JAIIB CAPSULE
Paper-1 IE&IFS

MODULE A INDIAN ECONOMIC ARCHITECTURE

MODULE B ECONOMIC CONCEPTS RELATED TO BANKING

MODULE C INDIAN FINANCIAL ARCHITECTURE

MODULE D FINANCIAL PRODUCTS AND SERVICES

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JAIIB Paper 1: Indian Economy and Indian Financial System (IE & IFS) Capsule PDF

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JAIIB Paper 1: Indian Economy & Indian Financial System

MODULE A: INDIAN ECONOMIC ARCHITECTURE

Module A, Unit 1: An Overview of Indian Economy

Evolution Of Indian Economy

According to the Angus Maddison database, India and China contributed:

- 1000 AD : 50.5% of global GDP (GDP computed in 1990 dollars and in purchasing power parity terms).
- 1600 AD: 52%

  29% - China

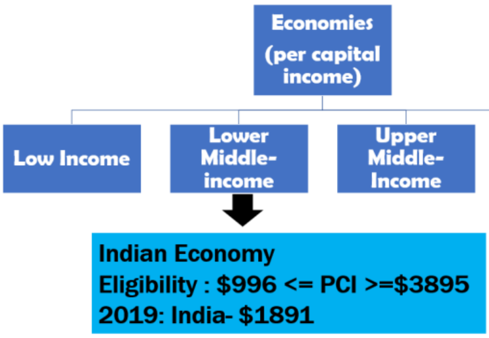
  23% - India

- A century later, China's GDP share had declined, while India's had risen to 24.4% of world output.
- British colonialism altered the dynamics, and by 1820, India's share had plummeted to 16.1%.
- **2021 :** According to the International Monetary Fund (IMF), India's contribution of global GDP reached 7.3% .
- However, in terms of GDP purchasing power parity (PPP), India is ranked 3rd in the world only after USA and China.
- Today, India is one of the world's fastest growing major economies.
- India's economic performance during the British Raj was dismal.
- The British East India Company ignored industrialisation in the nation, and infrastructure was created not to industrialise India but to exploit its raw materials.

- When India gained independence, the administration of the time had a significant challenge in systematic organisation of the economy.

Basic Characteristics of Indian Economy

World Bank classifies economies considering per capita income.



- **Indian economy in terms of**
  - **Purchasing Power Parity (PPP)** is the 3rd largest economy in the world but
  - in terms of PCI, India ranked very low.
- The low per capita income is **mainly attributed to high levels of poverty, unemployment, illiteracy, etc.**
- India was a backward nation at the time of its independence. The government addressed the developmental issues through five-year plans by setting targets and ensuring the allocation of funds for the development of various sectors.
- **A number of factors influence the nature and characteristics of the Indian economy.**
- **Some of these factors include:**

(i)low per capita real income,

(ii)rapid population growth,

(iii)a high rate of unemployment, underemployment, and disguised unemployment,

(iv)**excessive reliance on the primary sector,**

(v)a vicious circle of poverty, and

(vi)rising unemployment.

- **Following extract of India's macro-economic aggregates from RBI publication dated 15th September, 2021, will give an overall view of the economic status of India**

Item/Year	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
1	2	3	4	5	6	7	8
Population (in lakhs)	12670	12830	12990	13140	13270	13410	13554
GVA at Basic Prices	11504279	12574499	13965200	15505665	17161213	18461343	17915167
Net taxes on products	963680	1197375	1426469	1584377	1725744	1889670	1830503
Gross Domestic Product	12467959	13771874	15391669	17090042	18886957	20351013	19745670
Consumption of Fixed Capital	1342291	1449697	1591332	1764812	1979987	2163598	2099588
Net Domestic Product	11125668	12322177	13800337	15325231	16906970	18187414	17646082
Primary income receivable from ROW (net)	-147430	-159779	-176400	-184813	-202324	-193114	
Gross national Income	12320529	13612095	15215269	16905230	18684632	20157899	19561348
Net national Income	10978238	12162398	13623937	15140418	16704645	17994301	17461759
Other current transfers (net) from ROW	405154	413083	379438	405740	493740	540364	
Gross national Disposable Income	12725683	14025178	15594707	17310970	19178372	20698263	20128484
Net National Disposable Income	11383392	12575481	14003375	15546158	17198385	18534665	18028896
Gross Savings	4019957	4282259	4825113	5480741	5776960	6385981	
Net Savings	2677666	2832562	3233781	3715929	3796973	4222382	
Gross Capital Formation	4179779	4422659	4918077	5791573	6172623	6551251	
Net Capital Formation	2837487	2972961	3326745	4026761	4192635	4387653	
Per Capital GDP(₹)	98405	107341	118489	130061	142328	151760	145680
Per Capita GNI(₹)	97242	106096	117131	128655	140804	150320	144320
Per Capita NNI(₹)	86647	94797	104880	115224	125883	134186	128829
Per Capita GNDI(₹)	100439	109315	120052	131743	144524	154349	148504
Per Capita PFCE(₹)	57201	63339	70258	76379	84567	91790	85348

Macro-Economic Aggregates (Base Year: 2011-12 At Current Prices)

Notes:

1. Date for 2017-18 are 3rd Revised estimates, for 2018-19 are 2nd revised estimates & for 2019-20 are 1st revised estimates

2. Data for 2020-21 are provisional estimates

3. Population figures relates to mid- financial year

- **India was an agricultural economy,** with a very low per capita income.
- After independence, agriculture's share of GDP fell during the development process, while industry and services increased.
    - ✓ **1950 : Agriculture was a dominant sector : 53.1% of GDP.**
        - Industry : 16.6%,
        - services : 30.3%.
- Following independence and the start of the planning process, agriculture's share decreased while industry and services increased.
    - ✓ 1980–81, the services sector (38%) surpassed
        - **agriculture (36.1%) to become the largest contributor to India's GDP.**
        - **The industry : 25.9%**

Indian Economy In British Period

- During British colonialism, India's commerce, trade, and investment were hampered by the unilateral transfer of capital and raw materials to Britain.
- Under British rule, India remained a low-quality labour market.
- According to statistics, less **than 1/6 of Indians were only literate**.
- **1867-68 : Dadabhai Naoroji** published the first estimates of national income in India in his book "Poverty and Un-British Rule in India"

- According to him:
- British India's national **income was Rs. 340 crore**,
- Per capita income was **Rs. 20 per annum at current prices**
- 1948-49: Rs. 142 p.a
- Other economists of the period (William Digby, Findlay Shirras, V.K.R.V. Rao and R.C. Desai) produced estimates of India's national income, and the findings were almost identical.
- **Atkinson:** India's per capita **income to be Rs. 172**
- **Horne**: it to be Rs. 158 in 1948–1949 prices for the years 1875 and 1891, respectively.
- Curzon projected per capita income in 1902 to be Rs. 148 in 1948–1949 prices.
- However, **by 1947, the per capita income had risen to Rs. 250 per year**.
- According to the work of Cambridge economist Angus Maddison

Note:

- **India's share of global income**
- **1600 A.D= 23%**

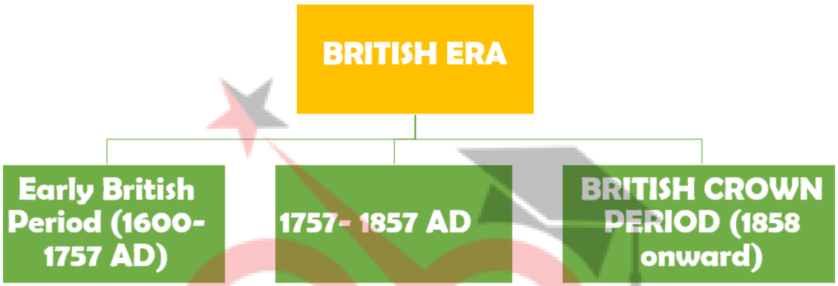
but

- **by the time the British left in 1947, it had shrunk to only 3%**
- **Similarly, India accounted for 33% of global trade in 1600 but fell to less than 3 per cent in 1947.**

According to former Prime Minister Manmohan Singh, at the turn of the twentieth century, India was the brightest jewel in the British Crown and the poorest country in the world, in terms of per capita income.

India: National Income, Per capital Income & population since 1 AD			
Year	**GDP (1990 Intl $)**	**Per capital GDP (1990 Intl $)**	**Population of India**
1 AD	$33750 mn	$450	5.5 cr
1000 AD	$33750 mn	$450	7.5 cr
1600 AD	$74250 mn	$550	13.5 cr
1820 AD	$111417 mn	$533	20.9 cr
1870 AD	$134882 mn	$533	25.3 cr
1913 AD	$204241 mn	$673	30.4 cr
1950 AD	$222222 mn	$619	35.9 cr

BRITISH ERA: Discussed in 3 different phases



- **3rd Phase : began in 1857 (Sepoy Mutiny)**
- Period marked by colonial exploitation through de-industralisation, agricultural commercialisation, wealth drain & westernisation of Indian education systems
- **British withdrew: India as a destitute economy**
  - Global GDP : 1600 AD (23%) to 1947 (3%)
  - Global export: from 33% to 3%
  - Introduced: Zamindari, Mahalwari & Ryotwari system – to take excessive land tax from farmers.
  - Commercialisation created a new class of intermediaries, increased the frequency of famines, & reduced farmers to landless labour.
- **Deindustralisation: in mid 19th century**
  - The fall of the Mughal Empire,
  - The decline of Indian agriculture,
  - An **increase in nominal wages,**
  - A **reduction in Indian textile c**ompetitiveness, and
  - An increase in transportation facilities

- Trade policy that was unfavourable to India also contributed to trade decline and aggravated deindustrialisation.
- Railways assisted the British in moving commodities from the hinterlands to ports and vice versa.
- It also enabled British investors to make attractive profits on their cash spent in railway infrastructure building and development.
- The fundamental goal of introducing Western education to India was to generate a group of Indians who neither good in English nor Indian culture.

Important Point

- **The wealth drain** : unilateral movement of riches from India to Britain, without a sufficient economic, commercial, and material return.
- It occurred through **remittances, home charges, and the transfer** of revenue from private business or investment, among other things.
- Many British philosophers and Indian nationalists, including **Dadabhai Naoroji, R.C. Dutta, and C.N. Vakil,** have done research and written about the wealth drain from India to Britain.
- **In 1783, Edmund Burke** explained the mechanism of economic drain and rising poverty in Indian situations.
- **In 1776, Philip Francis** studied the drain economy and classified it into four broad streams
- **As per the findings of Angus Maddison,**
    - India's share of world economy went down from **23% in 1600 to 3% in 1947.**
    - Clive took quarter of a million pounds for himself as **well as a Jagir worth £27,000 a year.**
    - British salaries were high: The Viceroy received **£25,000 a year, and governors £10,000.**
        - The starting salary in the engineering service was £420 a year or about sixty times the average income of the Indian labour force.
    - Under the rule of the East India Company, official transfers to the UK rose gradually, until they reached **about £3.5 million in 1856, the year before the mutiny.**

- **Private remittance**: From 1858 to 1947, the colonial government's official transfers of monies to the United Kingdom were referred to as "Home Charges".

- **Dividends to East India Company shareholders; interest on loans** raised by the Government of India in England;
- **Expenditure on British army** stationed in India and bringing them to India; pensions, annuities, etc., of retired British officers; payment of guaranteed interest to railway companies; and salaries of the secretary of state for India and his staff were all included in home charges.

▪ **According to Dadabhai Naoroji's** calculations, India paid Britain £10 crores in house costs between 1829 and 1865.

▪ By the 1930s, these residential levies were in the £40–50 million level each year.

