

MANAGING BANKS AND FINANCIAL INSTITUTIONS

Presented By:
Bavesetty Sushmitha
Designation :ASSISTANT
PROFESSOR
Department: DMS
College:GIET(A)

Lecture Details:

MANAGING BANKS AND FINANCIAL INSTITUTIONS

MBFI/MBA

UNIT I

Financial System in India: Introduction - Evolution of Banking - Phases of development - RBI and the Financial System - Committees on Banking Sector Reforms - Prudential Banking -- RBI Guidelines and directions.



Financial Activities



1. Lending
2. Purchasing/Buying
3. Investing
4. Borrowing
5. Selling
6. Foreign Exchange

Financial system:

Definition: A financial system is set of institution such as banks, insurance companies and stock exchanges that permit the exchange of funds

Financial Activities



- Financial systems deals with the financial transactions and exchange of money through investors, lenders and borrowers.
- It exist on or at firm level, regional level and global level
- The financial system of a country is an important tool for economic development of the country, as it helps in creation of wealth by linking savings with investments. It facilitates the flow of funds from the households(savers) to business firms(investors) to aid in wealth creation and development of both the parties
- Definition: According to Robinson, the primary function of a financial system is “to provide a link between savings and investment for creation of wealth and to permit portfolio adjustment in composition of existing wealth”

Features of Financial System

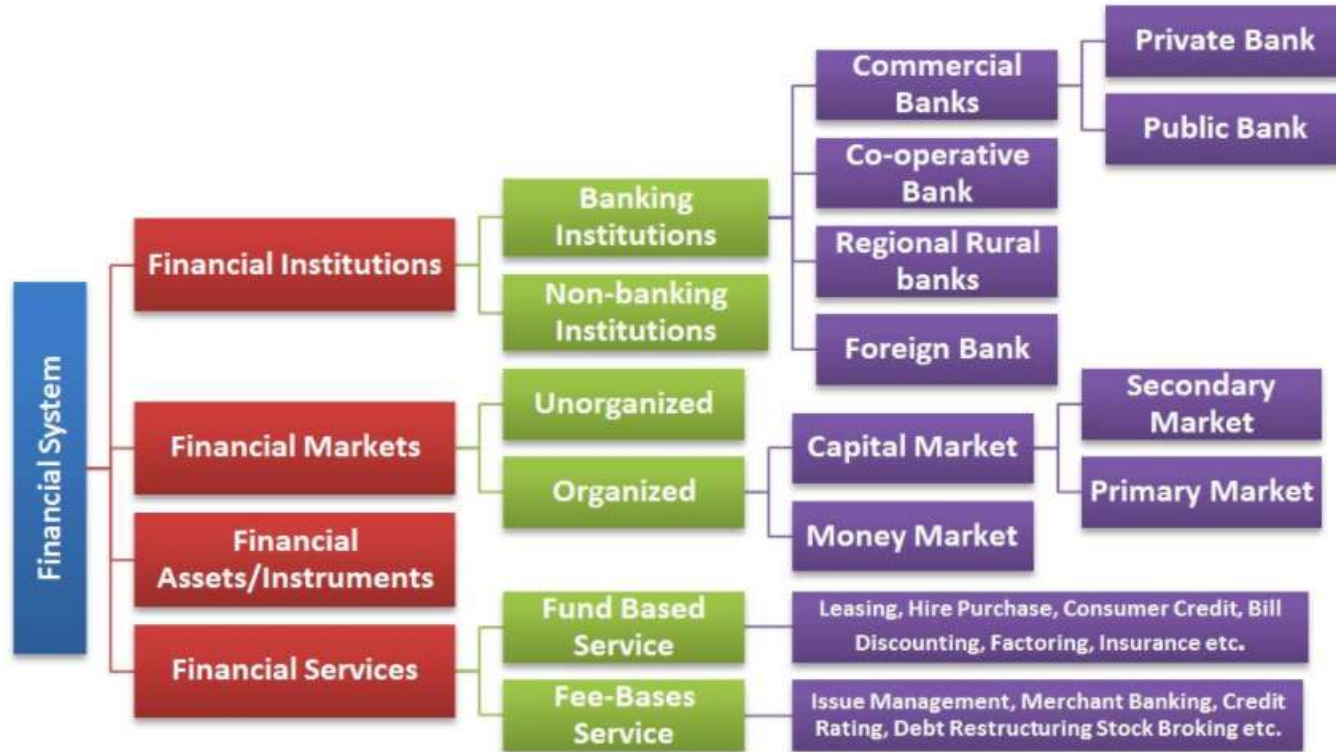
Features of Financial system:

- It plays a vital role in economic development of a country
- It encourages both savings and investment
- It links savers and investors
- It helps in capital formation
- It helps in allocation of risk
- It facilitates expansion of financial markets

Functions of Financial system

- ✓ Financial system bridges the gap between savings and investment through efficient mobilization and allocation of surplus funds
- ✓ Financial system helps a business in capital formation
- ✓ Financial system helps in minimizing risk and allocating risk efficiently
- ✓ Financial system helps a business to liquidate tied up funds
- ✓ Financial system facilitates financial transactions through provision of various financial instruments
- ✓ Financial system facilitate trading of financial assets/instruments by developing and regulating markets

Structure of the Financial system



Financial Institutions



Financial Institutions: Financial Institutions are intermediaries of financial markets which facilitate financial transactions between individual and financial customers

Financial Institutions are categorized into two:

- i) Banking Institutions: These are banks and credit unions that collect money from the public in return of interest on money deposits and use that money to advance loans to financial customers
- ii) Non-Banking Financial Institutions: These are the brokerage firms, insurance and mutual funds companies that can collect money deposits but can sell financial products to financial customers

Financial institutions may be classified into three categories:

- a) Regulatory : It includes institutions such like SEBI, RBI, IRDA which regulate the financial markets and protect the interest of investors

Financial Institutions

b) Intermediaries: It includes commercial banks such as SBI, PNB that provide short term loans and other financial services to individuals and corporate customers

c) Non-Intermediaries: It includes financial institutions like NABARD, IDBI that provide long-term loans to corporate customers

2) Financial Markets: It refers to any market place where buyers and sellers participate in trading of assets such as shares, bonds, currencies and other financial instruments

Financial market may be divided into two:

- a) Capital market: It deals in long term securities having maturity period of more than one year,
- b) Money market: It deals with short-term debt instruments having maturity period of less than one year

Structure of the Financial system



3. Financial Assets/Instruments: Financial assets includes cash deposits, cheques, loans, accounts receivable and other financial instruments to provide a claim against financial institution to pay either a specific amount on a certain future date or to pay the principal amount along with interest

4. Financial Services: Financial Services are concerned with the design and delivery of financial instruments and advisory services to individuals and business within the area of banking and related institutions, personal financial planning, leasing, investment, assets, insurance etc. It involves provision of a wide variety of fund/assets based and non-fund based/ advisory services and includes all kinds of institutions which provide intermediate financial assistance and facilitate financial transactions between individuals and corporate customers.

Structure of the Financial system

Treasury bills: They are issued by the central Govt of India and known to be the safest money market instruments available.

- Traded duration of treasury bills is 15days-365 days

Types of Treasury bills:

- 15days
- 184days
- 364days

Certificate of deposits : It is a money market instrument which is issued in dematerialized form.

- . Governed by the RBI
- . Are issued at minimum of Rs.1,00,000/- and there on in the multiples of Rs.4,00,000.

Structure of the Financial system



Commercial paper: It is unsecured money market instruments which are issued by large corporation to obtain funds to meet short term debts.

Minimum maturity period : 7 days

Maximum maturity period : < 1year from the date of issue.

Capital market: Capital market deals in financial security for the medium and long term debts more than 1year

i) Stock market: A stock market/equity market/share market is the aggregation of buyers and sellers of stocks of shares which represents ownership claim on businesses.

ii) Debt market : Debt market is a market where debt instrument are traded. Debt instruments are assets that require a fixed payment to the owner. Example: Bonds, Mortgage.

Structure of the Financial system



iii) Derivatives market: It is a financial market for derivative financial instruments like future contract or options, which are derived from other form of assets.

Primary market: The primary market is where securities are created.

- It is in this market where new form of stocks and bonds are sold to the public.

Example : Initial public offering(IPO).

Secondary market: Secondary market is where investors buy and sell securities they already own

Example: Stock market NSE,BSE

Indicators of Financial development



1.Finance ratio: This ratio total issue primary and secondary claims to National income.

2.Finance inter-relation ratio: This is the ratio of financial assets to physical assets in the economy.

3.New Issue ratio : This is the ratio of primary issues which indicates how far investment has been financed by direct issue to the savers by the investing sectors.

4.Intermediation ratio: This is the ratio of secondary issues to the primary issues which indicates the extent of development of financial institutions.

Financial system and Economic development



- Economic development of any country is depended on its financial system which Includes Banks, stocks, market, insurance companies.
- The financial system plays a key role in the employment growth in an economy.
- Businesses and industry of the finance by financial system which lead to the growth in employment generation which in turn increases economic activities.

Financial Reforms after 1991

- LPG- Liberalization Privatization Globalization

Aim of the Financial Sector Reforms:

- The major aim of the financial sector reforms are to allocate the resources proficiently increasing the return on investment to improve the growth of real sector in the economy.

Financial Sector Reforms

- The new processes introduced by the Govt of India under reforms are intended
- To upturn the operational efficiency of the financial sector.

The major delineations: The major delineations of the financial sector reforms in India were found as under

1. To create an efficient profitability and productive financial sector.
2. Preparing the financial system for increase internal competition.
3. Promoting financial stability.
4. Enabling the process of price discovery by the market determination of the interest rates that improves the efficiency of resources.
5. Remove the erst while existing financial repression

Financial repression: It is a method for Govt to increase tax income and domestically

Held debt.

Financial Sector Reforms

Financial reforms after 1991: classified into four categories:

1. Banking sector reforms
2. Government debt reforms
3. Forex market reforms
4. Other reforms

1. Banking Sector reforms:

- In August 1991, the Govt of India appointed a committee on financial system under the chairmanship of M.Narasimham.
- On the recommendations of Narasimham committee, following measures were under taken by Govt in 1991:

a) Lowering Statutory liquidity ratio(SLR) & Cash Reserve ratio(CRR):

SLR has been reduced from 38.8% in the year 1991 to 25% in 1997.(current rate:

b) The higher SLR means reduction of profits of the banks.

c) The CRR is the minimum deposit that the bank has to maintain with the RBI.

d) The CRR has been brought down from 15% in 1991 to 4.1% in June 2003.

