share (₹)	Market Value of Securities (₹)
A Ltd.	20,000	20.00	400,000
B Ltd.	30,000	315.50	9,465,000
C Ltd.	20,000	360.30	7,206,000
D Ltd.	60,000	507.20	30,432,000
		Total	47,503,000

NAV= $\frac{₹47,503,000}{6,00,000}$= ₹79.17

Illustration 4

Find out Net Asset Value (NAV) per unit from the following information of Scheme Grow Money.

Name of the scheme Grow Money

Size of the scheme	₹ 250 Lakhs
Face value of the unit	₹ 10
Number of the outstanding units	2.5 Lakhs
Market value of the fund's investments	₹ 160 Lakhs
Cash and other assets in hand	₹ 1 Lakh
Receivables	₹ 3 Lakhs
Liabilities	₹1.2 Lakhs

Answer:

Total Assets

Market value of the fund's investments	₹ 160 Lakhs
Cash and other assets in hand	₹ 1 Lakhs
Receivables	₹ 3 Lakhs
Total	₹ 164 Lakhs

Total Liabilities

Liabilities	₹1.2 Lakhs

Net Asset Value (NAV) = $\frac{Total\ Assets - Total\ Liabilities}{No.of\ Units\ Outstanding}$

= $\frac{Rs.164\ lakhs - Rs.1.2\ Lakhs}{2.5\ lakhs}$

= ₹65

Illustration 5

The following portfolio details of a mutual fund scheme are given below:

Stock	No. of shares	Price (₹)
P	4 Lakh	45
Q	6 Lakh	50
R	8 Lakh	25
S	12 Lakh	30

The scheme has accrued expenses towards portfolio managers of ₹ 6 Lakh. There are 80 lakh units outstanding. Find out the NAV (Net Asset Value) per unit of the scheme.

Answer:

Portfolio of the Scheme

Stock	No. of shares	Price (₹)	Value (₹)
P	4 Lakh	45	180 Lakhs
Q	6 Lakh	50	300 Lakhs
R	8 Lakh	25	200 Lakhs

S	12 Lakh	30	360 Lakhs
Total			1040 Lakhs

NAV per Unit= Net Asset Value (NAV) = $\frac{Total\ portfolio\ -Total\ Expenses}{No.of\ Units\ Outstanding}$

$= \frac{Rs.1040\ lakhs - Rs.6\ Lakhs}{80\ lakhs}$

= ₹12.925

Illustration 6

Following information is available regarding four mutual funds:

Mutual Fund	Return (%)	Risk (σ)	Beta	Risk free rate (%)
P	13	16	0.90	10
Q	17	23	0.86	10
R	23	39	1.20	10
S	15	25	1.38	10

Evaluate performance of these mutual funds using Sharp Ratio and Treynor's Ratio. Comment on the evaluation after ranking the funds.

Answer:

Mutual Fund	Under Sharpe's Method [(R_P-R_F) ÷ σP]	Ranking	Under Treynor Method [(R_P-R_F) ÷ β_P]	Ranking
P	[(13-10) ÷ 16] = 0.19	4	[(13-10) ÷ 0.90] = 3.33	4
Q	[(17-10) ÷ 23] = 0.31	2	[(17-10) ÷ 0.86] = 8.14	2
R	[(23-10) ÷ 39] = 0.33	1	[(23-10) ÷ 1.20] = 10.83	1
S	[(15-10) ÷ 25] = 0.2	3	[(15-10) ÷ 1.38] = 3.63	3

Inference: Ranks obtained as per Sharpe Ratio as well as Treynor's Ratio is same. This indicates that all the mutual funds seem to be reasonably well diversified.