Comparative Macroeconomic Performance

Comparative Macroeconomic Performance of India and Britain, 1600–1947		
Per Capita GDP (1990 int. Dollars)		
India	550	618
United Kingdom	974	6,361
Population		
India	13.5 crore	41.4 crore*
United Kingdom	61.7 lakhs	4.95 crore
GDP (Million 1990 int. Dollars)		
India	74,250	255,852
United Kingdom	6,007	314,969

Source: Tabulated by author from Maddison, A. (2001). The world economy: A millennial perspective. Development Centre Studies, OECD. Paris; *: Including Pakistan

- India's per capita income from **1600–1947 increased by 12%** whereas the increase for Britain for the same **period was 55%.**
- India's total GDP during **1600–1947 increased by 2.44 times**, but for Britain the rise was 52 times.

Economy Till 2008 & After 2008

1951–1980

- **1st three decades:** India's growth rate was slow
- **In 1978, Professor Raj Krishna** coined the phrase "Hindu rate of growth" to describe the slow growth of the Indian economy.
  - The term refers to
  - India's planned economy's low annual growth rate - around 3.5% from the 1950s to the 1980
  - Per capita income **growth : averaged 1.3%.**

1980-90

- **Period of Economic buoyancy and recovery.**
- **During the 6th five-year plan (1980–1985)** India could break the curse of the **'Hindu Rate of Growth'.**
- Higher government spending, fiscal stimulus to the economy, higher economic growth.
- The liberalised import policies- increased imports of capital goods and raw materials for manufacturing, boosting the production of luxury goods in the country.

2008 to 2021

- **The 2008 growth euphoria**: widespread belief that the Indian economy was decoupled from that of the developed world in the days following the Lehman collapse (September 15, 2008).
- **In September 2008**: India took unprecedented action.
- In order to mitigate the effects of the crisis, the government provided fiscal stimulus to the economy.
- **3 stimulus packages totalling Rs. 1.86 lakh crore (3.5% of GDP).**
- The RBI eased monetary conditions and **injected Rs 5.6 lakh crore** (roughly 9% of GDP), in domestic and external liquidity.
- Economy recovered but at the expense of a larger fiscal deficit, which continued to grow beyond the limit set by the **Fiscal Responsibility and Budget Management Act.**
- The fiscal stimulus was never phased out, the current account deficit (CAD) increased.
- The previous decade's high economic growth drove credit growth in the system as the economy's productive capacity expanded dramatically.
- **Revolutionary policies such as the**
- **Goods and Services Tax (GST),**
- the Insolvency and Bankruptcy Code (IBC),
- corporate tax cuts, and demonetisation were implemented.
- Prior to the COVID-19 pandemic, the economy's average annual growth rate between **2008-09 and 2019-20 = 6.5% (base year 2011-12 prices)**
- In 2019-20, the economy expanded by only 4.0 per cent.

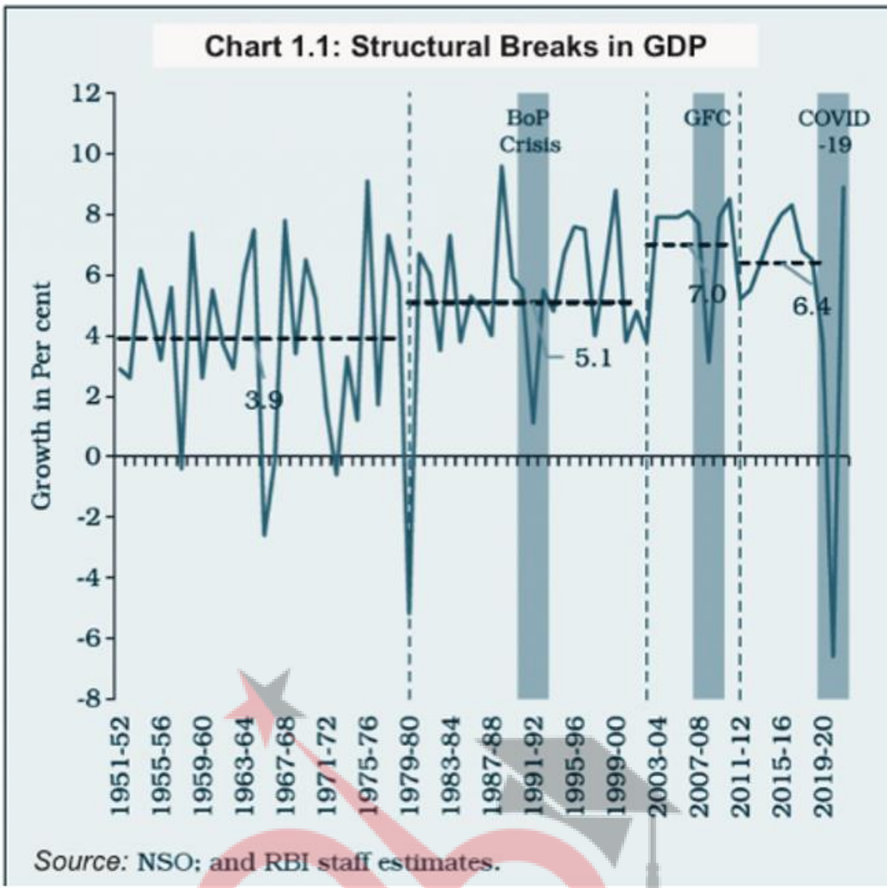
Structural Changes In Indian Economy

Indian Economy Post COVID-19

- In the last four decades, India has faced three major shocks:
- **Mar 11, 2020:** COVID-19 was declared as pandemic
- **End of Dec 2019**: First reported officially in Wuhan, China
- **Jan 30 2020:** 1st COVID-19 case was recorded in
- India has had three waves of infections as on June 2022, pushing its total case load to the world's second highest.
- A stringent lockdown during the initial wave
- On January 16, 2021, India launched its vaccination programme.
- A number of factors responsible for the most severe economic impact on India, with the severity of the lockdown being the most frequently stated explanation.
- GDP contraction was more severe in countries with a higher stringency index — India, Argentina, Italy, and the United Kingdom**.**

Sectoral Impact of COVID-19

- Due to stringent restrictive measures, contact-intensive services were almost halted during the pandemic.
- The services sector, which encompasses the bulk of contact-intensive and non-essential activities in India suffered the brunt of the pandemic's impact.
- The pandemic has reduced the profitability of contact-intensive businesses such as retail trading, hotels and restaurants, air transportation services, transportation logistics services, and education.
- **The real estate and automobile sector**: was severely impacted by the pandemic, but there were signs of slowdown in these sectors prior to the pandemic.



The Indian labour market:

- severe decline during the first wave of the epidemic
- unemployment hitting an all-time high
- labour force participation plummeting.
- Reverse migration from urban to rural areas raised demand for Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS) employment in rural areas
- The second and third waves had a little impact, and work conditions had stabilised**.**

- Because of the lockdown, investment demand ceased **during Q1:2020-21 and experienced the most severe contraction.**
- The recovery in gross fixed capital formation (GFCF) has been expedited, mainly mostly to active government investment – the only sector that positively contributed to investment demand in 2020-21.
- **Agriculture remained robust** in terms of production during the pandemic since agriculture and allied activities were spared from the lockdown restrictions.
- **Manufacturing, mining and quarrying**, and electricity, gas, and water supply all saw significant drops

- M**anufacturing**, which had led the recovery following the first wave, remained strong during the second wave

Table 1.2 Sector-wise Recovery Pattern Sector Trend Growth

Table 1.2 Sector-wise Recovery Pattern

Sector		Trend Growth Pre-Pandemic		Growth Pandemic Period		Status
		2012-2017	2017-2020	2020-21	2021-22 over 2019-20	
1. Agriculture, forestry & fishing		3.6	5.2	3.3	6.7	Resilient
2. Mining & quarrying		2.4	2.4	-8.6	2.9	Recovering/ Need Repair
3. Manufacturing		6.8	5	-0.6	9.8	
4. Electricity, gas, water supply & other utility services		6	7.5	-3.6	3.9	
5. Construction		4.2	4.6	-7.3	1.9	
6. Trade, hotels, transport, communication and services related to broadcasting	6.1. Trade, hotel and repair	8.4	8.1	-22.4	-10.9	Still Suffering
	6.2. Transport, communication and services related to broadcasting			-15.3		
7. Financial, real estate & professional services	7.1. Financial services	8.2	5.4	5.1	6.6	Resilient
	7.2. Real estate, and professional services			1.2		
8. Public Administration, defence and other services	8.1. Public Administration, defence	6.5	7.0	2.3	6.4	Resilient
	8.2. Other services			-11.5		Recovering/ Need Repair
GVA at basic prices		6.6	5.9	-4.8	3.1	Recovering/ Need Repair

Economic Recovery Dynamism Post COVID

- During the first wave of infections, India had one of the world's worst recessions, with
  - **In the Q1 of 2020-21**: GDP contracting by as much as 23.8%
  - **Q3: 0.7% & Q4: 2.5%: A gradual recovery** - resulting in a substantially less severe contraction of 6.6% for the entire fiscal year, placing India in a relatively better position among the G-20 countries in terms of annual GDP growth for 2020.
- **Regardless of the second wave**: economic activity rebounded fast in June 2021 and remained persistent, indicating a steady recovery through October 2021.
- **3rd wave:** Shortage of Coal and semiconductor chip led in a reduction in momentum beginning in November 2021.
- Rural demand, in particular, dropped after the second wave, but urban demand rebounded.
- Contagion from the Russia- Ukraine conflict impeded activities beginning in March 2022, eroding and delaying recovery.
- The COVID-19 pandemic disrupted global supply chains, shipping, and logistics, as well as affecting the Indian economy through mass lockdown, loss of life, and destruction in permanent demand.
- According to the provisional estimates of annual national income, 2021-22, GDP growth in 2021-22 at Constant (2011-12) Prices in the year 2021-22, is

estimated to attain a level of Rs. 147.36 lakh crore. Supported by low base, economy recovered handsomely in 2021-22.

Economy expanded in 2021- 22

- **Q1- 20.1%,**
- **Q2- 8.4%,**
- **Q3 - 5.4% and**
- **Q4- 4.1%.**

The growth in GDP during 2021-22

- Estimated at 8.7% as compared to a contraction of 6.6 % in 2020-21.

Nominal GDP or GDP at Current Prices in the year 2021-22,

- Estimated to attain a level of Rs. 236.65 lakh crore, as against Rs. 198.01 lakh crore in 2020-21, (growth rate of 19.5%)

The pre COVID trend growth rate is 6.6% (CAGR from 2012-13 to 2019-20).

- **Using the growth rate of -6.6% for 2020-21, 8.9 per cent for 2021-22, and 7.2 per cent for 2022-23** and 7.5 per cent beyond that, RBI has predicted that India to offset COVID-19 losses in 2034-35.
- Hence, India is expected to overcome COVID-19 pandemic losses in 12 years' period.
- Structural change refers to the fundamental changes that have occurred in the critical components of the Indian economy over time.
- The primary sector's contribution to GDP decreases over time, while the secondary and tertiary sectors increase.
- In the long run, the tertiary sector surpasses the secondary sector, as the major contributor to the economy.
- In India, the services sector has largely replaced the industrial sector, and it now dominates the economy.
- The role of the primary sector declines as income rises, and India is no exception.