Financial Sector Reforms

- **Debts:** It is mandatory requirement for all the banks to make 100% provisions for all NPA (Non-performing assets).
- **De-regulation of interest rates:** The Narasimham committee advocated that the interest rate should be allowed to be determined by market forces. Since 1992, Interest rates had become much simpler
- **Competition from new private sector banks:** New private sector banks were introduced and new banks were allowed to raise capital contribution from foreign Institutional investors up to 20% and from NRI's up to 40%. This has led to increase competition in a business sector.
- **Access to capital market:** The companies act was amended to enable the banks to Raise the capital through public issues(IPO).

Financial Sector Reforms



2. Government debt market reforms:

- Many different reforms have been introduced in securities debt market after 1991.
- Debt market deals with tradable debt instruments issued by the Government for making its financial requirements.
- Debt market, stock market and derivatives market-capital market.

3. Forex market reforms:

- The foreign exchange market in India has been characterized by heavy control since 1950's with increasing trade controls.
- Forex was made available through a complex license system undertaken by RBI.

Thus, the major task before the Govt was to move away from the system of total control to a market based exchange rate system.

- This transformation in 1993 has paved a way for introduction of forex reforms in an Indian market.

Financial Sector Reforms



- Under these reforms authorized dealers of foreign exchange as well as banks have been given greater autonomy to carry out different range of activities.
4. Other reforms:
- Several measures have been introduced for non-banking financial intermediaries (NBFC) including those involved in public deposits activities have been brought under the supervision of the RBI.
 - Till 1990's insurance business was under public ownership after the introduction of IRDA act in the year 1992.
 - Many changes have been introduced that is privatization of insurance.
 - SEBI: It was established in the year 1988 and was statutory powers in April 1992, SEBI act. As a regulator for equity market and to improve the market efficiency and integration of national markets and to prevent unfair practices regarding trading.

Financial Sector Reforms



- The Financial reform process had the effect of putting an end to the monopoly of UTI(united trust of India) by opening up of mutual funds to the private sector in 1992.
- Another development which took place in 1992 was the entry of foreign institutional investors.
- The Indian corporate sector has been granted permission to tap international capital markets through American depository, receipts, foreign currency convertible bonds and global depository receipts, moreover overseas corporate bodies and NRIs were allowed to invest in Indian companies.

Rajan Committee:

- It is constituted by the Govt of India in the year 2007 for proposing the next generation of financial sector reforms in India.
- The committee on financial sector reforms headed by the Raghuram Rajan have

Financial Sector Reforms



- suggested a shift a true auction method for securities besides seeking a reduction in the period between auction and listing.
- Better exchange rate system to manage exchange rates.
- The committee suggested that the insurance companies and provident funds to be invested abroad including foreign Govt securities.
- All regulations related to trading including those on Govt bonds should be supervised by SEBI to strength the interconnected markets and to improve liquidity and increase competition.

Recent developments in the Financial System:

Some of the important recent financial developments:

1. Establishment of NITI Aayog: National institution for transforming India.
 - This scheme was established by the central govt in Jan 2015 to replace the planning commission.
 - The NITI aayog with the Prime Minister as its chairperson is expected to provide

Recent developments in the Financial System



Strategic and technical advice to the states on various issues.

New 5yr foreign trade policy(FTP) for 2015-2020:

- This was introduced with a framework for increasing exports
- To generate employment
- To increase value addition in the country keeping in view, Make in India vision.
- Two new schemes were introduced under this policy:
 - i) Merchandise exports from India scheme:
 - For the export of specified goods to specified market
 - ii) Service export from India scheme:
 - For increasing the exports of notified services

Recent developments in the Financial System

Gold monetization scheme:

- The union cabinet approved the introduction of this scheme announced in 2015-16 budget.
- The scheme aims to mobilize the Gold held by households and institution in the country and to use this Gold productively.
- The long term objective of this scheme is reduce the country's reliability on the import of Gold to meet domestic demands.

Pradhan Mantri Jan Dhan Yojana(PMJDY):

- The Govt launched PMJDY in august 2014.
- The PMJDY aims to promote financial inclusion by providing each channel all Central and State Govt benefits to the beneficiaries through this bank accounts

Recent developments in the Financial System



Reserve Bank of India:

- Established in 1935 by the Banking regulation act 1934 with a capital of 5crores
- Nationalized on Jan 1st 1949
- Supreme monetary authority of India
- Responsible for printing currency notes except 1 Rupee coin
- Managing supply of money in Indian economy
- Also known as Central Bank of India

Functions of RBI:

1) Issue of Currency notes:

- i) The RBI has the monopoly for printing the currency notes in the country.
- ii) It has the sole right to issue currency notes of various denominations except 1 rupee note/coin(issued by ministry of finance)

Functions of RBI

iii) The RBI has adopted the minimum reserve system for issuing/printing currency notes in India. Since 1957, it maintains gold and foreign exchange reserves of Rs 200 crores of which at least 115 crores should be in gold coins/ gold bullion and remaining in the form of foreign exchange reserve (foreign currency)

2. Banker to Govt:

- i) It acts as the banker, agent, advisor to the Govt of India.\
- ii) It performs all the banking functions of the State and Central Govt
- iii) It also renders useful advice to the Govt on matters related to economic and monetary policies

3. Bankers Bank:

- i) RBI performs the same functions for other commercial banks as the other banks Ordinarily perform for their customers.
- ii) RBI lends money to all the commercial banks

Functions of RBI

4) Controller of credit:

- i) The RBI undertakes the responsibility of controlling credit created by the commercial banks.
- ii) It uses two methods to control the extra flow of money in the economy and are called as quantitative and qualitative techniques to control and regulate the credit flow in the country
- iii) When RBI observes that the economy has sufficient money supply and it may create inflationary situation in the country
- iv) If the supply of money increase than inflation starts raising.

5) Custodian of foreign reserves:

- i) For the purpose to maintain the foreign exchange rates stable.

Functions of RBI

iv) It sells the foreign currency in a foreign currency market when its supply decreases in the economy and vice-versa

6. Acts as a facilitator:

The commercial banks approach the reserve bank during emergencies to tide over financial difficulties and the RBI comes to their rescue though it may charge a higher rate of interest.

7. Other functions:

- i) It performs a number of functions like buying and selling of Govt securities (T-bills)
- ii) Giving loans to the Government for buying and selling
- iii) Collecting and publishing economic data

Monetary policy

Definition:

Monetary policy is how a central bank or other agency governs the supply of money and interest rates an economy in order to influence output, employment and prices.

Objectives of Monetary Policy:

i) High employment:

- a) Any Govt is committed to promote high employment as it is a desirable goal of monetary policy for 2 main resources.
- b) High unemployment causes financial distress in an economy
- c) When unemployment rate is high it indicates lower GDP (as loss of output)

ii) Price stability :

- a) It is desirable in a developing country like India because a rise in price level inflation creates considerable uncertainty.
- b) Inflation also makes it difficult to plan for the future.

Monetary policy

iii) Interest rate stability:

- a) Stability in interest rate is desirable because fluctuations in interest rate can create uncertainty in an economy and make it more and more difficult to plan for the future.
- b) Fluctuations in interest rates also effects the consumers willingness to buy durable goods.

iv) Stability of financial markets :

- a) The major reason for the creation of central banks is that it can promote a more stable financial system as it helps in preventing financial crisis.
- b) The central bank is the ultimate source of funds in the money market.

v) Stability in foreign exchange:

- a) With the increasing importance of international trade to the Indian economy the value of the rupee relative to other currency has become a major consideration for RBI.
- b) A raise in the value of rupee makes Indian industries less competitive

Monetary policy

with those abroad and declines in the value of the rupee stimulate inflation in India

vi) Economic Growth:

The goal of study economic growth because business are more likely to invest capital equipment to increase productivity which in the effects the economic growth.

Techniques of monetary policy:

a) Quantitative/General methods:

- i) Bank rate/Discount rate
- ii) Open market operations
- iii) Variable reserve ratio
- iv) Change of liquidity

Recent changes in Monetary policy

b) Qualitative/Selective method:

- i) Ceiling on credit
- ii) Margin requirements
- iii) Discriminating interest rate
- iv) Directives
- v) Repo and reverse repo rates

Recent changes in Monetary policy:

Bank rate policy

- i) Open market operations
- ii) CRR(Cash reserve ratio)
- iii) SLR (Statutory liquidity ratio)
- iv) LAF (liquidity adjustment facility)
- v) Provision of micro finance

SEBI

Securities Exchange Board of India: Established in the year 1988 but it got legal status/statutory power in the year 1992

Role of SEBI:

- Promoting investors, investment and protecting them
- Promoting and regulating self regulatory organization/stock exchanges
- Undertaking inspection and enquiries
- Conducting audits of the stock exchanges, intermediaries or any other organization associated with the securities market.

Functions of SEBI:

i) Protective functions:

- a) Checks in price rigging
- b) Prevents insider trading
- c) Prohibits fraud and unfair practices

SEBI



2) Developmental functions

3) Regulatory functions

Non-Statutory Financial Organization (NSFO):

- The financial system has a strong group of financial institutions which are different in nature from banks and financial intermediaries such institutions are called as Non-Statutory financial organization
- Development banks, special development financial institutions like NABARD, IFC(Industrial finance corporation), SFC(State financial corporation)

Role of NSFO's:

- Planning, promoting and developing activities related to NSFO's till the gaps in various sectors
- Coordinating the working of institution engaged in financing, promoting or developing industries.
- Conducting promotional services such as undertaking feasibility studies and providing technical, financial & managerial assistance for the implementation of new projects

NSFO's

Industrial Finance Corporation of India(IFCI): Established in 1948

Role of IFCI:

- To be a solution provider to various financial needs(loans and advances)
- To remain competitive, competent to the economic growth
- To design customer focused solutions
- Acting as an agent to the Central Govt with respect to sanctioning loans to industrial units.

Industrial Re-construction Bank of India(IRBI): Established in the year 1985

- The IRBI provides financial assistance to sick and closed industrial unit.

Role of IRBI:

- To provide financial managerial and technical assistance to sick industrial units
- To undertake leasing business

NSFO's



Role of IRBI:

- To provide financial managerial and technical assistance to sick industrial units
- To undertake leasing business
- To provide consultancy services to the banks in the matter of sick units
- To secure the assistance of other financial institutions and Govt agencies for the revival of sick Industrial units.

Infrastructure Development Finance Company (IDFC) :

- Established on 30th Jan 1997
- It is a specialized institute to facilitate the flow of private finance to commercially viable infrastructure projects such as Telecom, Power, Roads, Railways, port.