Multiple Choice Questions (MCQs)

1. Which of the following statements is incorrect?
   (A) Mutual funds serve as a key financial intermediary.
   (B) Managers of mutual funds do not analyze economic and industry trends.
   (C) Because of their diversification, management expertise, and liquidity, mutual funds have grown at a rapid pace.
   (D) Some mutual funds offer check-writing privileges.
   Answer: (B)
2. Consider the following statements:
   A mutual fund helps the investor in securing:
   i) professional management
   ii) diversification of risk
   iii) steady appreciation
   iv) lower cost of operation

   Of these statements:
   (a) 1 and 2 are correct
   (b) 1,2 and 4 are correct
   (c) 1, 2,3 and 4 are correct
   (d) 2, 3 and 4 are correct
   Ans: (c)

3. Mutual funds that do not repurchase their shares from investors are _______ mutual funds.
   (A) closed-end
   (B) load
   (C) no-load
   (D) open-end
   Answer: (A)

4. The important role while establishing the mutual fund scheme is played by the
   (A) AMC
   (B) Trustees
   (C) Sponsors
   (D) Custodians
   Answer: (C)

5. Money market funds invest mostly in:
   (A) Stocks
   (B) Long-term bonds
   (C) Real estate
   (D) Short-term securities
   Answer: (C)

6. Settlements are done at the instance of the
   (A) Custodian

(B) AMC
(C) Trustees
(D) Sponsors
Answer: (B)

7. The functions of the trustees is/are
   (A) Marketing the mutual fund schemes
   (B) To seek the RBI approval in case the scheme is open for NRIs
   (C) Submitting compliance reports to SEBI
   (D) All of the above
   Answer: (D)

8. Balanced funds have the following characteristics
   (A) They consist of equity and bonds in equal proportion
   (B) They have moderate risk component
   (C) They have above average growth potential
   (D) None of the above
   Answer: (B)

9. The function(s) of AMC is/are
   (A) Taking investment decisions and committing the funds in the primary/secondary market
   (B) Maintaining the records and necessary information systems
   (C) Inform the trustees of the latest happenings and decisions
   (D) All of the above
   Answer: (D)

10. Which among the following increases the NAV of a mutual fund scheme?
    (A) Value of investments
    (B) Receivables
    (C) Accrued income
    (D) All of (a), (b) and (c)
    Answer: (D)

11. Following is/are the advantages of investing in mutual funds
    (A) Diversified investment
    (B) Professional management
    (C) Tax benefits
    (D) All of (a), (b) and (c)
    Answer: (D)

12. Which of the following benefits is not usually conferred by mutual funds?
    (A) Diversified investment portfolio

(B) Professional stock selection and asset management
(C) Tax benefits
(D) Assured returns
Answer: (D)

13. Which of the following is not an advantage of mutual funds?

(A) Expertise in selection and timing of investment

(B) Economies of scale and lower transaction costs

(C) Reinvestment of dividend income possible

(D) Limited investment opportunities and hence no need for the investor to have knowledge on investment management
Answer: (D)

14. The mutual funds are likely to perform better in the market than a small investor because they

(A) Depend on the technical analysis tools and have the expertise to use them

(B) Depend on the fundamental analysis which ensures the long-term performance of the fund

(C) Have access to better information, ability and infrastructure to utilize it

(D) None of the above
Answer: (C)

15. Identify the statement that applies to open-end mutual funds

(A) They do not redeem or issue shares

(B) Shares of such funds are traded on organized exchanges

(C) Their price can't fall below the NAV

(D) Exit from such funds involves selling shares to other investors.
Answer: (D)

16. Which of the following is an advantage to investors of exchange traded funds (ETFs) that is not available to investors in open-end mutual funds?

(A) ETFs allow investors to invest in broad market indexes as well as international indexes

(B) Investors can avoid incurring an expense in the form of a bid ask spread by purchasing an ETF rather than

(C) investing in an open-end mutual fund

(D) ETFs offer a potential tax advantage to investors who incur capital gains taxes only when they sell ETF shares ETF prices cannot deviate from net asset value
Answer: (B)

17. Which of the following mutual fund scheme that provides tax benefits under 80C?

(A) Gilt Funds
(B) Fixed Income Fund
(C) Equity Linked Saving Scheme (ELSS)
(D) Growth Funds

Answer: (C)

18. Basic objective of a money market mutual fund is
    (A) Guaranteed rate of return
    (B) Investment in short-term securities
    (C) Both (a) and (b)
    (D) None of (a) and (b)

Answer: (B)

19. The NAV of mutual fund scheme must by mutual fund on ___basis
    (A) Yearly
    (B) Monthly
    (C) Weekly
    (D) Daily

Answer: (D)

20. Who conducts the certification that have to be passed by persons/entities engaged in marketing and selling of mutual funds?
    (A) SEBI
    (B) AMFI
    (C) IRDAI
    (D) PFRDA

Answer: (B)

21. Fund of funds (FoF) mutual funds invests in _________
    (A) Equities
    (B) Corporate Bonds
    (C) G-Sec
    (D) Other Mutual Funds

Answer: (D)

22. You are given the following information:

    Size of the mutual fund ₹300 crore;
    Face value per unit ₹10;
    Market value of investment ₹320 crore;
    Receivables ₹3 crore;
    Accrued income ₹2 crore;

Liabilities ₹3 crore;
Accrued expenses ₹1 crore.