Agriculture's share of GDP has steadily declined

- from 26.9% in 1990 to 21.6% in 2000, and the decline has continued to 17.8% in 2010 and 17.7% in 2019 owing to service-led growth in India.
- **The onset of the pandemic has increased the primary sector's contribution to the economy as agriculture was the only sector allowed to function smoothly during the economic lockdown.**

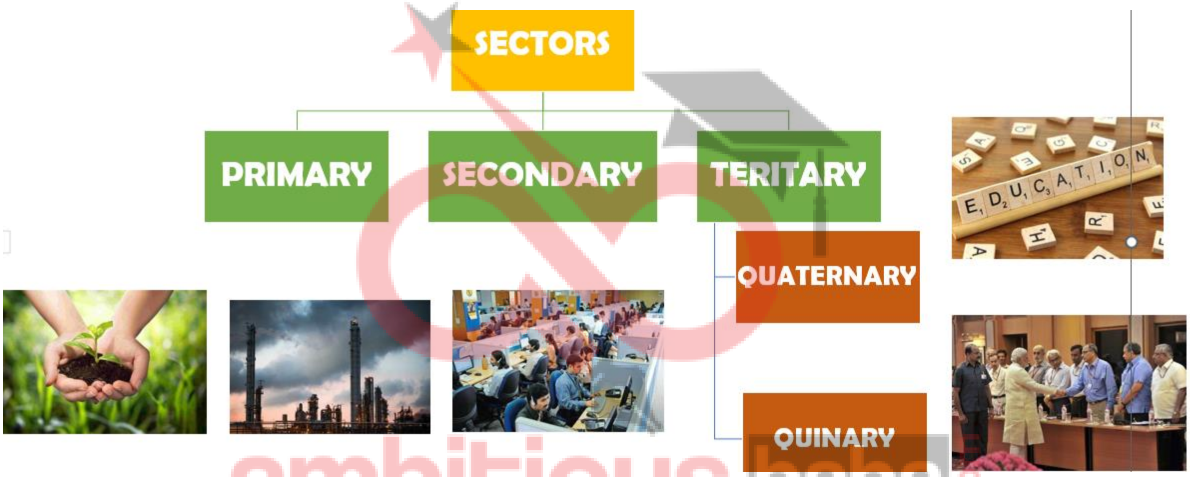
In 2020-21, the services sector contributed 60.9%

- followed by the secondary sector (19.8%) and the primary sector (20.1%).
- An empirical examination of the nature and causes of structural change in the Indian economy reveals that the services sector drives the industry and the overall economy, and the sector's growth and dominance is influenced by external factors such as foreign direct investment.

Paper IE and IFS Module A, Unit 2: Sectors of the Indian Economy

Sectors of the Indian Economy

Economic activities in an economy are usually classified into three major sectors, and economies achieve development via their dominance in such areas.



ROLE & IMPORTANCE OF PRIMARY, SECONDARY, TERTIARY SECTOR, QUATERNARY & QUINARY SECTORS

Primary Sector

- This sector includes all those economic activities where there is the direct use of natural resources as
    - **agriculture, forestry, fishing, fuels, metals, minerals, etc.**
- An agrarian economy exists when the agriculture sector (one of the key sectors) provides at least 50% of a country's national revenue and livelihood.
- **Primary sector constitutes**

    (a)agriculture,

    (b)forestry, and

    (c)fishing

Secondary Sector

- Includes all economic activities that involve the processing of raw materials extracted from the primary sector also called **industrial sector**.
- **Manufacturin**g, one of its sub-sectors, has proven to be the largest employer in the Western developed economies.
- **An industrial economy** is one, in which, the secondary sector generates at least half of a country's national GDP and employment.

Tertiary Sector

- This sector includes all economic activities that produce services, such as **education, healthcare, banking, communication, and so on.**
- A service-based economy exists when this sector generates at least half of a country's national income and livelihood.
- Along with these 3 main sectors, the **quaternary and quinary sectors have been introduced.** In a broader they are tertiary sector sub sectors

Quaternary Sector

- Also known as the '**knowledge' sector.**
- Includes activities such as ***teaching, research, and development.***
- Most important in assessing the strength of an economy's human resources.
- The intellectual aspect of the economy is represented by the quaternary sector.

<u>This group includes:</u>

- Employees in office buildings,
- Elementary schools and university classrooms,
- Hospitals and physicians' offices,
- Theatres,
- Accountancy and
- Brokerage businesses, and so on.

Quinary Sector

- Includes activities in which key choices are made.
- Includes the highest level of decision makers in governments (including their bureaucracy) and the private corporate sector.
- The number of people participating in this sector is quite small, yet they are regarded the "**brain" behind an economy's** socioeconomic performance.

<u>This group includes occupations such as</u>

- Senior company executives,
- Government officials,
- Research scientists,
- Financial and legal advisors and others.

DIFFERENCE BETWEEN THE SECTORS

The differences in activities are the foundations of their classification. The following are some of the most significant variations.

Primary Sector	Secondary sector	Tertiary sector
Agriculture, forestry, and mining are examples of activities in this sector	Manufacturing units, small-scale units, major enterprises, and global organisations are all included	This sector involves banking, insurance, and communications
Known as agriculture and associated services	The industrial and manufacturing sector is often known as the manufacturing sector	Known as the service sector
Provides raw materials for the production of goods and services	Transforms one good into another by value addition to it	Offers valuable services to the primary and secondary sectors
Unorganised and most of the times employs old methods	Organised and employs more efficient production methods	It is well-organised and use advanced logistics techniques to carry out its tasks
In most developing economies, such as India, this sector employs a large proportion of the workforce, compared to developed countries	Since this sector requires a particular set of talents, the employment rate is in equilibrium.	This sector's employment share has risen dramatically in recent years

DIFFERENT REVOLUTIONS IN PRIMARY SECTOR

- Agriculture has always been the most important industry in India.
- Traditional, subsistence and livelihood, rain fed farming, food grain oriented, and deficient in diversification and commercialisation characterise India's agricultural sector.
- To overcome the decreased supply in recent time, the government carried out a series of revolutions in the primary sector to increase capacity. ***The multiple revolutions influencing agricultural production:***

Revolution	Field/ Product	Father of revolution	Period
Green Revolution	Agriculture	M.S. Swaminathan	1966-78
White Revolution or Operation Flood	Milk/ Dairy Product	Verghese Kurian	1970-96
Yellow revolution	Oil seeds	Sam Pitroda	1986-90
Blue revolution	Fish & aqua	Arun Krishnan	1973-2002
Golden Revolution	Fruits, Honey & Horticulture	Nipakh Tutej	1991-2003
Golden Fibre Revolution	Jute	-	1991-2003
Silver Revolution	Eggs	Indira Gandhi	1969-78
Silver Fiber Revolution	Cotton		2000s
Pink Revolution	Pharma, Prawns, Onion	Durgesh Patel	1970s

Brown revolution	Leather, cocoa, non-conventional energy	Hiralal Chaudhari	-
Red revolution	Meat, Tomato	Vishwa Tewari	1980s
Grey Revolution	Fertilisers	-	1960-1970
Evergreen Revolution	Overall product of agriculture	M.S. Swaminathan	2014-22
Black Revolution	Petroleum	-	-
Round Revolution	Potato		1965-2005
Protein Revolution	Agriculture (Higher Production)	Coined by Narendra Modi	2020

GDP CONTRIBUTION OF DIFFERENT SECTORS

- **By the late 1990s, :** India had transitioned from agricultural dominance to services supremacy, with services accounting for over half of her national GDP.
- **The agriculture sector -** 18% of total GDP.
- **The services sector -** more than 55%
- **secondary sector -** 27%, with only 14% coming from the manufacturing sector.

Year	Agriculture & Allied	Industry	Services
1950-51	51.8	14.2	33.3
1960-61	42.6	19.3	38.3
1970-71	42	20.5	37.2
1980-81	35.4	24.3	39.9
1990-91	29	26.5	44.2
2000-01	23	26	51
2010-11	18.2	27.2	54.6
2019-20	18.3	26.9	54.8
2020-21	20	26.9	53.1
2021-22	18.6	28.6	52.8

AGRICULTURE

- Most significant sector in India.
- Not only the largest sector, but also the biggest private sector.
- Main unorganised sector of the economy, accounting for more than 90% of all unorganised labour
    - **(93.4% of the total labour force of the economy, i.e., 40.0 crore is employed in the unorganised sector).**
- Agriculture's share in gross income has been declining, while the industrial and service sectors' shares have been steadily increasing.

Agriculture has recently had satisfactory development as a result of:

- improved technology,
- irrigation,
- inputs, and
- pricing strategies

- In recent years**, livestock, poultry , fisheries, and horticulture** have led the way in terms of output increase.
- Despite all these structural changes, agriculture remains a critical sector, offering employment and livelihood opportunities to a large segment of the population.

- **Government of India Report of 2020-21 by Ministry of Agriculture & Farmers' Welfare**
    - "Agriculture plays a vital role in India's economy.
    - **54.6%** of the total workforce is engaged in agricultural and allied sector activities (Census 2011) and accounts for **17.8% of the country's Gross** Value Added (GVA) for the year 2019-20 (at current prices).
    - Given the importance of the agriculture sector, Government of India has taken several steps for its development in a sustainable manner.
    - Steps have been taken to improve the income of farmers.
    - Further, to mitigate risk in the agriculture sector, a scheme **'Pradhan** ***Mantri Fasal Bima Yojana' (PMFBY) was also launched in 2016***.
    - Schemes such as Formation & promotion of 10,000 FPOs & the Agriculture Infrastructure Fund have also been launched recently to benefit the sector."

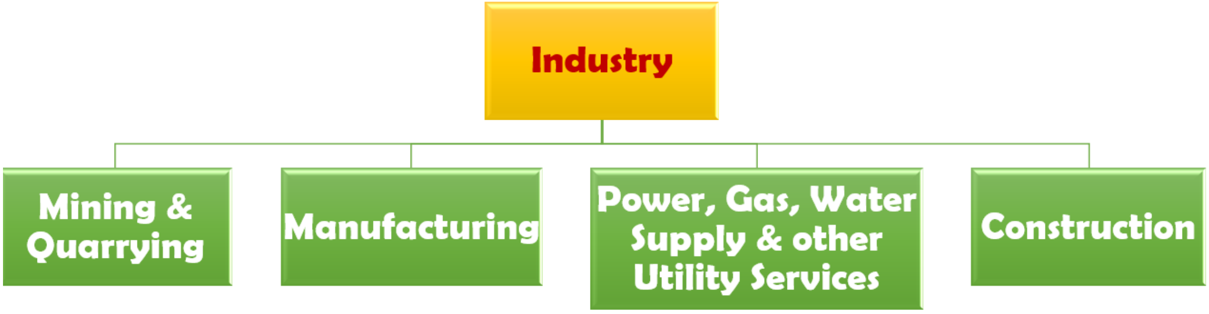
As per the Land Use Statistics 2016-17

Total geographical area	328.7 million hectares
Net sown area	139.4 million hectares [works out to 42.4% of the total geographical area]
Gross cropped area	200.2 million hectares [cropping intensity of 143.6%.]
Net irrigated area	68.6 million hectares

- Agriculture Gross Value Added (GVA): As per the provisional estimates of Annual National Income released by Central Statistics Office (CSO), Ministry of Statistics & Programme Implementation, the agriculture and allied sectors contributed approx 17.8% of India's GVA at current prices, during 2019-20, marginally higher than 17.7% in 2015**-19.**

INDUSTRY

- **The industrial sector is equally vital, since it promotes**
    - Economic growth,
    - Provides self-sufficiency and employment,
    - Generates demand for agricultural commodities and produces a 'ripple effect



- **Manufacturing =** Around 18% of total gross value added (GVA),
- **construction =** Around 8% of total GVA.
- **Mining and quarrying, as well as power, gas, water supply, and other utility services =** Approx 3% and 2% respectively.
- **Industry's share of GVA has increased**
  - 1950-51 : nearly 17%
  - 2021-22 : 29%

The journey of Indian industry can be summed up into 4 phases including both pre-reform and post-reform period.

Phase I (1951–1965): The period of industrial foundation

Phase II (1965–1980): The period of industrial fall

Phase III (1980–1991): The period of industrial recovery

Phase IV (1991 onwards): The post-reform period

- **IIP :** The Index of Industrial Production (IIP) measures the change in volume of production in a given year (base year 2010-11).
- It is an index reflecting growth in the broad sectors of mining, manufacturing and electricity and also the growth in use-based sectors of basic goods, capital goods and intermediate goods.
- Calculated by the National Statistical Office which also calculates the Index of Core Industries (ICI).

8 Core industries:

- Refinery
- Products
- Electricity,

- Steel,
- Coal,
- Crude oil,
- Natural gas,
- Cement
- Fertilisers.