Role of IDFC:

- To provide long term finance for infrastructure development
- Support and advisory services to other institutions

NABARD

National Bank for Agriculture and Rural Development:

- Established in July 12 1982
- Headquarters: Mumbai
- NABARD is an apex development financial institution in India
- The bank has been entrusted with matters concerning policy planning and operations in the field of credit for agricultural and other economic activities in rural areas in India.

Role of NABARD:

- NABARD is the most important institution of the country which undertakes the development of agricultural sector, small scale industry located in the rural areas.
- NABARD reaches out to allied economies, supports and promotes integrated development.
- Serves as an apex financial agency for the institution providing investments and production credits for promoting various deep activities in rural areas.

NABARD



- Undertakes monitoring and evaluation of projects refinancing
- Involves in the development of institutions which help the rural economy
- Provides training facilities to the institutions for the rural upliftment
- Regulates and supervise the co-operative banks and regional rural banks activities through out India.

Small Industrial Development Bank of India SIDBI:

Established on April 2, 1990

Headquarters: Lucknow

- SIDBI objective is to provide refinance facilities and short term lending to Industries and serves as the principal financial institution is the micro small and medium enterprises sector(MSME)

SIDBI



Role OF SIDBI:

- SIDBI is active in the development of micro finance institution for providing credit facilities and assists in extending micro finance through finance institution
- Its promotional development program focuses on rural enterprises and entrepreneurship development
- It operates a refinance program in order to increase and support money supply to the micro small and medium enterprises msme sector

State Finance Corporation(SFC):

- In order to meet the varied financial needs of small and medium sized industries, the Govt of India passed the SFC act in 1951 which empowers the State Govt to establish such corporations in their states
- The first SFC was established in 1953 in Punjab
- In undivided AP it was started in the year 1956

SFC

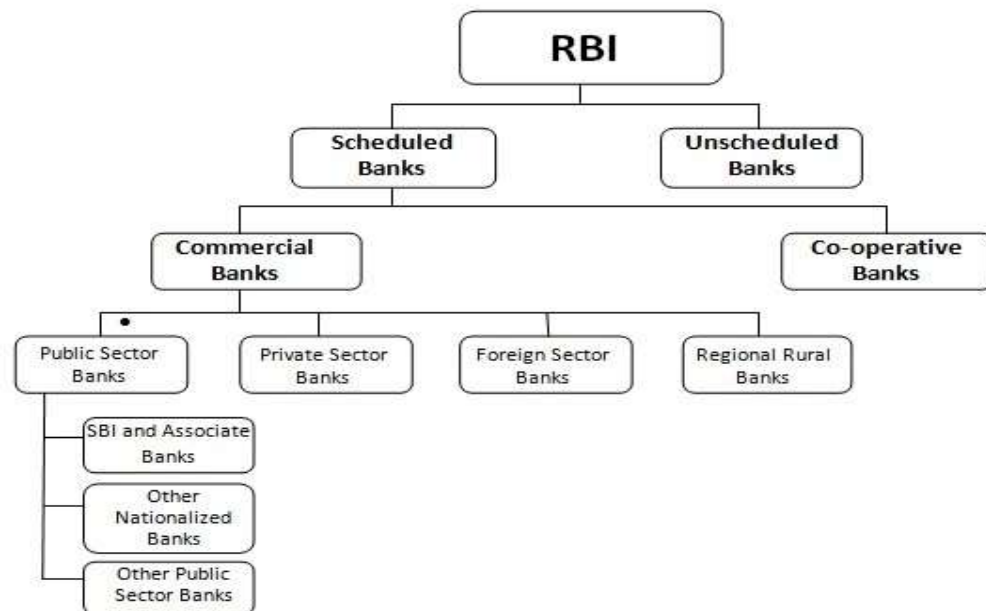
- Sfc provides financial assistance to industrial units in backward areas

Role of SFC:

- SFC's provides finance to industrial unit of backward areas
- Provides assistance to the industrial units located the backward areas in the form of soft loans at concessional rates, lower margins, reduced service charges
- In order to encourage self employment SFC's have formulated schemes of assistance to technician entrepreneurs
- Major beneficiaries of the financial assistance of Sfc's have been the food processing industries, chemical industries, textile and metal products

UNIT II

- Organization, Structure and Functions of RBI and Commercial Banks:
Introduction - Origination, Structure and Functions of RBI and Commercial Banks - Role of RBI and Commercial Banks - Lending and Operation policies - Banks as Intermediaries - NBFCs - Growth of NBFCs - FDI in Banking Sector
Banking Regulations - Law and Practice-UPI-NPCI.



Commercial Banks

- Commercial banks are banks which accept deposits of money from the public for the purpose of lending or investment with an aim of earning profits
- Commercial banks are business entities which are involved in finances, financial instruments and provide financial services for a price which may be in the form of interest, commission, dividend or discount

Example: SBI, Andhra bank, Canara bank

The commercial banks perform two main functions:

- i) Accepting deposits
- ii) Giving loans

Commercial Banks

I Primary functions:

- i) Accept deposits : a) Current deposits b) Fixed deposits c) Savings deposits
- ii) Grant loans: a) Cash credit b) Bank loans c) Bank overdrafts
- d) Discounts

II Secondary Functions:

- a) Agency Functions: i) Collecting cheques ii) Collecting Income iii) Paying expenses
- b) General Utility Functions : i) Locker facilities ii) issuing traveller's cheque iii) Foreign exchange iv) Transfer of funds
- c) Other Functions:
 - a) Debt cards b) Credit cards c) Internet banking d) E-banking

Commercial Banks

Scheduled Banks:

Scheduled banks in India refers to those banks which have been included in the second schedule of the RBI act 1934, which have a paid up capital of an aggregate value of at least 5lakhs

Non-Scheduled Banks:

Banks which are not under the second schedule of the RBI act 1934 are called as Non-Scheduled banks

- The cash reserve requirements they will maintain for themselves

Structure of Commercial Banks

Competition:

Definition: It may be defined as the ability of an organization to gain superiority over others in market.

Problems of Competition in Indian Banking:

- Interest rates on deposits were completely controlled by monetary authorities till 1991
- Banks were obliged to provide finance to Govt by purchasing Govt securities
- They were subjected to finance important sector and sick units

Oligopolistic: The banking market is oligopolistic in nature(A competitive oligopoly is a market that is dominated by only a few large firms 2-4 firms)

Commercial Banks

Interest rate: It is the price that the lender impose on the money borrowed to borrower for a period of time and rate of interest depends on the maturity of financial instruments

Interest rate: i) Short-term rate : Call rate, Bank rate

- **Call rate**: It is a interest rate on a type of short term loan that bank gives to broker who lend the money to investors to fund the margin account
- **Margin a/c**: It is a brokerage account in which the broker lends the customers cash to purchase stock for any other financial securities

ii) Medium term rate : F.D rate

iii) Long term rates : Deposit rate

Spreads

Spreads: Auction traders consider to take advantage of a raising stock price while managing risk to opt for a spread strategy

- Spread brings limited profits and limited losses to both buyers and sellers. This implies that, when profits are limited there is a scope to reduce cost on the other hand, limited losses would result in reduction of risk. It is neither highly risky nor highly profitable to the users

a) Bull Spread:

- When the trader assumes to increase the prices in future then he purchases large quantity at a low price and sells at a higher price in future to earn profits. This is called Bull Spread also known as Call Spread

b) Bear Spread:

- When investors assumes to decrease the prices in future it is termed as Bear Spread

Non Performing Assets

NPA: An asset is said to be NPA, if it remains due for over a period of 90days

- NPAs are listed in balance sheet
- Banks usually categorize loans as Non performing after 90days of non-payment of interest or principal for the said period 90days

Type of NPAs:

- Sub-Standard Assets(less than 12months)
- Doubtful Assets(more than 12months)
- Loss Assets(Assets written off): Loss assets or assets with losses identified by the bank, RBI inspectors, auditors and not fully written off in the books of accounts

Bank capital: It reflects the net worth of the bank. It consists of both assets and liabilities

Capital Adequacy

Capital adequacy:

- Banks need capital to run the daily operations and to meet unexpected losses. Thus banks are supposed to maintain adequate levels of capital with themselves. This is known as capital adequacy requirement

Norms of Capital adequacy of banks:

- This norms are defined by Basel Committee under the supervision of RBI and Basel committee has introduced the bank capital management system called Basel Capital Accord in the year 1988

Capital Market Supports:

In order to meet the obligations to creditors, banking firm require periodical liquidation of assets. If there is a substantial decrease in the value of the assets, banks should use the capital funds to meet the obligation, otherwise the bank is said to be insolvent.

Recent innovation in Banking Sector

Important innovations in the banking sector:

- i) Arrival of card based payments-ATM, debit card, credit card
- ii) Introduction of electronic clearing service(ECS)
- iii) Real time gross settlement(RTGS) was introduced in March 2004
- iv) Introduction of NEFT(National Electronic Fund Transfer) 2005
- v) Introduction of CTS(Cheque Truncation System) in 2008

Recent Innovations in Indian Banking Sector:

- Banking sector has witnessed a number of changes since 1980
- The banking sector in India observe great emphasis being levied on technology
- Banks being use technology to provide better quality services at greater speed

Recent Innovations in the Banking Sector

- Technological improvement has paved way for new innovations in banking sector

ECS: It is a retail payment system that can be used to make bill payments of similar nature especially where each individual payment of repetitive nature

RTGS: It is an electronic form of funds transfer where the transmission takes place on a real time bases

NEFT: It is an electronic transfer of money from one bank or branch to another. NEFT also helps in transfer of funds without having a bank account

CTS: It is a cheque clearing system under taken by the RBI for quicker cheque clearance. In this process an electronic image of the cheque is transferred with essential data. CTS is more advance and secure. It reduces operational cost and risks. It is quite easy & quick

E-Banking

Forms of Electronic Banking:

- Phone banking/Tele banking
- Internet banking
- Mobile banking
- ATM

E-banking: Electronic banking is a major innovation in banking industry

- E-banking means provision of banking products & services by banks directly to customers through electronic delivery channels that is through E-banking

E-Banking

Benefits of E-banking:

- E-banking provides a better brand image to the bank.
- It is very quick and easy and continuous process provides access to information 24/7
- Operational cost of the banks would come down
- There is more scope for offering differential services under e-banking

Risk management by Bank in India:

Types of risk faced by banks

1. Financial risk : Two types a) Credit risk b) Market risk

Risk Mgt by Banks in India

- Operational risk
- Strategic risk
- Liquidity risk
- Foreign exchange risk

Risk Management: Risk can be defined as a chance or probability of deviation from the expected results arises due to internal and external factors. Risk management is a proactive strategy to plan, lead, organize and control a wide variety of risk faced by banks.