The NAV per unit of the mutual fund scheme is:

(A) ₹12.00
(B) ₹11.50
(C) ₹13.00
(D) ₹ 10.70

Answer: (D)

23. The market price (ex-dividend) of an open-ended mutual fund scheme unit was ₹30. A dividend of ₹3 has been paid during the year. The ex-dividend price of the unit is ₹35. The rate of return of the past year of the unit is-

(A) 24.32%
(B) 25.52%
(C) 26.67%
(D) 28.56%

Answer: (C)

Return = (Cash dividend + Capital Appreciation+ Capital Gains)/Opening NAV
= (3+5)/30=26.67%

24. The NAV of each unit of a close ended fund at the beginning of the year was ₹20. At the end of the year NAV increases to ₹23.50. At the beginning of the year, each unit was selling at a 5% premium to NAV. By the end of the year, each unit is selling at a discount of 4% to NAV. The fund paid year end distribution of income and capital gains of ₹3.50 on each unit. The rate of return to the investor in the fund during the year is

(A) 23.47%
(B) 23.96%
(C) 24.09%
(D) 26.33%

Answer: (C)

The price of the unit at the beginning of the year = ₹20 × 1.05= ₹21.00
The price of the unit at the end of the year =₹23.50× 0.96=₹22.56
Return= (Cash dividend + Capital Appreciation+ Capital Gains)/Opening NAV
= [3.5+(22.56−21.00)]/21.00=24.09%

25. Following information is available regarding a mutual fund:

Return	12%
Risk (S.D. i.e. σ)	15%
Beta (ß)	0.90
Risk Free Rate	9%

The Treynor's Ratio of the mutual fund is-

(A) 3.33
(B) 3.75

(C) 3.90
(D) 4.33
Answer: (A)
Treynor's Ratio = (R_p – R_f)/ ß = (12-9)/0.90=3.33
Where R_p=Return
R_f=Risk Free Rate of Return
ß =Beta

26. Following information is available regarding a mutual fund:

Return	13%
Risk (S.D. i.e. σ)	16%
Beta (ß)	0.90
Risk Free Rate	10%

The Sharpe Ratio of the mutual fund is-
(A) 0.1875
(B) 0.1845
(C) 0.1975
(D) 0.2045

Answer: (A)
Sharpe Ratio = (R_p – R_f)/σ= (13-10)/16=0.1875
Where R_p=Return
R_f=Risk Free Rate of Return
σ=Standard Deviation (risk)

27. An investor invested in a mutual fund when the Net Asset Value (NAV) was ₹ 15.65. After 60 days, the Net Asset Value per unit of the fund was ₹15.25. Meanwhile, he received a cash dividend of ₹ 0.50 and a Capital Gain distribution of ₹30. The annualized return of the fund will be-
(A) 14.25%
(B) 15.57%
(C) 15.90%
(D) 16.60%

Answer: (B) 15.57%
Capital appreciation = (₹0.40) = (Opening NAV−Closing NAV) = ₹15.25−₹15.65.
Returns= [Dividend+ Capital Gain Distribution +Capital Appreciation]/Opening NAV.
=[₹0.50+₹0.30−₹0.40]/ ₹15.65=2.56%
Annualized return=Return×365days ÷period
=2.56% × 365Days ÷60 days =15.57%

28. The market price (ex-dividend) of an open-ended mutual fund scheme unit was ₹25. A dividend of ₹3 has been paid during the year the ex-dividend price of the unit is ₹29. The rate of return of the past year of the unit is
(A) 30%

(B) 32%

(C) 28%

(D) 19%

Ans: (C) Return= (Cash dividend + Capital Appreciation+ Capital Gains)/Opening NAV

= (3+4)/25=28%