SERVICES

- The sector produces **'intangible or invisible goods'** for businesses as well as consumers, Trade, repairs, hotels & restaurants, transport, storage, communication & broadcasting services, railways, road transport, water transport, air transport, services incidental to transport, storage, financial, real estate, and professional services are all sub-sectors of the services sector.
- **Financial services, real estate, property ownership**, and professional services, communal, social, and personal services, government administration and defence, and other services are all a part of the services.
- The services sector's proportion has increased from **33% in 1950 to 53% in 2021-22.**
- As per Government of India publication, chapter 9 of Union Budget 2019-20 –
- "The services sector accounts for **54% of India's Gross Value Added (GVA).**
- Its growth rate moderated to **7.5% in 2018-19 from 8.1% in 2017- 18**.
- The segments that saw deceleration are tourism, trade, hotels, transport, communication and services related to broadcasting, public administration and defence.
- Financial, real estate and professional services category accelerated.
- An important finding is that India's services sector does not generate jobs in proportion to its share in GVA.
- **Foreign Tourist:** 2017-18 : 10.4 million
- **2018-19 :** 10.6 million
- **Foreign exchange earnings from tourism in India**
    - 2017-18: US$28.7 billion
    - 2018-19: US$27.7 billion
- Many of the high frequency indicators, such as bank credit to services sector, decelerated in 2018-19.

- However, the IT-BPM industry grew by 8.4% in 2017-18 (US$167 bn) & is estimated to have reached US$181 bn in 2018-19".

As per the findings of the Ministry of Statistics and Programme Implementation (MoSPI), in the year 2019-20

share of the Service Sector in GVA	55.3%
Trade, hotels, transport, communication and services related to broadcasting	18.3%
financial, real estate & professional services Public;	21.4%
public administration, defence & other services	15.6%

- As per the World Investment Report 2021 by the UN Conference on Trade and Development (UNCTAD), India in 2020 was the 5th largest recipient of FDI.
- India has made a global impact by being amongst the top ten service exporter countries.
- India's and Indians dominance in Software is globally respected. Of the total net **Service Exports, about 40% pertains to Software.**

Employment Growth Rate In Secondary Sector

Industrial Category	Rural place of residence	Urban place of residence	Male	Female	Total
Primary	66.6	9	43.6	62.8	48.9
Secondary	16	31	25.9	20	24.3
Service/ Tertiary	17.4	60	30.5	17.2	26.8
	100	100	100	100	100

- **Manufacturing employs roughly 12% of the labour force.**
  - Known throughout the world for creating mass employment for low-skilled workers in the modern economy.
- With agriculture's capability to provide jobs rapidly dwindling and the modern services sector's limited ability to absorb relatively unskilled labour displaced from agriculture, hopes are that the **manufacturing sector will generate mass employment.**
- **The construction sector** : 2nd largest employment sector in the country, only after agriculture.
- Construction activity is an essential component of a country's industrial and infrastructure growth, as well as a key input for socioeconomic development.
- This sector provides significant employment and growth input to other sectors via backward and forward linkages.

- Cement, steel, bricks, tiles, sand, aggregates, fixtures, fillings, paints & chemicals, construction equipment, petro-products, timber, mineral products, metal, glass, and plastics are all important components of the construction industry.
- The Indian construction sector is an important element of the economy, and it is positioned for strong expansion as a result of **industrialisation, urbanisation, and economic development, as** well as people's aspirations of higher living standards.
- The construction industry employs over 31 million people and accounting for around 8% of total employment.

SUNRISE SECTOR OF INDIAN ECONOMY

- **A sunrise sector is one that is still in its infancy, but has the potential for significant growth.**
- **CHARACTERISTICS:**
  - strong growth rates,
  - a high degree of innovation,
  - a high level of public awareness, with investors attracted to its long-term growth prospects.

Existing Indian industries that may be categorised as Sunrise sectors are likely to benefit the economy in terms of job creation and business growth, in the future.

  - Green Energy,
  - Fintech, Information Technology,
  - Electronics,
  - Pharmaceuticals,
  - Automobiles,
  - Healthcare,
  - Infrastructure Sector,
  - Retail Sector,
  - Processing Plants,
  - and other emerging sectors of the Indian economy

ORGANISED AND UNORGANISED SECTORS

- **Organised Sector :** where the job terms are fixed and regular, and the employees are guaranteed work and social security
  - **Comprises :** Manufacturing, enterprise, business, school, hospital, and unit registered with the government.

- Also comprises legally licenced stores, clinics, and offices.
- Lower unemployment than the unorganised sector**.**

- **Unorganised sector:** where employment terms are not defined and regular, and enterprises are not registered with the government**.**
  - Construction workers, domestic workers, street workers, and those operating in tiny workshops unaffiliated with the government are all part of the unorganised sector.
  - A home-based worker, self-employed worker or wage worker in the unorganised sector is an unorganised worker.
  - Characteristics: Low wages, unstable and irregular work, and a lack of protection from legislation or trade unions Relies heavily on labour and indigenous technologies.
  - **According to the NCEUS (National Commission for Enterprises in Unorganised Sector)** categorisation, "the unorganised sector comprises of all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with fewer than ten total workers."
  - However, "**informal workers" are defined a**s "those who work in unorganised firms or families, excluding regular workers with social security benefits, and workers in the formal sector who do not get any employment benefits/social security from their employers."

Difference between Organised and Unorganised sectors

BASIS FOR COMPARISON	ORGANISED SECTOR	UNORGANISED SECTOR
Meaning	The sector in which the employment terms are fixed and employees have assured work is Organised sector.	The sector that comprises of small scale emterprises or units and are not registered with the government.
Governed by	Various acts like Factories Act, Bonus Act, PF Act, Minimum Wages Act etc.	Not governed by any act.
Government rules	Strictly followed	Not followed
Remuneration	Regular monthly salary.	Daily wages
Job security	Yes	No
Working hours	Fixed	Not fixed

Overtime	Workers are paid remuneration for overtime.	No provision for overtime.
Salary of workers	As prescribed by the government.	Less than the salary prescribed by the government.
Contribution to Provident fund by the employer	Yes	No
Increment in salary	Once in a while	Rarely
Benefits and perquisites	Employees get add-on benefits like medical facilities, pension, leave travel compensation, etc.	Not provided.

Paper IE and IFS Module A Unit 3 Economic Planning in India & NITI Aayog

Definition Of Economic Planning

- **Economist H. D. Dickinson** - "the making of major economic decisions–what and how much is to be produced and to whom it is to be allocated by the conscious decision of a determinate authority, on the basis of a comprehensive survey of the economic system as a whole."
- **National Planning Committee**, set up in 1938 by the Indian National Congress defined planning in India as "Planning, under a democratic system, may be defined as the technical coordination, by disinterested experts of consumption, production, investment, trade, and income distribution, in accordance with social objectives set by bodies representative of the nation. Such planning is not only to be considered from the point of view of economics, and raising of the standard of living, but must include cultural and spiritual values, and the human side of life."
- Planning is the skill of reaching any sort of objective utilising the resources at hand.

Types Of Planning

- **Depending on the goal, planning may be categorised into several types.**
- **Territorial standpoint:** Planning may be regional or national.
- **Political standpoint:** Federal, state, or local.
- **Participation :** Centralised or decentralised planning
- **Temporal standpoint:** long-term or short-term.

- **Similarly, planning may be sectoral as well as geographical**
- **Sectoral planning** : Focuses on a single sector of the economy**,**
- **Spatial planning** : Focuses on development in the geographical context (which aims at influencing the distribution of people and activities in places).
- **Some of the key forms of planning that are a part of the Indian planning process are as follows:**

National Planning:

- **Joseph Stalin** was the first person to implement the **Five-Year Plan in the Soviet Union, in the year 1928-1933.**
- Various Industrialists came together in 1944 and drafted a joint proposal for setting up a planned economy in India. It is famously **known as the Bombay Plan.**
- The government sought national strategy in order to take an active role in resource allocation and mobilisation for equitable growth and development as a result of the abject poverty.

Regional Planning:

- **1st country** : US in 1916
- It was a huge success in achieving its well-defined goals.
- Planning is implemented at the regional level and is targeted to a wide geographical area (i.e., a region consisting of rural and/or urban communities), guaranteeing optimal space utilisation and human activity distribution.

Objectives Of Economic Planning In India

In India, the primary goals of planning are not only broad, but also open-ended. However, the following are some of the broad objectives of planning in India.

- **Economic Growth:** It aims for a **sustainable growth** in the economy's output levels. Sustained growth in economic output, is one of the primary goals of planning in India.
- **Poverty Alleviation:** One of the goals of Indian planning is to alleviate poverty. Several programmes aimed at alleviating poverty have been introduced in India, by all governments, till date.
- **Employment Generation:** Fundamental goals of planning has been to reduce unemployment. Employment generation in India has therefore been an integral aspect of poverty alleviation programmed in India.
- **Social justice and reducing the inequalities**: Economic disparities have far-reaching negative consequences in any society, and there were visible economic inequalities in India at both the interpersonal and intra-personal levels. By the time India started planning, economic planning was widely acknowledged, as a technique for addressing all types of economic inequities and injustices.
- **Self-reliant economy:** Self-reliance was characterised as an endeavor, to combat a subservient position in the global economy, not as autarchy.

- **Modernisation of the economy:** India's plans prioritised the industrialisation . Began with agriculture, a traditional sector that necessitated the quick integration of modern farming, dairying, and other practices**.**

Note: Modernisation also refers to changes in social outlook such as the recognition that women should have the same rights as men.

History Of Economic Planning In India

- **By the 1930s,** there was political agreement that independent India would be a planned economy
- **By early 1950s,** India had begun economic planning.
- **Directed by five-year plans, with a mid-term review.**
- In unusual years of wars and other such crises, India has opted for yearly plans, commonly denoted as 'plan holidays', as a departure from five-year plans.
- **In 2015, - established the NITI (National Institution for Transforming India) Aayog, [**nature of the economy had shifted to a market-dominated system and that state rights required to be prioritised, necessitating the establishment of a new structure with dynamic purposes.
- **Centralised Planning Procedure**: Offers a broad framework for the economy's developmental and investment requirements.
- Also aims for equal resource mobilisation to accomplish targeted socioeconomic progress.

Planning Commission

- **In charge of planning in India since 1950.**
- **Chairman :** Prime Minister and headed by a Deputy Chairman [Not a statutory entity]
- Plans are approved for implementation by **the National Development Council (NDC), which is chaired by the Prime Minister.**
- Meanwhile, the central government sought to redefine the parameters of decentralised planning throughout the **country.**
- GoI established the NITI Aayog, to replace the Planning Commission.
- This was done to better serve the needs and ambitions of the people of India
- **NITI Aayog, serves as the Government of India's primary platform for bringing States together in national interest, fostering Cooperative Federalism.**
- Established as a Think Tank, to provide relevant strategic and technical assistance to governments at the federal and state levels, on a wide range of policy issues.

Five Year Plan	Highlights
First Five-Year Plan (1951-56)	▪ The First Five Year Plan laid the thrust of economic development in India. ▪ It was presented by the first Indian Prime Minister, Jawaharlal Nehru to the Parliament of India. ▪ **K.N Raj,** a young economist, argued that India should "hasten slowly" for the first two decades. ▪ It mainly addressed the **agrarian sector, including investment in dams and irrigation.** Ex- Huge allocations were made for Bhakhra Nangal Dam. ▪ It was **based on the Harrod Domar Model** and emphasised increasing savings. ▪ By the end of 1956, **five Indian Institutes of Technology** were established. ▪ The target growth rate was 2.1% and the achieved growth rate was 3.6%.
Second Five Year Plan (1956-61)	▪ The Second Five year Plan stressed **rapid industrialisation and the public sector.** ▪ It was drafted and planned under the leadership of P.C Mahalanobis. ▪ It emphasised quick structural transformation. ▪ The government imposed tariffs on imports to protect domestic industries under this plan. ▪ The target growth rate was 4.5% and the actual growth rate was slightly less than expected, 4.27%.
Third Five Year Plan (1961-66)	▪ The focus was on agriculture and improvement in the production of wheat. ▪ States were entrusted with additional development responsibilities. Ex- States were made responsible for secondary and higher education. ▪ **Panchayat elections** were introduced to bring democracy to the grassroots level.