1. Financial risk: It is defined as any risk which results from any business transactions under taken by a bank which is exposes to potential loss

Risk Mgt by banks in India

- i) **Credit Risk:** It can be defined as a potential of a bank borrowers who fail to meet his obligation. According to the agreed terms, loans of the largest credit risk in all the banks.
- ii) **Market Risk:** It can be defined possibility of loss to the bank on account of moment in market prices. Market risk is a risk where bank earnings and capital is depend upon the changes in the interest rates of prices of securities
- 2. **Operational Risk:** It is a risk of loss resulting from inadequate or fail internal process, people and systems on from external sources
- 3. **Strategic risk:** It is the risk that arises from that inability to implement appropriate business plans, strategies, decisions with regard to changing business environment
- 4. **Liquidity risk:** It arises when the bank is not able to produce cash to meet with any increase in the value of asset or decreasing the liability

Risk mgt by banks in India

5. Foreign Exchange risk: Fluctuations in the currency rate due to uncertainty in the global market which could be due to demand and supply, interest rates, trade deficit all this contribute to foreign exchange risk faced by banks

6. NPA's & Interest rates: Also considered as risk factors faced by the banks

Risk management procedure:

Step by Step process: Risk Identification-> Risk assessment & management-> Risk Control-> Risk monitoring->Risk return trade off

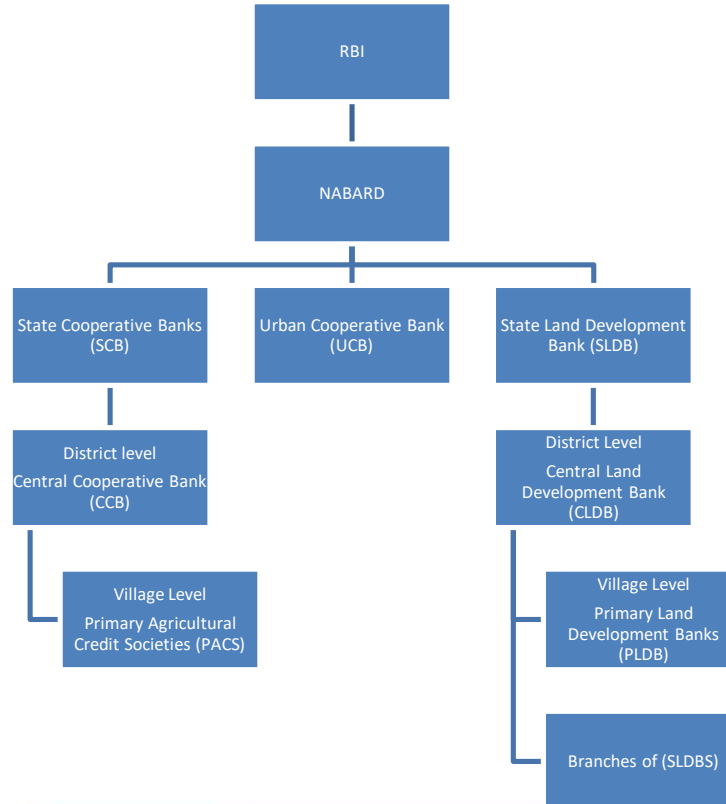
Co-operative Banks

- Registered under co-operative societies act and governed by banking regulation act 1949 & Banking Law act 1965
- Co-operative banks were started under the co-operative societies act 1904
- The main objective was to establish co-operative credit societies to encourage farmers, artisans self employment groups and persons or individuals

Definition: Co-operative banks are the financial institutions that offer the lending facility to the small business mainly in rural, semi-urban areas

- They provide most services such as savings and current account opening, loans or mortgages, safe deposit lockers to customers
- Co-operative banks primarily finance to a agricultural based activities

Tier Structure of Co-operative banks



Tier Structure of Co-operative banks

- State level co-operative banks: The state level co-operative banks comprises of SCB,UCB,SLDB
- District level comprises of CCB,CLDB : The land development banks SLDB,CLDB,PLDB and branches of SLDB comprise the long-term credit structure
- PLDBs are similar to primary co-op agriculture rural development banks and SLDBs are similar to State co-op agriculture and rural development banks

Role of Co-operative banks:

- Co-operative banks aim at providing credit facility to farmers at lesser rate of interest
- Co-operative banks participate in rural and micro finance.

Tier Structure of Co-operative banks

They work towards the upliftment of rural people and weaker section

- This banks primarily offer personal banking and financial services to small businessmen and small scale units

Initiative by Govt to strengthen co-operative banks by RBI & Govt of India:

- i) Re-organization of PACS and this scheme was implemented in the states which gave its acceptance
- ii) 15 point program for the enhancement of PACS was carried out in 16 districts which resulted in mobilization of deposits, issue of loans and collection of due from members
- iii) 175 CCBS and 7 SCBs were recognized as weak bank and a rehabilitation program was conducted to uplift the banks

NBFI

iv) A 12 point action program was initiated by NABARD to provide support to weak banks

v) A revival package was declared in all the states by the Govt of india in the year 2006

Non-banking Financial Institutions:

UTI (Unit Trust of India)

- Set up on 01.02.1964 under the UTI act 1963
- UTI was the idea of the then Finance minister T.T.Krishnamachari

NBFI

Definition: UTI is controlled or governed by Govt of India and it is a statutory public sector financial institution. It operates functions on the principles of “No Profit” “No loss”

Objective of UTI:

- Intermediary to fulfill the twin objectives
 - a) Mobilizing retail savings
 - +
 - a) b) Investing those savings => In the capital market and passing on the benefits earned/accrued to the investors

Structure of UTI



ONS
INDIA

Under the provision of UTI act 1963



Chairman of the board of UTI



Appointed by the Govt of India



Perform its functions



Functions of UTI

1. Mobilizing savings of small investors and channelized savings into productive investments
2. Encourage savings of people from lower and middle class groups
3. Convert the small savings into industrial finance
4. To grant loans and advances to investors
5. To provide liquidity to all units
6. Buy or sell or dealing foreign currency

Mutual Funds

Mutual Funds:

- Mutual funds is an investment security that enables the investors to pool their money together into professional managed investment.
- Mutual funds can be invested in stocks, bonds, cash or a combination of other assets.
- The first company that dealt with mutual funds was UTI in the year 1964. Later on, in 1987 SBI mutual fund was introduced

Why MF?

- Professionally managed
- Investment diversification
- Liquidity
- Better investment option

MF companies are regulated by **AMFI (Association of Mutual funds in India)**

Types of Mutual Funds

Mutual funds are divided into two types:

- i) **Open ended MF** : Accept funds from investors and sell shares to the investors. They are not traded in open market. In open ended schemes of mutual funds duration is not specified for redemption. The main advantage of open ended MF is liquidity

- ii) **Close ended MF**: This funds issue a fixed number of units that are traded on the stock market. This funds has a fixed maturity period and they are listed on stock exchange. The main advantage of close ended MF are the market forces of demand and supply

AMFI



Association of Mutual Funds in India:

It is the body which regulates the Mutual fund companies in India

Incorporated on 22nd Aug 1995

Objective:

- To monitor and control all the activities related to Mutual funds in India
- Promote and protect the interest of Mutual Fund's customers and shareholders

Role of AMFI:

- It is the regulatory frame work of mutual funds in India
- Monitor the Mutual funds
- Advice about Mutual funds
- Conduct exam for having qualified distributor for MF

Growth of Mutual Funds in India

- Phase-I (1964-87) : The concept of MF emerged with the establishment of UTI in the year 1964
- The first unit scheme is the open ended scheme
- Phase II (1987-92) : The second phase started with the entry of MF which was sponsored by Nationalized banks and Insurance companies such as LIC, GIC
- Phase III (1992-97) : After the introduction of LPG policy, the doors of MF was opened for private, multi-national companies Ex: ICICI, HDFC
- Phase IV (1997-till date): The MF industry witnessed increase in the flow of funds by 1999-2000 the sales of MF picked up

Insurance Industry in India



Insurance sector:

- Robust demand
- Attractive opportunities
- Policy support
- Increasing investment

Insurance sector

Insurance sector is divided into two:

1) Life insurance-> Public Sector-> LIC

Life insurance-> Private sector-> Birla Sun life insurance

2) General Insurance: Public Sector-> GIC

Private Sector-> ICICI Lombard general insurance

Challenges of Insurance industry:

- Cut-throat competition
- New entrants
- Customers switching to other companies
- Managing risk

IRDA



Insurance Regulatory Development Authority -IRDA

- Started in the year 2000

Objectives:

- To protect the interest of policy holders
- To promote, regulate and ensure orderly growth of the insurance industry
- To monitor and regulate the activities of insurance business across India

UNIT III

Risk Management in Banks : Introduction - Asset/Liability Management Practices - Credit Risk Management –CAMEL approche-5C of credit-causes of merging banks- Credit Risk Models - Country Risk Management - Insurance Regulations and Development Authority (IRDA)

Financial Market

1. Money market: It is a place where short-term surface investible funds at a disposal of the financial institution. It meets the short term requirements of the borrower and provide liquidity or cash to lenders
- a) Call Money: It consists of overnight financing and money needed at short notice for a period up to 14days
 - When the money lend for one day or overnight it is known as “ Call Money”.
 - If it is exceeding more than 1day and less than 14days it is known as Notice money

Functions of Call Money Market:

- i) Development of trade and industry
- ii) Development of capital market
- iii) Smooth functioning of commercial banks
- iv) Effective central bank control

Functions of Call Money Market

5. Formulation of suitable monetary policy through its intervention in this market

6. Addresses temporary mismatch of fund

- Banks have to maintain a mandatory minimum cash reserve known as CRR and have to maintain sufficient SLR for their day to day operations
- Call money market serves this purpose of meeting the short term requirements of banks

Commercial Bills Market

- Also known as discount market
- It is the short-term money market instrument traded in money market
- It is also a negotiable instrument
- It is a self-liquidating, instrument with low risk
- Maturity period of the bill may vary from 3-6months
- It enhances the liability to make payment on a fixed date when the goods are bought on credit

Treasury Bills Market

- Introduced in 1917 by the Govt of India
- These are the short-term money market instrument traded in money market
- Only Central Govt have a right to issue and subscribe capital from public
- It is a negotiable instrument
- Traded duration: 75 days - 365 days
- Higher denomination value
- Issued at discount and redeemed at par value/face value
- Issued for 15 days, 184 days, 364 days
- It is a secured investment

Certificate of Deposits

- Introduced in the year 1989
- It provides highest liquidity
- Issued by scheduled commercial banks
- Deals with higher value of denomination
- It is also a negotiable instrument
- Short-term market instrument traded in money market
- There is no regulation on interest rate
- This instrument can be traded in secondary market

Commercial Papers

- Introduced in the year 1990
- Short-term money market instrument traded in the market
- Traded duration 3months-6months
- It is also a negotiable instrument
- This commercial paper can raise volume of denominal of exchange
- Only big enterprises called institutional investors can participate
- This can be discounted at certain value and redeemed face value
- Issued by Banking and Non-Banking institutions

Capital Market

- Capital market is a market for long term funds for both debt(over a year) and equity based securities are bought and sold

Capital market:

- i) industrial securities ii) Govt securities market iii) Long term loans market

Role of Capital Market:

- i) Capital formation
- ii) Mobilization of savings
- iii) Provision of investment avenue
- iv) Increase in economic growth

Capital Market

- Providing services such as underwriting and advisory services(process of selling securities on behalf of client)
- Provision of long-term loan to start-ups

Various measures taken recently to vibrant capital market

- i) Free pricing
- ii) Introduction of book building
- iii) Electronic trading
- iv) Instruments and market participants
- v) Improvement in trading, clearing and settlement system

Government Securities

- vi) Increased de-materialization
- vii) Focusing on fair trade practices
- viii) Impact on changing structure

Govt securities: (Treasury bills, Government bonds)

- A Govt securities is a bond or other type of debt obligation that is issued by Govt of India with a promise of repayment upon the security's maturity date

Features:

- They are considered as low-risk investment

Government Securities

- The term ranges from 92 days to 30years
- They are liquid and secured in nature
- Interest on dividends are tax exempted

3 types of Government Securities:

- i) Stock certificate: Not available in India
- ii) Promissory Note : Only available here
- iii) Bearer bond : Not available in India

- Listing of securities: The securities that are traded on stock exchange are said to be listed or quoted.

Government Securities

- Stock exchange establish their listing requirement for trading the securities. These requirements may change periodically for widening the group of shareholders and to reduce the presence of bulk amount of shares with the management group of the companies

Trading and settlement of securities:

- The business transactions in the stock exchange involves the following stages:

Stage 1 -> Order placement with brokers

Stage 2 -> Order execution

Stage 3 -> Reporting the deal to the client

Stage 4 -> Settlement of transactions 1-7days

Role of SEBI in Capital Market

- SEBI was set up on 12th April 1992, SEBI Act

Role of SEBI:

- To protect the rights and interests of shareholders
- To prevent insider trading and mal practices
- To control major acquisition of shares and take over of organization
- To control and monitor stock exchange business
- To promote the development of securities for the business
- To provide advisory and consultancy services
- To conduct awareness programs in investors and encourage them to invest in securities

Role of SEBI in Capital Market

Role of SEBI in capital market :

- Capital market -> a) Primary market b) Secondary market
- a) Primary market:
 - The fresh securities issued in exchange of funds through public issues and private placement
 - They may issues securities at face value or at discount/premium
 - They issue shares in domestic market

Issues : a) Public Issue b) Right issue c) Private placement preferential shares

- a) Public Issue -> i) IPO (Initial Public Offering) for unlisted companies
- ii) FPO (Further Public Offering) for listed companies-> I) Fresh issue
- II) Offer for sale

Issues

a) Public issues can be classified into IPO and FPO

I) IPO: When an unlisted company makes either a fresh issue of security or an offer for sale of its existing securities to the public or an offer for sale to the public through an offer document

II) FPO: When already listed company makes either a fresh issue of securities to the public or an offer for sale to the public through an offer document

b) Right Issue: It is when the listed company which proposes to issue fresh securities to its existing share holders the right issues normally offered in a particular rate to the number of securities held prior to the issue. This type of issues is best suited for the company which would like to raise capital through existing shareholders

Issues

c) Private placement or preferential issue:

It is a issue of shares which are of convertible securities of a company to a selected group of existing investors or individual under 81 of the company act

Role of SEBI in Secondary market:

Secondary market is the place for the sale and purchase of existing securities. The securities are traded, cleared and as per prescribed regulatory

CCIL

The Clearing Corporation of India Limited (CCIL):

- Set up by RBI on 30th April 2001
- Began its operations on 15th Feb 2002
- It is the first clearing house of India for Government securities
- Forex and other market segments

Role of CCIL:

- i) Clearing & Settlement of Securities
- ii) Clearing & Settlement of Forex
- iii) Collateralized borrowing and lending obligation

UNIT IV

Financial Institutions and Development Banking
Introduction - Origin, Growth and Lending Policies of
Terms lending Institutions - Working of IDBI - IFCI -
STCs - SIDBI - LIC - GIC - UTI - Role of Financial
Institutions in Capital Market. Legal issues of LIC

Lease Finance

Lease Finance:

Leasing is an agreement which is made between two parties that is the leasing company or lessor and the user or lessee where in the former make arrangement to buy capital equipment for the usage for agreed period in return for the payment of rent

Leasing agreement involves 2 parties:

- i) Lessor (Owner of the asset)
- ii) Lessee (Who gets right to use the asset)

Lease Finance

Steps in Leasing transactions:

1. Lessee identifies the equipment and the supplier or lessor of the asset
2. Lessee enters into agreement with lessor containing:
 - . The Basic period
 - . Timing and amount of rent
 - . Details of renewal option, if any
 - . Details of maintenance and repairs, taxes
3. After signing the above agreement, Lessor request the supplier to deliver the asset to the lessee

Advantages of Leasing

1. **Liquidity:** The lessee can use the asset to earn without investing money in the asset. He can employ his funds for working capital needs.
2. **Convenience:** Leasing is the easiest method of financing fixed assets. No mortgage or hypothecation is required. Restrictions involved in long-term borrowing from financial institutions are avoided. Formalities involved in leasing are much less than in case of borrowing from financial institutions
3. **Hidden Liability:** Lease obligations are not reported as a liability in the company's balance sheet. On the other hand, loans raised to buy assets are reported as liability. Thus, leasing helps the lessee to report a better debt-equity ratio.
4. **Time Saving:** The asset is available for use immediately without loss of time in applying for the loan, waiting for approval and sanction, etc. Lease rentals can be matched with cash flows of the lessee.
5. **No Risk of Obsolescence:** The risk of the asset becoming obsolete due to technological advancements is borne by the lessor.
6. **Cost Saving:** Lease rentals are deductible from taxable income. The lessee has lower obligation in bankruptcy than under debt financing.
7. **Flexibility:** Leasing arrangement is more flexible. The rental schedule can be adjusted to accommodate genuine needs and problems of the less.

Disadvantages of Leasing

- If the lessee not able to make the rental payments then lessor would suffer the loss particularly when an asset is less liquid in nature
- Certain tax benefits such as subsidy may not be available on leased equipment
- The value of real asset such as land and building may increase during lease period
- The lease finance is not suitable for new projects, cash generation may start only after certain period

Types of Lease

1. Financial Lease
2. Operating Lease
3. Leverage Lease
4. Sale & Lease back
5. Cross Border Lease
6. Direct Lease

Types of Lease

Financial Lease:

- It is like an installment loan with the legal commitment to pay for the entire cost of equipment plus interest over a specified time period
- The lessee commits to a series of payment which in total the cost of equipment
- The contract period ranges from medium to long term
- The contract are usually non-cancellable
- Aircrafts, Land and building and heavy machinery are leased
- The lessee fulfills the financial function

Lease Finance

Operating Lease:

- It is a rental agreement where the lessee is not committed to pay more than the original cost of equipment
- It provides maintenance expenses and taxes to be borne by lessor
- The contract period range from immediate to short-term
- The contracts can be cancelled either by the lessee or by the lessor
- Computers, office equipments, trucks, automobiles are leased
- The lessor fulfills the service function

Types of Lease

Leverage Lease:

- It is used for financing those assets which require huge finance/capital
- It involves 3 parties: i) Lessee ii) Lessor iii) Lender
- i) The lessee acquires the asset as per term of lease agreement but finances only a part of total investment say 20% to 50%

Sale & Lease Back:

- The firm which has an asset and sold it to the leasing company and get its back on lease
- The asset is generally sold at market value the firm receives the sale price in cash and gets right to use the asset during the leasing period

Types of Lease

Cross Border Lease:

- It is also known as Transactional leasing
- It relates to lease transactions between lessor and lessee domiciled different countries and it include export leasing/International leasing

Direct Lease:

- It is one of the type of lease finance where in lessor purchases the asset and transfer's it to the lessee under the lease agreement
- A manufacturer can act as lessor and deliver the assets to the lessee

Legal aspects of Leasing

Legal aspects of Leasing:

- There is no separate statutory body for equipment leasing in India
- The provisions related to bailment in the Indian contract act govern equipment leasing agreement as well as section 148 of Indian contract act
- The obligations of lessor and lessee are similar to those of the bailor and bailee which was defined by the section 150,168 of ICA

Evaluation & Growth of Leasing Industry in India

- Leasing activity was initiated in India in 1973
- The first leasing company – First leasing company of India Ltd”
- The industry entered 3rd staged in growth phase in late 1982
- Industrial credit & Investment corporation entered into leasing sector in 1983 giving boost to the industry
- In the meantime, International financial corporation announced its decision to open 4 leasing joint ventures in India
- An amendment of Banking Regulation Act,1949 facilitated commercial banks to enter into leasing business
- In 1986, SBI started leasing operations
- The number of leasing companies increased to 400 by 1990

Hire Purchasing

Definition: Hire Purchase System is a system under which money is paid for goods by means of periodical installments with the view of ultimate purchase. All money being paid in the mean time is regarded as payment of hire and the goods become the property of the buyers only when all the installments have been paid”—Carter

According to Stephenson “The hire-purchase is a form of trade in which credit is granted to the customer on the security of a lien on the goods”.

- Hire purchase is a mode of financing the price of the goods to be sold on a future date
- In a hire purchase transaction, goods are let on hire, the purchaser makes the payment in installments
- Payment to be made in installment over a period of time
- The ownership would be transferred to the hirer immediately after entering into the contract
- The buyer can exercise the option of return of goods

Advantages of Hire Purchase system



- i) **Convenience in Payment:** The buyer is greatly benefited as he has to make the payment in installments. This system is greatly advantageous to the people having limited income.
- ii) **Increased Volume Of Sales:** This system attracts more customers as the payment is to be made in easy installments. This leads to increased volume of sales.
- iii) **Increased Profits:** Large volume of sales ensures increased profits to seller.
- iv) **Encourage Savings:** It encourages thrift among buyers who are forced to save some portion of their income for the payment of installments.
- v) **Helpful For Small Traders:** This system is a blessing for the small manufacturers and traders. They can purchase machinery and other equipment on installment basis and in turn sell to the buyer charging full price.
- vi) **Earning of Interest:** The seller gets the installment which includes original price and interest. The interest is calculated in advance and added in total installments to be paid by the buyer.
- vii) **Lesser Risk:** From the point of view of seller, this system is greatly beneficial as he knows that if the buyer fails to pay one installment, he can get it back.