	▪ The target growth rate was 5.6% and the actual growth rate only achieved 2.4% ▪ This indicated a miserable failure of the Third Plan, and the government had to declare **"Plan Holidays"** (1966-67, 1967-68, and 1968-69). The Sino-Indian War and the Indo-Pak War, which caused the Third Five Year Plan to fail, were the primary causes of the plan holidays.
Fourth Five-Year Plan: (1969-74)	▪ It was introduced under the Prime Ministership of **Indira Gandhi** and attempted to correct the previous failures. ▪ Based on Gadgil Formula, a great deal of emphasis was laid on growth with stability and progress towards self-reliance. ▪ The government **nationalised 14 major Indian Banks and the Green Revolution** boosted agriculture. ▪ The Drought Prone Area Programme was also launched. ▪ The target growth rate was 5.6%, but the actual growth rate was 3.3%.
Fifth Five-Year Plan (1974-78)	▪ It laid stress on increasing employment and poverty alleviation (garibi hatao). ▪ In 1975, the Electricity Supply Act was amended, enabling the central government to enter into power generation and transmission. ▪ The **Indian National Highway System** was introduced. ▪ The **Minimum Needs Programme** introduced in the first year of this plan, aimed to provide basic minimum needs. MNP was prepared by D.P. Dhar. ▪ The target growth rate was 4.4% and the actual growth rate turned out to be 4.8% ▪ In 1978, the newly elected Morarji Desai government rejected this plan.

Rolling Plan (1978-80)

This was a period of instability. The Janata Party government rejected the fifth five-year Plan and introduced a new Sixth Five-Year Plan. This, in turn, was rejected by the Indian National Congress in 1980 upon Indira Gandhi's re-election.

A rolling plan is one in which the effectiveness of the plan is evaluated annually and a new plan is created the following year based on this evaluation. As a result, throughout this plan, both the allocation and the targets are updated.	
Sixth Five Year Plan (1980-85)	▪ It underlined the beginning of economic liberation by eliminating price controls. ▪ It was seen as the end of Nehruvian Socialism. ▪ To prevent overpopulation, **family planning** was introduced. ▪ On the recommendation of the **Shivaraman Committee, the National Bank for Agriculture and Rural Development** was established. ▪ The target growth rate was 5.2% and the actual growth rate was 5.7%, implying that it was a success.
Seventh Five Year Plan (1985-90)	▪ This plan was led by the Prime Ministership of Rajiv Gandhi. ▪ It laid stress on improving Industrial **productivity levels through the use of technology.** ▪ Other objectives included increasing economic productivity, increasing the production of food grains and generating employment by providing Social Justice. ▪ The outcome of the Sixth Five-Year Plan provided a robust base for the success of the seventh five-year plan. ▪ It emphasised anti-poverty programmes, the use of modern technology, and the need to make India an independent economy. ▪ It focused on attaining prerequisites for self-sustained growth by 2000. ▪ The target growth rate was 5.0%. However, the actual growth rate grew to reach 6.01%
Annual Plans (1990-92) The Eight Five Year Plan was not introduced in 1990 and the following years 1990-91 and 1991-92 were treated as Annual Plans. This was largely because of the economic instability. India faced a crisis of foreign exchange reserves during this time. Liberalisation, Privatisation, Globalisation (LPG) was introduced in India to grapple with the problem of the economy under prime minister P.V Narasimha Rao.	

Eighth Five Year Plan (1992-97)	▪ The Eighth Plan promoted the **modernisation of Industries.** ▪ India became a member of the World Trade Organisation on 1 January 1995. ▪ The goals were to control population growth, reduce poverty, generate employment, strengthen the development of infrastructure, manage tourism, focus on human resource development etc. ▪ It also laid emphasis on involving the Panchayats and Nagar Palikas through decentralisation. ▪ The target growth rate was 5.6% but the actual growth rate was an incredible 6.8%.
Ninth Five Year Plan (1997-2002)	▪ It marked India's fifty years since Independence and Atal Bihari Vajpayee led the prime ministership. ▪ It offered support for social spheres to achieve complete elimination of poverty and witnessed the joint efforts of public and private sectors in guaranteeing economic development. ▪ The focus was also to balance the relationship between rapid growth and the quality of life for the people. ▪ The objectives, further included, empowering socially disadvantaged classes, developing self-reliance and primary education for all children in the country. ▪ Strategies included enhancing the high rate of export to gain self-reliance, efficient use of scarce resources for rapid growth etc. ▪ The target growth rate was estimated at 7.1% but its actual growth rate fell shorter to 6.8%
Tenth Five Year Plan (2002-07)	▪ The features of this plan were to promote inclusive growth and equitable development. ▪ It intended for an 8% GDP growth per year. ▪ It aimed at reducing the poverty by half and creating employment for 80million people. Further, it aimed to reduce regional inequalities. ▪ It also emphasised reducing the gender gaps in the field of education and wage rates by 2007.

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	▪ The target growth rate was 8.1% while the actual growth was 7.6%.
Eleventh Five Year Plan (2007-2012)	▪ The Eleventh Plan was significant in its aim to increase enrolment in higher education and focused on distant education as well as IT institutes. Ex: The Right to Education Act was introduced in 2009, and came into effect in 2010, making education free and compulsory for children aged between 6-14 years. ▪ Its main theme was **rapid and more inclusive growth.** ▪ It is aimed at environmental sustainability and reduction in gender inequality. ▪ C.Rangarajan prepared the Eleventh Five Year Plan. ▪ The focus was also laid on providing clean drinking water for all by 2009. ▪ The target rate was 9% and the actual growth rate was 8%.
Twelfth Five Year Plan (2012-17)	▪ The last Five Year Plan had **"Faster, More Inclusive and Sustainable Growth"** as its theme. ▪ The plan aimed at strengthening infrastructure projects, and providing electricity supply in all villages. ▪ It also aimed at removing the gender and social gap in admissions at school and improved access to higher education. ▪ Further, it aspired to enhance the green cover by 1 million hectares each year and to create new opportunities in the non-farming sector. ▪ The target growth rate was 9% but in 2012, National Development Council approved a growth rate of 8% for this twelfth plan.

Assessment Of Five-Year Plan Performance

- **Fundamental goal :** To raise national income as well as per capita income**.**
- However, both national and per capita income growth were quite modest during the planning era.
- 7 of the 12 five-year plans experienced lower growth rates than expected.

- Growth rates were modest during the first three decades of planning, but then picked up.
- Massive fluctuations were another aspect of growth story.
- **Negative per capita** income growth has recorded in times such as **1971–72 and 1991–92.**
- Agriculture growth has indeed been highly volatile, due to the change in environmental factors. The green revolution of the 1960s and the government's efforts to promote agriculture via different programmes have worked splendidly for the country.
- Today, India, has not only attained self-sufficiency in food grains production, but also a leading exporter of many agricultural products.
- With the expansion of the iron and steel, machine tool, and heavy engineering industries, India has made major strides toward capital equipment self-sufficiency.
- Engineering items account up a significant portion of India's exports, contributing for around 86 per cent of overall merchandise exports.

National Institution For Transforming India (Niti Aayog)

- **Established**: January 1, 2015, by a resolution of the Union Cabinet.
- Government of India's top policy "**Think Tank**," offering both directional and policy suggestions.
- Gives relevant technical assistance to the Centre and States in designing strategic and long-term policies and programmes for the Government of India
- NITI Aayog serves as the Government of India's central platform for bringing states together to work in the national interest, fostering Cooperative Federalism.
- **The creation of NITI Aayog is focused on two hubs:**

  i)Team India
  ii)Knowledge and Innovation Hub.

- **Team India Hub :** coordinates state involvement with the central government, while the Knowledge and Innovation Hub : strengthens NITI's think-tank capabilities.
- These hubs reflect the NITI Aayog's two primary responsibilities.
- NITI Aayog is also transforming itself into a cutting-edge resource centre, with the requisite resources, expertise, and abilities to move quickly, promote research and innovation, provide strategic policy vision for the government, and cope with unforeseen situations.

- **Chairman : Prime Minister.**

Govering Council

- **Chairperson : PM**
- **Ex-officio member of NITI Aayog**
- **Vice Chairperson**
- **Full- time members**
- **CM of States**
- **LG of the Andaman & Nicobar Islands**
- **Special Invitees**

Functions of NITI Aayog

NITI Aayog has following important functions to perform:

- To develop a shared vision of national development priority sectors and strategies, with active state participation, in the light of national objectives.
- To promote cooperative federalism on a constant basis through organised support programmes and process with the states, understanding the strong states make a strong nation.
- To create procedures for developing viable plans at the village level and gradually aggregating these at higher levels of government.
- To ensure that national security considerations are included into economic strategy and policy in areas explicitly referenced to it.
- To give special attention to those segments of our society, who may be at danger of not benefiting adequately from economic advancement.
- Create strategic and long-term policy and programme frameworks and initiatives, as well as track their development and efficacy. Lessons learned through monitoring and feedback will be utilised to make novel changes, including midcourse adjustments.
- To give guidance and foster collaboration between important stakeholders and like-minded think tanks on a national and worldwide level, as well as educational and policy research organisations.

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- To establish a collaborative network of national and international specialists, practitioners, and other partners to encourage knowledge, innovation, and entrepreneurship.
- To provide a forum for the resolution of cross-sectoral and cross-departmental issues in order to expedite the execution of the development plan.
- Maintaining a cutting-edge Resource Centre, serving as a repository for research on good governance and best practices, in sustainable and equitable development, and assisting in their dissemination to stakeholders
- Actively monitor and assess programme and initiative execution, including the identification of required resources, in order to increase the likelihood of success and scope of delivery.
- To concentrate on technological advancement and capacity building for programme and initiative execution.
- To carry out any additional actions that may be required to enhance the implementation of the national development strategy and the previously indicated goals.

The case for NITI Aayog

Planning Commission-not in tune with new development strategy

- The Planning Commission is out of sync with the current development strategy:
- Over the years, there were two inconsistencies between the Indian development strategy and the five-year planning model that hampered the economic climate.
    - **1st : Between the planning framework and the market's role**.
    - In the early years after independence, a planning framework was necessary to distribute the low levels of savings to invest **in badly needed infrastructure and priority sectors i**n order to overcome serious infrastructure deficiencies and the economy's lack of competitiveness.
    - However, the framework did not adjust to the transition phase, following the 1991 economic reform era.
    - With budgetary restrictions tightening and political economic concerns crowding out infrastructure expenditure with subsidies and transfers, the planning process has lost much of its importance.
    - **2nd: between centralised authority over resource** allocation and the states' developmental role, in a federal system of government.
    - The loss of single-party dominance, as well as the rise of coalition governments and regional parties as members of the central coalition,

highlighted the conflict between **centralised planning in a federal structure.**

- As a result of the above, the two major sources of economic dynamism, the private sector and the states, were forced to operate in a limited environment.

Paper IE and IFS Module A Unit 4: Role of Priority Sector and MSME in the Indian Economy

Role of Priority Sector and MSME in the Indian Economy

- Development of Priority sectors are much needed, for balanced and inclusive growth.
- The RBI's Priority Sector Lending classifications and standards are meant to match with emerging national priorities and bring a deeper focus on inclusive development, thereby building consensus among all stakeholders.
- Banks are entrusted with encouraging the growth of such sectors, by providing appropriate and timely financing
- **Micro, Small, and Medium Enterprises (MSMEs**) : country's strongest drivers of economic growth, innovation, and employment.
    - vast network of over 64 million enterprises, the MSME sector contributes significantly to the growth of the Indian **economy.**

The sector contributes

- manufacturing output = roughly 45 %
- Exports= >40%
- GDP = >28%

Employing = approximately 120 million people

- **Ranking 2nd only to agriculture, in terms of size of employment.**

Diverse: In terms of enterprise size, product and service diversity, and level of technology deployed.

Driver of economic growth : Potential to grow faster and viewed as a driver of economic growth and a means of promoting equitable development.