Disadvantages of Hire Purchase System

1. **Higher Price:** A buyer has to pay higher price for the article purchased which includes cost plus interest. The rate of interest is very high.
2. **Artificial Demand:** Hire purchase system creates artificial demand for the product. The buyer is tempted to purchase the products, even if he does not need or afford to buy the product.
3. **Heavy Risk:** The seller runs a heavy risk under such system, though he has the right to take back the articles from the defaulting customers. The second hand goods fetch little price.
4. **Difficulties in Recovery of Installments:** It has been observed that the sellers do not get the installments from the purchasers on time. They may choose wrong buyers which may put them in trouble. They have to waste time and incur extra expenditure for the recovery of the installments. This sometimes led to serious conflicts between the buyers and the sellers.
5. **Break Up Of Families:** The system puts a great financial burden on the families which cannot afford to buy costly and luxurious items. Recent studies in western countries have revealed that thousands of happy homes and families have been broken by hire purchase buying's.

Hire Purchasing

Hire Purchasing: Mathematics of purchases

- Computation of interest where the division of installment amount = principal + interest
- Interest amount is computed in terms of = Interest rate on outstanding principal amount starting of each period
- Principal amount is calculated = Difference between installment amount period and interest amount per period

Factoring

Definition: Factoring is an agreement in which receivables arising out of sale of goods are sold by a firm(client) to the factor(financial intermediary) as a result of which the title to the goods represented as said receivables are passed on to the factor

3 parties involved:

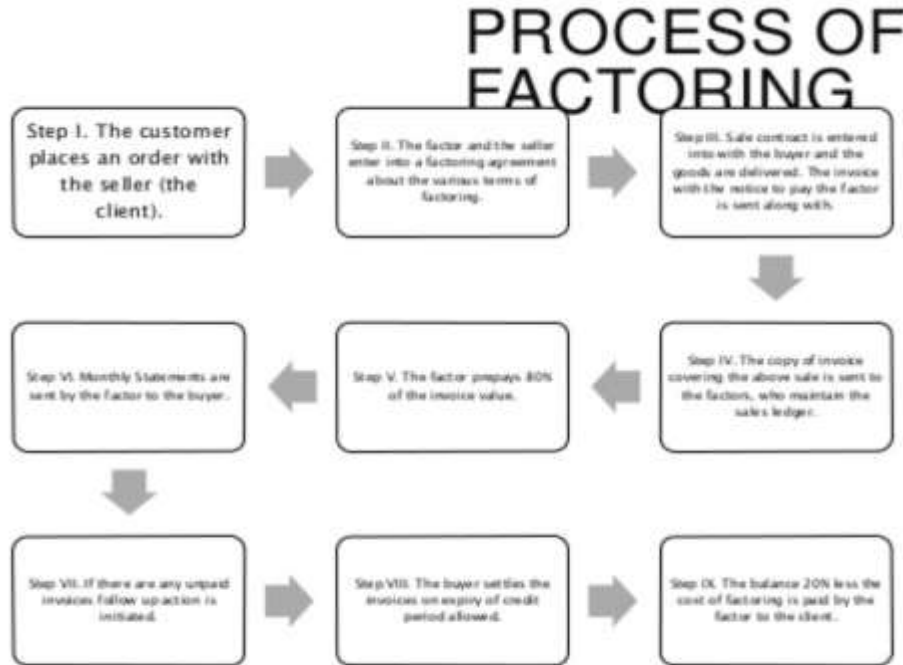
- i) Seller (Client)
- ii) Buyer(Customer)
- iii) Financial Intermediary(Factor)

Mechanism of Factoring

A factoring contract for sale of receivables:

- It starts with a credit sale and agreement between the client and the buyer
- The client(seller)
- Sells good on credit to buyer/customer
- Prepares invoice, delivery challan, factoring agreement and other documents
- Hands over the documents to factor (Financial institution/Banks)
- Receives payment in advance up to 80% of cost of good by factor
- Makes an advance payment to factor on receiving all the documents (invoice, challan, agreement)
- Prepares and sends periodical account statements to customer

Process of Factoring



Mechanism of Factoring

- Receives payment from customer/buyer on due date
- Remits the balance(20%) from the money collected to the client/seller after deducting its commission, fees, service charges

Factoring in India :

- Kalyana Sundram committee recommended introduction of factoring in the year 1989
- Banking Regulation act 1949, was amended in 1991 for Banks setting up Factoring services
- RBI has permitted banks to undertake factoring services through subsidiaries
- SBI/Canara bank have set up their first factoring subsidiaries:
- SBI factors Ltd (Apr,1991) and CanBank Factors Ltd(Aug 1991)

Functions of Factoring

- i) **Credit administration:** Factor provides full credit administrative services helps and advise sellers from the stage of deciding credit expansion to customers to the final stage of book debt collection
- ii) **Credit protection:** Where individual book debts are due from the customers the factor and undertakes all collection related activities wherever necessary
- iii) **Advisory services:** Advices the client regarding credit worthiness of a buyer, potential customers, market trends
- iv) **Short-term finance:** Provides money in advance up to 80% of the receivables
- v) **Collection facilities:** collect money on behalf of the client and remits the money back after deducting his charges

Advantages of Factoring



To Client/Seller:

1. The client gets immediate cash on sale which can be invested
2. Protects the client against credit risk(risk of non-payment by buyer)
3. Allows the client to offer lucrative credit schemes to customers and increase his sales and profit
4. Reduces the financial burden of the client and relieves him maintaining accounts and collection of receivables
5. Acts as an additional source of finance for the client and allows him to explore new markets

Advantages of Factoring



To Customers/buyers

1. Allows customers to save bank charges and expenses
2. Allows customers to purchase expensive products through flexible credit schemes
3. The factoring procedure is simple and easy than applying for a bank loan, it saves time, money and effort

Limitations of Factoring

1. Factoring is a high risk area, and it may result in over dependence on factoring, mismanagement, over trading of even dishonesty on behalf of the clients
2. It is uneconomical for small companies with less turnover
3. The factoring is not suitable to the company's manufacturing and selling highly specialized items because the factor may not have sufficient expertise to assess the credit risk
4. The developing countries such as India are not able to be well verse in factoring due to lack of professionalism, non-acceptance of change and developed expertise

Types of Factoring

Types of Factoring:

- i) Recourse Factoring
- ii) Non-Recourse Factoring
- iii) Maturity Factoring
- iv) Cross border Factoring
- v) Recourse Factoring:

- Upto 75% to 85% of Invoice receivable are factored
- Interest is charged from the date of advance to the date of collection
- Credit risk is with the client

Types of Factoring

i) Recourse Factoring:

- Recourse factoring is an agreement between the client and the factor in which the client is required to buy back the unpaid bills receivable from the factor.
- The credit risk stays with the client in case of non-payment by the debtor
- Upto 75% to 85% of Invoice receivable are factored
- Interest is charged from the date of advance to the date of collection
- Credit risk is with the client in case of non-payment
- In India, Recourse factoring is more prevalent

Types of Factoring

ii) Non-Recourse Factoring:

- Non-recourse factoring allows a company to sell its invoices to a factor without the obligation of absorbing any unpaid invoices.
- Involves a true sale of receivable
- Credit risk is with the factor
- Rate of commission is very high
- Factor purchases receivable on the condition that the factor has no recourse to the client if the debt turns out to be non-recoverable
- This is more popular in USA,UK
- The major benefit is that it brings more clarity and strength to company's balance sheet

Types of Factoring

iii) Maturity Factoring:

- In this type of factoring, factor does make any advance payment to the client
- Payment made on guaranteed/fixed date or on collection of receivables
- Guaranteed payment date is usually fixed taking into account previous collection experience of the client
- Nominal commission is charged
- No risk involved to factor

Types of Factoring

4) Cross border Factoring:

- . Also called as two-factor system of factoring
- . In cross-border factoring 4 parties are involved
 - a) Exporter b) Importer c) Export Factor d) Import Factor
- . Exporter(Client) enters into factoring arrangement with export factor in his country and assigns to him export receivables
- . Export factor enters into arrangement with Import factor and has arrangement for credit evaluation and collection of payment for an agreed fee
- . Notation is made on the invoice that importer has to make payment to the import factor
- . Import factor collects payment and remits to export factor who passes on the proceeds to the Exporter after adjusting his advance, if any
- . Factor covers exchange risk also as foreign currency is involved

Why use Factoring

- . Through the use of Factoring, receivables are instantly converted into cash leading to improved cash flows that can help funding of future growth
- . Facilitates an efficient follow up of payment from buyers, which is made possible through relationships developed by factors with client's buyers.
- . Provides credit protection for export sales which enables to do business with buyers who are unwilling to open Letters of credit
- . Provides services such as advisory services, credit assessment.

Consumer Credit



Consumer credit is the short/medium term loan issued for personal consumption of goods and services or repayment of the debts caused from the consumption through commercial channels

Types of Consumer Credit:

- a) Installment credit
- b) Non-Installment Credit : 3types
 - i) Single payment
 - ii) Open-ended credit
 - iii) Service credit

Consumer Credit

a) Installment credit :The borrowed party has to repay the owed amount including interest in particular or specific number of equal installment for the agreed period of time

b) Non-Installment Credit :

i) Single payment : This is the simplest among all the three non installment credit option where the payment can be done or made or one-go

ii)Open-ended credit: Here the credit is extended prior to any transaction to make sure that the borrower will not apply for the credit each time

iii)Service credit: Consumers are given service credit through public utilities Doctors, Dentists, Physicians

Consumer Credit

Advantages of Consumer Credit:

- It allows the customers to enjoy the goods and services
- It transfers the ownership on the first installments
- It provides greater options to the consumer to repay the product
- It provides flat interest rate

Disadvantages of Consumer Credit:

- It is not possible for the consumer to sell or hypothecate the goods or services
- Incase of default of the consumer, It is a loss to the seller

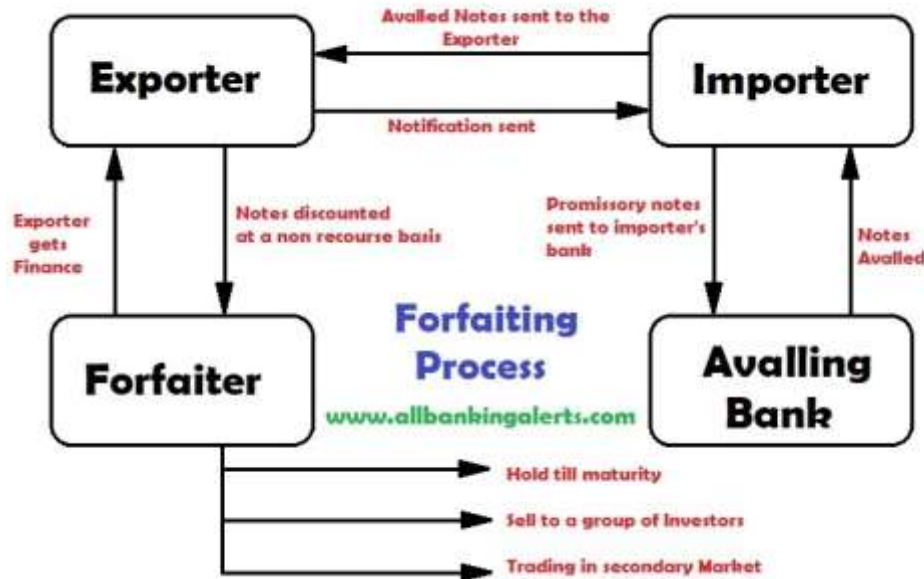
Forfeiting

- Forfeiting is derived from a French word “forfeit” meaning “surrender of rights”
- Forfeiting is a form of financing of receivables arising from international trade
- Purchase is through discounting of the documents covering the entire risk of non-payment at the time of collection.
- Within this arrangement, a bank/financial institution undertakes the purchase of trade bills/promissory notes without recourse to the seller
- All risks become the full responsibility of the purchaser(Forfeiter)
- Forfeiter pays cash to the seller after discounting the bills

Forfeiting

- Forfeiting is a mechanism of financing exports
 - i) By discounting export receivables
 - ii) By Bills of exchange or promissory notes
 - iii) Without recourse to the seller via exporter
 - iv) Carrying medium to long term maturities
 - v) On a fixed rate basis(discount)
 - vi) Up to 100percent of the contract value

Forfeiting Process



Forfeiting Process

1. Before resorting to forfeiting, the exporter approaches the forfeiting company with the details of his export and the details of the importer and the importing country.
2. On approval by the forfeiter, along with the terms and conditions, a sale contract is entered into between the exporter and importer
3. On execution of the export, the exporter submits the bill to the forfeiter and obtains payment. In this way, three parties involved in the forfeiting process are the i) Exporter ii) Importer and iii) Forfeiter
4. If the exports are done against the Document Acceptance bill, it has to be signed by the importer and since the importer's bank has guaranteed through L/C, it will be easy for the forfeiter to collect payment
5. All the trade documents, connected with exports, are handed over by the exporter to his bank which in turn hands over the documents to the importer's bank.

Forfeiting Process

6. The proof of all these documents will be submitted by the exporter to the forfeiter who will make payment for the export
7. The cost of the forfeiting is included in the bill. The exporter may not lose much as the interest will be included in the invoice and recovered from the importer. However, the forfeiter is exposed to the risk of fluctuations in the exchange rate and interest rate.

Features of Forfeiting:

- Forfeiting can be used to finance any export transaction
- This technique is highly useful because of offered interest rate and no currency risk involved
- Exporters can use forfeiting in place of any other credit transaction or insurance coverage for buying or selling of goods

Forfeiting in India

- For a long time, Forfeiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of export-import banks, since 1994 forfeiting is available on liberalized basis.
- The **Exim bank** undertakes forfeiting for a minimum value of Rs. 5 lakhs. For this purpose, the exporter has to execute a special Pronote in favor of the Exim bank. The exporter will first enter into an agreement with the importer as per the quotation given to him by the Exim bank. The Exim bank on its part, gets quotation from the forfeiting agency abroad. Thus, the entire forfeiting process is completed by exporter agreeing to the terms of the Exim bank and signing the Pro-note
- Forfeiting business in India will pick up only when there is trading of foreign bills in international currencies in India for which the value of domestic currency has to be strengthened. This would be possible only with increasing exports. At present, India's share stands at 1.7 percent in the world exports. Perhaps, this will bring a push to the forfeiting market.

Advantages of Forfeiting



1. It provides immediate funds to the exporter who is saved from the risk of the defaulting importer.
2. It is an earning to commercial banks who by taking the bills of highly valued currencies can gain on the appreciation of currencies.
3. The forfeiter can also discount these bills in the foreign market to meet more demands of the exporters.
4. There is very little risk for the forfeiter as both importer's bank and exporter's banks are involved.
5. Letter of Credit plays a major role for the forfeiter. Moreover, he enters into an agreement with the exporter on his terms and conditions and covers his risks by separate charges.
6. As forfeiting provides 100% finance to exporter against his exports, he can concentrate on his other exports.

Disadvantages of Forfeiting

The following are some of the disadvantages of forfeiting.

1. Forfeiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
2. There is discrimination between Western countries and the countries in the Southern Hemisphere which are mostly underdeveloped (countries in South Asia, Africa and Latin America).
3. There is no International Credit Agency which can guarantee for forfeiting companies which affects long-term forfeiting.
4. Only selected currencies are taken for forfeiting as they alone enjoy international liquidity.

Venture Capital Financing

Venture Capital Financing:

The money provided by investors to start up firms and small business with perceived long term growth potential

Features:

- i) Long time horizon
- ii) Lack of liquidity
- iii) High risk
- iv) Capital gains

Venture Capital Financing

Advantages:

- i) **No collateral required** : If you have a business plan along with the business model and profitability then angel investors or venture capitalists invest in your project without any collateral.
- ii) **No repayment period** : Unlike debt financing, you need not pay any fixed monthly or yearly payments to make it happen. This enables a company to manage funds efficiently for expansion of business or purchase of machinery to boost production.
- iii) **More cash on hand** : You have more cash on hand and no loan burden. So, you as the company can declare a dividend to the shareholders in accordance with the profitability of the company.
- iv) **Long term planning** : Since the investors do not expect the immediate return on their investment, you can manage the funds efficiently which will yield better returns in the near future.

Venture Capital Financing



Disadvantages of venture capital financing:

- i) **Complex process:** In order to raise funds you need to approach venture capitalists or angel investors by submitting a robust business model, future revenue projection, whether your venture will succeed in the future, profitability, etc. So, raising a fund from venture capitalists is quite a long and complex process.
- ii) **Share of Profit of the company:** Since equity gives an ownership right and voting right to the shareholders, the dividend paid to the shareholders is more than the interest payable in the case of debt financing.
- iii) **Loss of control :** Since the shareholders are the owners of the company, you need to consent or consult with the shareholders in the case of differences of opinions among the shareholders.

Methods of Evaluating VCF

1. Equity Financing: A firm needs funds for a longer period to survive and grow, but as venture capital firm is a new company the firm is not able to give timely returns to its investors, for which equity financing proves beneficial. The investor's contribution is not more than 49% of the total stake, and so the ultimate power remains with the entrepreneur.

2. Conditional Loan: Conditional loans are the one that does not carry interest and are repayable to the lender in the form of royalty after the venture capital undertaking is able to make revenue. The royalty rate may vary from 2% to 15%, on the basis of factors such as gestation period, external risk and cash flow patterns.

3. Income Note: A form of hybrid financing, that combines the characteristics of the traditional loan and conditional loan, on which the venture capital firm pays both royalty and interest, but at low rates.

Methods of Evaluating VCF



4. **Participating Debentures:** The interest on participating debentures is payable at three various rates, as per the phase of operation:

- i) Start-up phase — Nil
- ii) Initial operations phase — Low rate of interest
- iii) After a particular level of operations – High rate of interest

5. **Convertible loans:** The loans which are convertible into equity when interest on the loan is not paid within the stipulated period.

Conclusion: Venture Capital provides long term funding to unquoted companies to grow and succeed. Raising venture capital is a bit different from borrowing money from lenders because lenders have the right to interest on the loan and capital repayment. On the other hand, venture capital investment provides equity stake to the investor, and the return on investment relies on the growth and profitability.

Stages of Venture Capital Financing

Venture capital financing is quite helpful to nurture and grow a start-up into a profitable venture. Here are the different stages of venture capital financing

- i) **Seed Stage** :As the term suggests the start-up will grow by making use of the capital invested by angel investors or venture capitalists. In this stage, an investor investigates the business plan and the potential of the product or service to succeed in the future, which is to be delivered by the entrepreneur.
- ii) **Start-up Stage**: If the idea/product has the potential to cater or solve any problem then the entrepreneur needs to submit the business plan along with,
 - In-depth analysis of revenue model i.e. how the company generates revenue,
 - Current competition in the peer industry or sector
 - Details of the management such as CEO, CIO, Director of the company and their work experience part from educational qualification
 - Size and potential of the desired market.

Stages of Venture capital Financing



After analyzing the above-mentioned points, venture capitalists decide whether they are going to invest. At this stage, the risk factor is quite high because there is an inherent risk of losing the invested capital if the business does not succeed. The money invested by the venture capitalists will be used for the development of product or services and marketing strategies.

iii) Early-stage/First stage : This stage is also known as the emerging stage. The capital received from the venture capitalists goes into manufacturing products or delivering services by setting up an office to capture the market shares from the competitors in the industry. Venture capitalists have a close eye on the management to know the capacity of the management and how they can tackle the competition from the peer companies. In this stage, the capital is invested to grow inventory to increase sales.

Stages of Venture Capital Financing

- iv) The Expansion stage/Second stage/Third stage:** In this stage, the capital is provided for marketing and promotion of the product, expansion, and acquisition to keep up with the demand of the product.
- Venture capitalists funding in the emerging stage is largely used for market expansion by setting up a new factory or acquisition of factory and product diversification.
 - Venture capitalists intend to invest in this stage since the chances of failure in the emerging stage are quite low. Apart from this venture capitalists have an option to analyze the past performance data i.e. sales, profit, etc., management team, and audited financial data of previous years.
- v) The Bridge Stage/ IPO stage :** This is the last stage of the venture capital financing process. At this stage, the company gains a certain amount of market share

Stages of Venture Capital Financing



- In this stage, the companies give the venture capitalists an opportunity to book the profit for the risk they have taken, and exit from the company by selling their share/stake when the company announces initial public offering. The fund raised from Initial Public Offering can be used for
- Mergers and acquisitions.
- Reduction of price and other strategies to drive out peer competitors.
- Introduction of products or services to attract new customers and markets

Housing Finance

Housing Finance means providing finance or loans for meeting the various needs relating to housing, namely:

- a) Purchase of a flat or house
- b) Acquisition of a plot
- c) Construction of a house
- d) Extension of a house
- e) Repairs, renovation of a house/flat

Importance of Housing Finance



- Create and meet a growing housing demand
- Reduce poverty
- Promote economic growth
- Since **housing** drives economic activity with both backward and forward linkages, it is considered as an **important** family investment activity.
- It is an integral part of the infrastructure sector. Construction of **houses** provides jobs and higher tax revenues for local, state and central governments.