The MSME sector's primary benefit is its employment potential, at a low capital cost.

The importance of the MSME sector in

- **employment creation,**

- **innovation,**
- **entrepreneurship, and**
- **supply chains is critical.**

Definition & Role Of Priority Sector

- **Social Control over banks :** Banking Laws (Amendment) Bill 1967, tabled in the Lok Sabha on December 23, 1967
- Banks were directed to align their activities with national objectives through social control.

The current framework of Priority Sector Lending (PSL)

- **Dec 14, 1967:** States in Lok Sabha by Morarji Desai, then Deputy Prime Minister and Minister of Finance ,that persistent complaints that several priority sectors, such as agriculture, SSI, & exports, had not received their fair share of bank credit.
- This appears to be the first time the phrase priority sector has been used. As a result, the concept of priority sector lending was born.
- **July 1968:** At a National Credit Council meeting , it was stressed that commercial banks should boost their involvement in financing priority sectors such as agriculture and small-scale industries.
- PSL comprises those sectors that have a substantial influence on vast portion of the population, the weaker sections & sectors that are employment intensive

List Of Priority Sectors Identified In India

- **To align it with emerging national priorities and bring a sharper focus on inclusive development, the RBI revised PSL guidelines on September 4, 2020, by including**
  - Bank finance to start-ups (up to Rs. 50 crores);
  - Loans to farmers for the installation of solar power plants for solarisation of grid-connected agriculture pumps;
  - And loans for the establishment of Compressed Biogas (CBG) plants.

The following are the priority sector categories:

I)Agriculture

II)MSMEs

III)Export Credit

IV) Education

V)Housing

VI)Social

VII)Renewable Energy

VIII)Others

IX)Weaker sections

Priority Sector Lending Norms

The priority sector lending targets and sub-targets are to be computed based on the Adjusted Net Bank Credit (ANBC)/ Credit Equivalent of Off-Balance-Sheet Exposures (CEOBE) as applicable on the corresponding date of the preceding year and are as follows.

Categories	Domestic commercial banks (excl. RRBs & SFBs) & foreign banks with 20 branches and above	Foreign banks with less than 20 branches	Regional Rural Banks	Small Finance Banks
Top Priority sector	40 % of ANBC as computed in para 6 below or CEOBE whichever is higher	40% of ANBC as computed in para 6 below or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector	75% of ANBC as computed in para 6 below or CEOBE whichever is higher; However, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15 per cent of ANBC	75% of ANBC or CEOBE whichever is higher;
Agriculture	18%of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18% ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs	18% ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs
Micro enterprises	7.5% of ANBC or CEOBE, whichever is higher		7.5% of ANBC or CEOBE, whichever is higher	7.5% of ANBC or CEOBE, whichever is higher
Advance to weaker sections	12% of ANBC or CEOBE, whichever is higher		15% of ANBC or CEOBE, whichever is higher	12% of ANBC or CEOBE, whichever is higher

Definition Of MSME

In terms of Government of India Gazette Notification S.O. 2119(E) dated June 26, 2020 the definition of Micro, Small and Medium Enterprises is changed as under:

OLD DEFINITION: CRITERIA: INVESSTMENT IN PLANT & MACHINERY EQUIPMENT			
Classification	**Micro**	**Small**	**Medium**
Manufacturing enterprises	Investment <25 l	Investment <5 cr	Investment <10 cr
Service enterprise	Investment <10 l	Investment <2 cr	Investment <5 cr

NEW DEFINITION: CRITERIA: INVESTMENT & ANNUAL TURNOVER			
Classification	**Micro**	**Small**	**Medium**
Manufacturing & Service enterprises	Investment <1 cr Turover < 5 cr	Investment <10 cr Turnover < 50 cr	Investment <50 cr Turnover <250 cr

- All enterprises are required to register online on Udyam Registration Portal and obtain '**Udyam Registration Certificate'.**
- The new definition of MSMEs will make it easier for small businesses to expand and flourish.
- The resulting economies of scale can boost productivity without depriving MSMEs of government benefits such as **market support, export promotion, preferential procurement in the public sector, and incentives through the Micro Small Enterprises-Cluster Development Programme (MSE-CDP**), Prime Minister Employment Generation Programme (PMEGP), and Scheme of Fund for Regeneration of Traditional Industries (SFURTI), as well as the enabling of IT ecosystems. This favourable atmosphere will encourage competitiveness and **help MSMEs avoid growth retardation.**
- The launch of the new Udyam Registration Portal in July 2020 is one of the recent efforts made by the government to boost the ease of doing business for MSMEs.
- The registration procedure is entirely online, digital, and paperless, and it is based on self-declaration. There are no documents or proof necessary to be supplied while registering.

Role & Significance Of Msme In Economic Development

- **Feature** : Employment potential at a low capital cost.
- Small and Medium Enterprises (SMEs) account for around **90% of businesses and more than 50% of employment globally.**
- The significance of the MSME sector is critical.
- Hence, it is important to foster, nurture, and assist new business ideas, as they develop into enterprises.
- The sector has benefited the economy, by encouraging the development of industries in all parts of the country. Factors such as SME finance from both domestic and foreign investors, as well as new technologies, are supporting SMEs in bringing substantial value to their businesses

I)Job creation,

II)Innovation,

III)Entrepreneurship

IV)Supply chains

MSME – Present Status In India

- Contributing significantly to the expansion of entrepreneurial endeavours through business innovations. The MSMEs are widening their domain across sectors of the economy, producing diverse range of products and services to meet the demands of domestic as well as global markets.

Contribution to GDP

- As per the data available with Central Statistics Office (CSO), M/o Statistics & Programme Implementation, the contribution of MSME sector in Country's Gross Value Added (GVA) and Gross Domestic Product (GDP) at current prices from 2014-15 to 2018-19 is as below:

Share of Gross Value Added (GVA) of MSME in all India GDP

Figures in Rs. Crores adjusted for FISIM at current prices						
Year	Total MSME GVA	Growth (%)	Total GVA	Share of MSME in GVA (%)	All India GDP	Share of MSME in All India GDP (in%)
2014-15	3658196	–	11504279	31.8	12467959	29.34
2015-16	4059660	10.97	12574499	32.28	13771874	29.48
2016-17	4502129	10.9	13965200	32.24	15391669	29.25
2017-18	5086493	12.98	15513122	32.79	17098304	29.75
2018-19	5741765	12.88	17139962	33.5	18971237	30.27

Bank Credit to MSME Sector

- The banking sector lending to industry has picked up, led by disbursals to the micro, small and medium enterprises (MSME) sector**.**
- Bank credit to industry improved **12.6% year-on-year in September 2022, compared to a muted 1.7% growth in the same month in FY 2021.**
- **Banks' lending:**
  - **Micro and small businesses**: Grew 27% YoY
  - **Medium enterprises:** Increased 36% during the month.
- The higher credit growth for the MSME sector may have come due to the extension of the Emergency Credit Line Guarantee Scheme till March 31,2022.

Employment Generation

- **MSME sector has been creating**
  - 11.10 crore jobs in the rural and the urban areas across the country.
    - 360.41 lakh in Manufacturing,
    - 0.07 lakh in non-captive Electricity Generation and Transmission,
    - 387.18 lakh in Trade
    - 362.82 lakh in Other Services
- Trade, import and export for MSMEs' share in exports assumes significance as the government has been targeting **$1 trillion in exports by FY27.**
- In accordance with the target, the government had added **'Capacity Building of First-Time MSME Exporters' (CBFTE**) scheme to enhance the quality of MSME products globally and increase exports.

MSME Sector has helped the country to achieve the following objectives:

- High contribution to domestic production
- Significant export earnings
- Low investment requirements
- Operational flexibility
- Location wise mobility
- Low intensive imports
- Capacities to develop appropriate indigenous technology
- Import substitution
- Contribution towards defence production
- Technology-oriented industries
- Competitiveness in domestic and export markets**.**

Contribution Of Msme In GDP

- MSMEs are among the most powerful engines of economic development, innovation, and employment generation.
- With a broad network of over 64 million firms, the MSME sector contributes significantly to the growth of the Indian economy.
  - **Industry generates**
    - Manufacturing output = roughly 45 %
    - Exports= >40%
    - GDP = >28%

  - **Employing = approximately 120 million people**
    - Ranking 2nd only to agriculture, in terms of size of employment.
- **As India grows to a $5 trillion economy,** the Ministry of MSME has set a goal of increasing the MSME sector's contribution **to GDP to 50 per cent, by 2025.**

RECENT INITIATIVES IN MSME SECTOR, VIZ., ATMANIRBHAR BHARAT PACKAGE, MAKE IN INDIA, START-UP INDIA, STAND-UP INDIA, ETC.

- The government revised the definition of the MSME in 2020, and the new MSME definition includes **around 99% of all enterprises.**
- **AIMS:** to assist MSMEs in expanding and creating more jobs.
- Abolish the difference between manufacturing and service MSMEs
- The Government of India has taken deliberate measures to guarantee that the benefits of these MSME initiatives reach MSMEs on time.
- Numerous announcements under **the Atmanirbahar Bharat Package** to offer urgent help to the MSME sector.
- The **'Make in India' initiative and the 'Atmanirbhar Bharat Abhiyaan'** (Self Reliant India Campaign) have played significant role in enhancing business and local manufacturing in the country, with a special emphasis on MSMEs
- To maintain business continuity during the COVID-19 pandemic, the national government has also undertaken fast response measures in the guise of the Atmanirbhar Bharat Package. Some of the most important measures are listed below.

➢ **Make in India**

- **Introduced: by** The Prime Minister in September 2014
- As part of a larger set of nation-building initiatives.
- **Objective**: Turning India into a global design and manufacturing hub.
- Built on four pillars established to boost entrepreneurship in India, not just in manufacturing but also in other sectors.
- **Aims:** to increase the manufacturing sector's contribution to GDP to 25%, by 2020–2022.

Four Pillars:

1.New Processes,

2.New Infrastructure,

3.New Sectors,

4.New Mind-set

Emergency Credit Line Guarantee Scheme (ECLGS)

- During COVID, the government introduced **a Rs. 3 lakh crore collateral-free credit scheme that is intended to benefit 45 lakh MSMEs.**
- Aims to provide much-needed relief to the MSME sector by incentivizing Member Lending Institutes (MLIs), to provide extra credit at reasonable interest rates, allowing MSMEs to fulfil operational liabilities and restart their businesses.

Credit Guarantee Fund Trust for Micro & Small Enterprises (CGTMSE)

- Individual Micro and Small Enterprises can apply for collateral-free loans **(up to Rs. 1 crore)** from the Ministry of MSME and the Small Industries Development Bank of India **(SIDBI).**
- To strengthen the credit delivery system and facilitate the flow of credit to the MSE sector: Acknowledging that the availability of bank credit without the hassles of collaterals or third-party guarantees would be a substantial source of support to first generation entrepreneurs, in realising their dream of having established their own Micro and Small Enterprise (MSE), the Ministry of MSME launched the Credit Guarantee Scheme (CGS)
- The CGTMSE supported the pandemic affected MSME sector in regaining its footing

➢ Interest Subsidy Eligibility Certificate (ISEC)

- The plan has been implemented as a funding mechanism for the khadi programme run by the country's khadi institutions.
- It facilitates borrowing from banks and bridges the gap between the availability of funds from budgetary sources and the real financial requirements.

➢ Start-up India

ambitious baba .com

- **Started :** In January 2016
- **Tagline :** "Start-up India and Stand-up India**."**
- The initiative intends to create a robust environment for fostering innovation, promoting longterm economic growth, and creating large-scale employment opportunities.
- Apart from the technology sector, the start-up movement will expand to agriculture, manufacturing, healthcare, and education; and from current tier 1 cities, it will spread to tier 2 and tier 3 cities, including semi-urban and rural areas.
- **Aims:** to support individuals or businesses that have recently formed their own start-ups, by offering better finance, including tax breaks, and ensuring that the process of establishing a start-up in India is smooth and quick.