National Housing Bank(NHB)



- National Housing Bank (NHB) was set up in July 1988 with the equity support from the RBI and is intended to act as the apex institution for coordinating and developing the housing finance schemes.
- Later, the UTI set up in 1989, a Housing Construction Investment fund for direct investment in construction projects and real estate development.
- The entry of LIC and GIC and many banks like SBI and Canara Bank through their subsidiaries has been started to be another landmark in the promotion of housing industry.
- The setting up of National Housing Bank as a fully owned subsidiary of the RBI, and as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in India.
- The system has also been characterized by the emergence of several specialized financial institutions, which have considerably strengthened the organization of the housing finance system in the country.

Housing Finance in India



- In 1985, RBI made many recommendations for liberalization in the housing finance system based on the report of Chakraborty Committee.
- In 1987, HFC's amended the Insurance Act of India to allow the Life Insurance Corporation (LIC) and the General Insurance Corporation (GIC) to enter the housing finance business.
- In 1988, the National Housing Bank was set up as a subsidiary of the RBI to act as an apex regulatory and promotional agency.
- In 1989, the RBI allowed Commercial banks to issue large loans for housing without imposing rigid restrictions on interest rate or loan quantity ceiling

Housing Finance in India



- In 1990's the pace set in the earlier decades was carried forward. Many HFCs were set up under the directions of the NHB.
- The process of liberalization covered the retail housing finance sector substantially. The most significant change was the enhancement of the amount set aside by the commercial banks for their lending to the housing sector from 1.5 per cent to 3 per cent(Union budget 1999-2000)

Types of Housing Home:

1. Home purchase loans
2. Home Improvement Loans
3. Land Purchase Loans
4. Balance Transfer Loans
5. Loans to NRIs

Issues of Housing Finance in India



- The housing sector of India has been stressed out from the time of independence. Builders and developers have also confronted several problems.
- The following are some of the major issues of the Indian housing financial sector:
 1. **Traditional Laws:** There are few legislations which restrict the growth and development of housing finance in India. For example, the old Urban Land Ceiling Regulation Act has not been successful in the Indian housing finance system. It resulted only in increase of land price, inadequate land supply for housing development and financing.
 2. **Improper Title:** Improper title to the property is another major issue. Nearly 90% of the Indian lands are without a proper title.
 3. **High Stamp Duty:** The expenditure involved in transferring the land, stamp duty, the registration charges are very high. Apart, from this, the method followed is also not transparent

Issues of Housing Finance in India



4. **Outdated Rented Laws:** Majority of the urban properties are out of the market due to the outdated tenancy and rental control laws. The rental laws need to be updated from time to time in order to safeguard the owner and the property from the tenant.
5. **Foreclosure Laws:** In spite of low levels of closure laws being present yet these laws are regarded as outdated. The laws for non-payment of EMI (Equated Monthly Installment) and the foreclosure and repossession of the property should be reviewed from time to time.
6. **Improper Infrastructure:** It is the common and the major problem of Indian cities. It is the duty of both the central and state governments to make a provision of adequate electricity, water and roads to cope up with the growing population.

Issues of Housing Finance in India



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UNIT V

New Financial Instruments and Institutions : Private Banks - Old generation and New generation private banks - Foreign Banks - NSE - Depositories - DFHI - New Equity and Debt Instruments - SEBI and RBI guidelines.

Merchant Banking



- The Merchant banks are the financial institution which provides financial services, solutions and advice to corporate houses
- A Merchant bank is a financial institution providing capital to companies in the form of share ownership instead of loans.
- A merchant bank also provides advisory on corporate matters to the firms in which they invest.

Definition: The Ministry of Finance in India defines Merchant Banker as “ any person who is engaged in the business of issue management either by making arrangements regarding buying, selling or subscribing to the securities as a manager, consultant , adviser in relation to such an issue management”.

Origin:

- Merchant banking came to India through Grindlays bank in the year 1967 and Citi bank in 1970
- SBI started the merchant banking division in the year 1972

Merchant Banking in India

Origin:

- Merchant banking came to India through Grindlays bank in the year 1967 .
- Grindlays started its operations with management of capital issues, recognized the requirements of upcoming class of Entrepreneurs for diverse financial services ranging from product planning and system design to market research.
- Citibank set up its merchant banking division in India in 1970
- SBI started the merchant banking division in the year 1972
- After that, there were many banks which set up the merchant bank division such as; ICICI, Bank of Baroda, Canara Bank
- The merchant bank got more importance in the year 1983 when there was a huge boom in the primary market where the companies were going for new issue.
- As of now, there are 135 merchant bankers who are registered with SEBI in India. It includes public, private sector and foreign players

Merchant Banking Services

The following are the major services provided by merchant bankers to customers:

- i) **Issue management:** This service deals with issuing equity shares, preference shares and debentures that acts as a partner for a high net-worth client by issuing shares and debentures to the general public.
- ii) **Portfolio Counseling:** It is a service where a merchant bank invests in different kind of financial instruments on behalf of clients as well as manages the whole investment.
- iii) **Project Counseling:** Project Counseling also involves filling up application forms and trying to fund projects through banks or financial institutions.
- iv) **Loan syndication :** In this case the bank provides term loans for the projects that need money.
- v) **Underwriting Services:** This is one of the main services offered by merchant bankers. It is a guarantee that states that if the subscription is below a specified level, then the merchant banker has to subscribe to the said amount.

Functions of Merchant Bankers



The important functions of merchant banking are discussed below:

- i) **Raising funds for clients:** Merchant banking helps clients to raise funds by issuing shares, debentures and bank loans. This helps clients raise funds both in the domestic as well as international market.
- ii) **Handling Government consent for industrial projects:** Any business requires Government permission for starting a project. Companies also require permission for expansion or modernization activities. Merchant banks do all this for their clients.
- iii) **Brokers in stock exchange:** The merchant bankers act as brokers of a stock exchange. These brokers buy and sell shares on behalf of their clients.
- iv) **Advice on expansion and modernization:** The banks have executives who advice their customers on the expansion and modernization of businesses. They give expert advice on mergers and acquisitions and takeovers.
- v) **Managing public issue of companies:** Merchant bankers advice and manage public issue of companies.

Functions of Merchant Bankers



- **Services to private sector units:** Merchant banks offer many services to public sector units and public utilities. They help in raising long term capital, marketing of securities and foreign collaboration and also managing long term finance.
- **Special assistance to small companies:** Merchant banks advise small companies on business opportunities, government benefits, incentives and policies.
- **Management of interest and dividends:** Merchant bankers help their clients in the management of interest on debentures and dividends on shares. They also provide expert advice to the client on the rate of dividend and timing.
- **Money market operation:** Merchant bankers deal with short term money market instruments like commercial paper issued by large corporate firms, government bonds and treasury bills issued by RBI
- **Leasing services:** Merchant bankers also help in leasing services where the lessor allows the use of specific assets to the lessee for a certain period on behalf of fees or rentals.

Lead Manager

- A lead manager is under an obligation to accept a minimum underwriting obligation of 5% of total underwriting commission or 25 lakhs whichever is less •
- If he is not able to comply with the above provision. It is his duty too to make arrangements with another merchant bankers associated with that issue to underwrite the said amount.
- In case of development, the lead manager has to ensure the collection of the specified amount from the underwriters.
- Every lead manager is responsible for ensuring timely refund of excess application money received from the applicants.
- It is the lead manager duty to mail the share or debenture certificate immediately on allotment/ inform it to the depository participant.
- Every lead manager has to submit all the particulars of an issue, draft prospectus or letter of offer to the SEBI at least two weeks before the date of filling with the registrar of companies or regional stock exchange or both.

Role of Lead Managers



- Lead managers are independent financial institution appointed by the company going public.
- Companies appoint more than one Lead manager to manage big IPO's

Underwriting



- Underwriting is the process through which an individual or institution takes on financial risk for a fee. This risk most typically involves loans, insurance, or investments.
- The term underwriter originated from the practice of having each risk-taker write their name under the total amount of risk they were willing to accept for a specified premium.
- Although the mechanics have changed over time, underwriting continues today as a key function in the financial world.
- Underwriters assess the degree of risk of insurers' business.
- Underwriting helps to set fair borrowing rates for loans, establish appropriate premiums, and create a market for securities by accurately pricing investment risk.
- Underwriting ensures that a company filing for an IPO will raise the amount of capital needed, and provides the underwriters with a premium or profit for their services.
- Underwriters are important in a financial world.
- They basically help in lowering the risk of the other party, but for a fee, commission or interest.

How Underwriting Works



- Underwriting involves conducting research and assessing the degree of risk each applicant or entity brings to the table before assuming that risk.
- This check helps to set fair borrowing rates for loans, establish appropriate premiums to adequately cover the true cost of insuring policyholders, and create a market for securities by accurately pricing investment risk. I
- If the risk is deemed too high, an underwriter may refuse coverage.
- Risk is the underlying factor in all underwriting. In the case of a loan, the risk has to do with whether the borrower will repay the loan as agreed or will default.
- With insurance, the risk involves the likelihood that too many policyholders will file claims at once.
- With securities, the risk is that the underwritten investments will not be profitable.
- Underwriters evaluate loans, particularly mortgages, to determine the likelihood that a borrower will pay as promised and that enough collateral is available in the event of default

How Underwriting Works



- In the case of insurance, underwriters seek to assess a policyholder's health and other factors and to spread the potential risk among as many people as possible. Underwriting securities, most often done via Initial Public offering (IPOs) helps to determine the underlying value of the company compared to the risk of funding its IPO.
- Use software to evaluate risk
- Vetting potential borrowers based on their background, assets, income and other factors
- Approving and declining applications based on research and valuations

Registration of Underwriters



Eligibility:

SEBI grants a certificate of registration to act as an underwriter based on the following criteria:

- i) Candidate should hold a certificate obtained from the Board
- ii) Should have sufficient Infrastructure
- iii) Past Experience in Underwriting for a minimum period of 2years
- iv) Capital adequacy of a min of Rs.20lakhs
- v) Any merchant banker or stock brokers holding certificate of registration as per section 12 shall be permitted to function as an underwriter without obtaining a separate license from SEBI.

Registration of Underwriters

- The SEBI has set the some requirements for registration of underwriters:
- Should meet the eligibility criteria
- Filling Form A with all the details as mentioned
- Fill the non-refundable fee of Rs 25000
- The board will review all the details provided in the form and recheck if the applicant is eligible for the registration and satisfies all eligibility criteria
- Grants “Certificate of Registration” in Form B