- Aimed at catalysing start-up culture and creating a robust and inclusive environment for innovation and entrepreneurship
- Start-ups promote economic development and wealth creation, create jobs, and foster an innovation culture, transforming millennials from job seekers to job givers—and so, potentially emerge as a vehicle to capture the demographic dividend.

Stand-up India

- **Launched** : To provide a business opportunity to those who are either females or belong to the SC/ST category and require financial assistance to start their greenfield business ventures. These individuals are given special loans ranging from Rs. 10 lakhs to Rs. 1 crore, at a low interest rate**.**

Production Linked Incentive Scheme(PLI)

- Keeping in mind India's ambition of becoming **an 'Atmanirbhar,'** an allocation of **Rs. 1.97 lakh crore** has been earmarked in the Union Budget 2021-22 for PLI programmes, for 13 important sectors over **a 5-year period, beginning with fiscal year (FY) 2021-22.**
- The PLI is a traditional and widely employed government method, for increasing the production of products considered important **for job creation, social welfare, and taxation.**
- PLIs are simply financial incentives for enterprises to increase output.
- They might take the form of **tax breaks, reduced import and export levies**, or reduced land acquisition requirements.
- The PLI scheme is a Government of India initiative that encourages not only international enterprises to locate workers in the country and so produce employment, but also domestic and local industry to create micro jobs.

The PLI schemes provide

- Qualifying manufacturers, incentives ranging from **4%-6% on additional sales**, above the base year of **2019-20, for a 4 to 6 year period.**
- It is comparable to a subsidy provided through direct payments as budgeted for locally made items by the selected beneficiaries.

No.	Sector Specific PLI Allocation	Rs. Crore
1	Mobile Manufacturing and Specified Electronic Components	40,951
2	Critical Key Starting materials/Drug Intermediaries & Active Pharmaceutical Ingredients,	6,940
3	Manufacturing of Medical Devices and 10 new key sectors, which have been approved by the Union Cabinet recently in November 2020.	3,420
4	Automobiles and Auto Components	57,042
5	Pharmaceuticals Drugs	15,000
6	Specialty Steel	6,322
7	Telecom & Networking Products	12,195
8	Electronic/Technology Products	5,000
9	White Goods (ACs and LEDs)	6,238
10	Food Products	10,900
11	Textile Products: MMF segment and technical textiles	10,683
12	High efficiency solar PV modules, and	4,500
13	Advanced Chemistry Cell (ACC) Battery	18,100

- These specialised sectors would make Indian firms globally competitive, encourage investment in core competencies and cutting-edge technologtechnology, assure efficiencies, produce economies of scale, boost exports, and integrate India into the global supply chain. Furthermore, it would promote the digital economy, boost exports, safeguard communications infrastructure, and double farmers' income.

Some of the other schemes to promote MSME are,

- **Udyami Mitra Portal**: Launched by SIDBI to improve accessibility of credit and handholding services to MSMEs.
- **MSME Sambandh:** To monitor the implementation of the public procurement from MSMEs by Central Public Sector Enterprises.
- **MSME Delayed Payment Portal:** This will empower Micro and Small entrepreneurs across the country to directly register their cases relating to delayed payments by Central Ministries/Departments/CPSEs/ State Governments.
- **Digital MSME Scheme**: It involves usage of Cloud Computing, where MSMEs use the internet to access common as well as tailor-made IT infrastructure.
- **Prime Minister Employment Generation Programme**: A credit linked subsidy programme under Ministry of MSME.
- **Scheme of Fund for Regeneration of Traditional Industries (SFURTI):** Organises traditional industries and artisans into clusters and make them competitive by enhancing their marketability & equipping them with improved skills.

- **A Scheme for Promotion of Innovation, Rural Industries & Entrepreneurship (ASPIRE):** It creates new jobs & reduce unemployment, promotes entrepreneurship culture, facilitates innovative business solution, etc.
- **National Manufacturing Competitiveness Programme (NMCP):** To develop global competitiveness among Indian MSMEs, by improving their processes, designs, technology, and market access.
- **Micro & Small Enterprises Cluster Development Programme (MSE-CDP):** Adopts cluster development approach, for enhancing the productivity and competitiveness as well as capacity building of MSEs.
- **Credit Linked Capital Subsidy Scheme (CLCSS):** It is operational for upgradation of technology for MSMEs.

Paper IE and IFS Module A Unit 5: Infrastructure Including Social Infrastructure

Infrastructure Including Social Infrastructure

- Infrastructure investment increases the **capital stock required for economic development.**
- Historically, infrastructure in India has always been funded by the government.
- However, considering the paucity of public resources and the necessity to redirect precious public resources to health and education, attempts have been made to encourage private sector investment in the development of this infrastructure.
- Currently, the source of finance differs greatly between sectors.

Govt monopoly – Railway & Nuclear Power

Industries dominated by govt spending

Overseas Development Aids

Private sector investment

PPP

NIIF [National Investment & Infrastructure Fund

Infrastructure & Economic Development

- Infrastructure is the foundation for economic growth, and it encompasses the **physical, natural, and organisational structures** required for long-term economic development.
- Economic infrastructure facilitates labour and capital mobility, within and between economies.
- Infrastructures provide a large number of job creations and possibilities.
- The availability of high-quality infrastructure ensures a rise in output and productivity.
- Facilitates the circulation of commodities and raw materials, eliminating inefficiencies and resulting in the effective use of scarce resources.

Infrastructures include

- Roads,
- Ports,
- Airports,
- Bridges,
- Railways,
- Water supply,
- Sewerage,
- Power,
- Telecommunications
- Irrigation, and so on.

A solid infrastructure facilitates the production of high-quality goods and services, as well as the transport of finished items to marketplaces and builds essential social institutions such as schools and hospitals. Infrastructure can be either Hard or soft.

It is also segregated as physical and social infrastructure.

Hard Infrastructure : Refers to major physical networks such as roads, ports, airports, pipelines, etc., that are required for the operation of a modern industrial nation.

Soft Infrastructure : Refers to institutions that are essential to keep the economy running, such as financial, educational, healthcare, and law-enforcement organisations.

Energy, Power, Transport System, Viz., Rail, Road, Civil Aviation

Some of the major infrastructures are presented below.

Energy Infrastructure

Energy infrastructure is the organizational framework that permits large-scale energy transmission from producer to consumer, as well as energy flow direction and management. Many components make up energy infrastructure: Natural gas pipelines, storage and distribution terminals; petroleum pipelines, specialized coal handling facilities for washing, storing, and transporting coal; renewable energy infrastructure, such as wind **power, solar power, hydro power, geothermal power, and biomass or biofuel facilities, etc.**

Renewable Energy

India has achieved a cumulative installed renewable energy capacity (excluding large hydro) **of 92.54 GW out of which 5.47 GW was added in the period April 2020 till January, 2021. During the period from April 2014 to January 2021,** the installed RE capacity of India has increased by two-and-half times, and in the same period, the installed solar energy capacity has increased 15 times.

Water Management Infrastructure

- This comprises drinking water supply, wastewater collection and disposal, drainage systems, major irrigation systems (reservoirs, irrigation canals), major flood control systems, and other infrastructure.
- Untreated sewage waste is one of the major causes of surface water and groundwater pollution in India**. The Water (Prevention and Control of Pollution) Act, 1974** was the first legislative measure taken to directly address the issue of water pollution and conservation in the country. This Act provides for establishing Central and State Pollution Control Boards responsible for the prevention and control of water pollution.

Communications Infrastructure

- Communication infrastructure includes **postal services, telephone networks, including mobile phone networks, television** and radio broadcast stations, the internet, communication satellites, and so on.

Few of the initiatives taken by Government to boost Communication Infrastructure in India are:

- FDI cap in the telecom sector has **been increased to 100% from 74%.**
- In 2020, the government approved the Production Incentive Scheme (PLI) for Large-scale Electronics Manufacturing.
- Department of Telecommunication launched '**Tarang Sanchar'** – a web portal sharing information on mobile towers and EMF Emission Compliances
- The government has approved a project at a cost of **20,000 crores for creating a National Optical Fiber Network (NOFN)** which will provide broadband connectivity to 2.5 lakh gram panchayats for various applications like eHealth, e-education, and e-governance.

Critical Infrastructure

- The assets on which the broader economy is dependent are referred to as critical infrastructure.
- Electricity generation, transmission, and distribution; **gas production, transport, and distribution; oil and oil product production, transport, and distribution; telecommunication; water supply, agriculture, food production and distribution, public health (hospitals, ambulances), transportation systems (fuel supply, railway network, airports, harbours, inland shipping), financial services (banking, clearing), and security services including police, military**, etc., are included in the critical infrastructure category.

Transport Infrastructure

Road Transport

- National Highways Network to be expanded by 25000 Km in 2022-23.
- Rs 20000 Crore to be mobilized for National Highways Network expansion.

Multimodal Logistics Parks

- Contracts to be awarded through PPP mode in 2022-23 for implementation of Multimodal Logistics Parks at four locations.

Railways

- One Station One Product concept to help local businesses & supply chains.
- 2000 Km of railway network to be brought under Kavach, the indigenous world class technology and capacity augmentation in 2022-23.
- 400 new generation Vande Bharat Trains to be manufactured during the next three years.
- 100 PM GatiShakti Cargo terminals for multimodal logistics to be developed during the next three years.

Parvatmala

- National Ropeways Development Program, **Parvatmala to be taken up on PPP mode.**
- Contracts to be awarded in 2022-23 for 8 ropeway projects of 60 Km length.

Urban Infrastructure

- Urbanization is an integral part of the process of economic growth. As in most countries, India's towns and cities make a major contribution to the country's economy. **With less than 1/3 of India's people, its urban areas generate over 2/3 of the country's GDP and account for 90% of government revenues**.
- Hard infrastructure systems owned and operated by municipalities, such as roadways, water distribution, and sewage, are referred to as urban or municipal infrastructure. It may also contain certain soft infrastructure assets, such as parks, public pools, and libraries.

Green Infrastructure

- Green infrastructure is a concept that highlights the **value of natural environment**.
- The life support service provided by a network of natural ecosystems are emphasized. **Examples include** green belts, wildlife sanctuaries, environmentally sensitive areas, tiger, lion, and elephant reserves, bird sanctuaries, and the conservation of the Western Ghats.

. Concept Of Social Sector & Social Infrastructure

- The Indian social sector is very important to the **country's growth and development.**
- It comprises multiple key components, all of which contribute to general human development.
- The expenditure on these elements is a critical indicator of the government's commitment to India's social sector.
- Positive externalities are associated with social infrastructure.
- Plays an important role in a country's economic development and wellbeing.

Social Sector:

- Health,
- Education,
- Water supply,
- Transportation,
- Agriculture and allied activities,

- Infrastructure,
- Irrigation,
- Management of natural resources such as water, forest, land, energy,
- Welfare programmes and services, and so on
- Investing in human capital including education, skill development, training, and the provision of healthcare facilities increases labour productivity and societal welfare.
- For inclusive development: Public investments in social infrastructure such as education, health, housing, and connectivity are critical.

At the time of independence:

- Literacy level: barely 17%
- Life expectancy: 32.5 years at birth.

Present time:

- Literacy rate = 74.04%
- Average life expectancy =70 years.

ESG

- **ESG has gained a foothold among the stakeholders** and is considered a modern dimension of corporate social responsibility.
- ESG (**Environmental, Social, and Governance**) refers to the three most essential factors which determine the long-term and ethical impact of a business or company investment. The majority of socially responsible investors use ESG criteria to screen investments.

Health, Education, Family Welfare

Health

H**ealth is the most crucial component of social infrastructure**. Healthcare has evolved to be one of India's most important industries, both in terms of income and employment. **Hospitals, medical devices, clinical trials, outsourcing, telemedicine, medical tourism, health insurance, and medical** equipment are all part of the industry.

- The necessity for a strong and resilient health infrastructure was emphasised during the recent COVID-19 pandemic, which exposed the weaknesses in social infrastructure across geographies

According to the Economic Survey 2021-22,

- **2021-22**: the healthcare sector's budgeted spending = **Rs. 4.7 lakh crore (roughly 2.1% of GDP and 6.6%of total Expenditure)**

- Over time, both the government and private entities have increased their investments in the healthcare industry.
- **The 2017 National Health Policy** aimed to boost government ***health spending to 2.5% of GDP by 2025.***

National Health Mission

The Union Budget 2021-22 announced the Ayushman Bharat Health Infrastructure Mission, a new Centrally Sponsored Scheme.

- Outlay of approximately Rs. 64,180 crores,
- Implemented over the next 5 years

Purpose:

- To develop capacities of primary, secondary, and tertiary care Health Systems,
- Strengthen existing national institutions,
- Establish new institutions to cater to the detection and cure of new and emerging diseases.

Family Walfare

The primary goal of the Family Welfare programme is to stabilise the population and offer high-quality health services, **including immunisation of pregnant women and children. In 19**52, India became the first country in the world to implement a National Programme for Family Planning.

The following are the fundamental premises of the Family Welfare Programme

- Acceptance of Family Welfare services is voluntary;
- **Family Welfare programme will provide**: integrated Maternal and Child Health (MCH) and family planning services, effective information education & communication (IEC) to improve awareness; easy and convenient access to Family Welfare services at free of cost.

Trends in Social Service Sector Expenditure by General Government

Item	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21 (RE)	2021-22 (BE)
(in lakh crore)								
Total Budgetary Expenditure	32.85	37.61	42.66	45.16	50.41	54.11	65.24	71.61
Expenditure on Social Services:	7.68	9.16	10.41	11.40	12.78	13.65	16.34	19.06
i) Education	3.54	3.92	4.35	4.83	5.26	5.80	6.21	6.97
ii) Health	1.49	1.75	2.13	2.43	2.66	2.73	3.50	4.72
iii) Others	2.65	3.48	3.93	4.13	4.86	5.13	6.63	7.37
(As percentage to GDP)								
Expenditure on Social Services:	6.2	6.6	6.8	6.7	6.8	6.7	8.3	8.6
i) Education	2.8	2.8	2.8	2.8	2.8	2.8	3.1	3.1
ii) Health	1.2	1.3	1.4	1.4	1.4	1.3	1.8	2.1
iii) Others	2.1	2.5	2.6	2.4	2.6	2.5	3.4	3.3
(As percentage to total expenditure)								
Expenditure on Social Services:	23.4	24.3	24.4	25.2	25.4	25.2	25.0	26.6
i) Education	10.8	10.4	10.2	10.7	10.4	10.7	9.5	9.7
ii) Health	4.5	4.7	5.0	5.4	5.3	5.0	5.4	6.6
iii) Others	8.1	9.3	9.2	9.1	9.6	9.5	10.2	10.3
(As percentage to social services)								
i) Education	46.1	42.8	41.8	42.4	41.2	42.5	38.0	36.6
ii) Health	19.4	19.1	20.5	21.4	20.8	20.0	21.4	24.7
iii) Others	34.6	38.0	37.7	36.2	38.0	37.6	40.6	38.7

Note:

- **Budget Estimate (BE) & Revised Estimate (RE)**.
- Social services include, education, sports, art and culture; medical and public health, family welfare; water supply and sanitation; housing; urban development; welfare of SCs, STs and OBCs, labour and labour welfare; social security and welfare, nutrition, relief on account of natural calamities etc.
- Expenditure on '**Education' pertains to expenditure on 'Education, Sports, Arts and Culture'.**
- Expenditure on 'Health' includes expenditure on **'Medical and Public Health', 'Family Welfare' and 'Water Supply and Sanitation'.**
- The ratios to Gross Domestic Product (GDP) at current market prices are based on 2011-12 base.
- Projected GDP for **BE 2021-2022 is Rs 222,87,379 crore**.

Development Of Health Infrastructure

- Health infrastructures are the essential services or social capital of a country or region that support economic and social activity.
- **In other words, these are the structures that contribute to public health.**

- Health infrastructure is an essential metric for assessing a country's healthcare policy and welfare system.
- Health disparities exist in India as a result of the uneven distribution of health infrastructure between Indian states, **which is primarily characterised by:**

(a) Institution

(b)Knowledge, capacity,

(c)healthcare service.

- All these challenges are linked to economic growth, with a specific emphasis on India.
- India has made significant progress in terms of health infrastructure and mass population access to healthcare services.
- The infrastructure of a health system is a critical part of any economy, because, it increases efficacy, safety, timeliness, patient-centredness, access, and efficiency.
- **Inadequacies:** limit access to services and contribute to poor quality of care and results, especially among underprivileged communities.
- **Challenges:** Inadequate financial resources, poor facilities, inadequate physical infrastructures, lack of efficient personnel and materials planning, lack of good transportation facilities, and others.

5 Basic area o health infrastructure

- Skilled labour,
- Integrated electronic information systems,
- Public health agencies,
- Resources,
- Research

Important Health Scheme

- **The PM-Ayushman Bharat Health Infrastructure Mission (PM-ABHIM)** : designed to improve primary, secondary, and tertiary care health systems and to establish new institutions to address the diagnosis and treatment of new and emerging illnesses.
- It has evolved to become the largest pan-India public health infrastructure initiative since 2005.
- **2021: Ayushman Bharat Digital Mission (ABDM)**, formerly known as the National Digital Health Mission (NDHM), was launched with the purpose of establishing the backbone built to support the country's integrated digital health infrastructure.
- In addition to the National Health Mission, the Union Budget 2021-22 announced the Ayushman Bharat Health Infrastructure Mission.

Paper IE and IFS Module A Unit 6- Globalisation: Impact On India

Globalisation

- **Globalisation is defined as a rise in economic integration among nations.** The concept of globalisation is an ancient one, dating back to the 18th century.
- The World War I, Great Depression and World War II forced a retreat from globalisation and several trade obstacles were raised. However, in the mid-1980s, the Organisation for Economic Cooperation and Development (OECD) popularised the term yet again.
- Globalisation is described by the World Trade Organization as the development towards "**unrestricted cross-border flows of goods and services, capital, and labour force.**" The concept was formally introduced in India with the '**new economic policy' in 1991–92.**

Globalisation and Its Advocacy

- The term "**globalisation" refers to the increasing interconnectedness of the world's economies, cultures, and inhabitants**, as a result of cross-border trade in goods and services, technology, and flows of investment, people, and knowledge.
- There is strong evidence from nations of all sizes and locations that when countries globalise, their citizens benefit from more exposure to a broader range of goods and services, reduced costs, more and better-paying employment, improved health, and higher overall living standards.
- Investment, the proliferation of technology, robust institutions, effective macroeconomic policies, educated workforce, and the presence of a market economy are some of the reasons for globalisation's wider acceptance.
- The phrase is also used to describe the movement of people (labour) and information (technology) across international borders. **Globalisation has larger cultural, political, and environmental implications.**

Globalisation and Its Impact On India

- The advent of globalisation caused significant changes in **the Indian economy's economic policy, production, and consumer behaviour.** Globalisation has an influence on its culture as well. The entry and expansion of foreign investment in various areas propelled the Indian economy's development, even further.
- **Following the 1991 reforms**, the average growth rate of the Indian economy was much higher than in prior decades. Exports were regarded as a growth

engine, and many new technologies **were implemented, which boosted productivity, in the long term.**

- Effects of globalisation include increased per capita income, better employment opportunities, and far more options for customers. **Globalisation opened up new options for agriculture exports.**

Fair Globalisation & The Need for Policy Framework

- **The importance of mutual understanding and dialogue among governments**, organisations within and across borders to promote social cohesion is a key proposition of fair Globalisation.
- **Fair globalisation** creates opportunities for all, while also ensuring that the advantages of globalisation are shared equally.
- Government measures must safeguard the interests of all citizens, including workers. **Their rights must be effectively protected, and they must be given their entitlements.**
- At the local, **national, regional, and global levels, fair globalisation must be supported by the interdependent** and mutually reinforcing pillars of **economic development, social development, and environmental protection.**

Globalisation In Reverse Gear – The Threatened Re-Emergence Of Protectionism

- **During economic and geopolitical crises, globalisation has always taken a hit as WTO regulations** allow governments to practise trade protection measures to preserve national interests within specific limits.
- **Deglobalisation**: The process of reducing dependency and integration amongst particular units throughout the world.
- It is commonly used to characterise historical eras, in which, **economic trade and investment between countries collapse.**
- When a government enacts laws that restrict or prohibit international trade, it is participating in protectionism, and protectionist measures frequently attempt to protect home producers and workers from foreign competition.

Protectionism takes three main forms:

- Tariffs,
- Import quotas,
- Non-tariff barriers.

- The protectionism results in decline in **trade, price rise, and the necessity for provision of subsidy f**or protected industries.
- Some jobs in these industries may be saved, but jobs in other industries are likely to be lost.

- Limited role of the World Trade Organization **'Dispute Settlement Mechanism'** also plays a critical role behind this.
- There has been a rise in populism principle that, it would be better off pursuing inward rather than outward **- looking policies, in both economic and foreign policies.**
- As **Michael O'Sullivan** has rightly said in his recent book, "**The Levelling: What's Next After Globalisation**", globalisation is already behind us.
- These inward-looking sovereign policies, prioritising domestic production, offering packages to enable domestic companies to increase their scale of operations, increase investments domestically, and promoting a protectionist policy to support the countries from unfair trade competitions from cheaper suppliers clearly demonstrates the effect of a strategic retreat from globalisation.

Paper IE and IFS Module A Unit 7: Economic Reforms

Economic Reforms

- Economic reform refers to the process, whereby, a government specifies a declining role for the state and an expanding one for the private sector in the economy.
- **'Economic reform'** usually refers to deregulation, or at times shrinking the size of government, to remove distortions caused by regulations or the presence of government, rather than new or enhanced regulations or government programmes to alleviate distortions caused by market failure.
- Historically, the reform process has seen the pursuit of market-oriented policies that foster private sector development—augmenting and controlling the market.

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A Brief Overview

- Economic reforms aimed at expanding private sector participation in the Indian economy's growth process.
- Since 1980s, India has seen a number of changes that fit into 2 categories.
- The 1980s reforms, influenced by the renowned **'Washington Consensus' doctrine.**
  - While the changes of the 1980s saw very limited deregulation and partial liberalisation of just a few parts of the previous regulatory system
- The reforms that started in the early 1990s, in the domains of industry, commerce, investment, and, subsequently, agriculture, were considerably broader in scope

1991 Economic reforms: Due to a number of economic factors, including.

- An adverse balance of payments,
- Poor performance of the public sector,
- Drop in foreign exchange reserves,
- Large government debts,
- Inflationary pressure
- Stringent conditions laid down by the World Bank and IMF

Transformation

The green revolution and industrial modernisation have transformed India's economy from an economic laggard to one of the world's fastest growing economies.

The term **'new economic reforms'** refers to the neoliberal policies put in place by the Indian government in 1991.

The three main pillars of this change were known as LPG

i)Liberalisation,

ii)Globalisation, and

iii)Privatisation

- The reforms intended to accomplish high economic growth, lowering inflation, minimise the current account deficit, and address the balance of payments issue.
- Policy changes were made in the areas of technology advancement, industrial licencing, abolition of restrictions on the private sector, foreign investments, and foreign trade.
- Attracting significant foreign direct investment was one of the key goals of the 1991 economic reform process.
- India's economic transformation reduced poverty throughout all socioeconomic categories, enhanced capacity in agriculture and industrial output. It also improved the socioeconomic indices and level of living among common people.

Economic Transformation-Real Sector

The economic changes introduced in India in 1991 were the result of a severe economic crisis caused by rising external debt. This crisis occurred mostly as a consequence of poor economic management in the 1980s. The reforms were broadly known as LPG reforms.

- **Liberalisation**: Liberalisation was conceived with the idea that regulations imposed on trade agreements must be relaxed, in favour for trade to thrive. It enabled the opening of economic frontiers, for international investors and multinationals. Several economic reforms enforced by Liberalisation, include enhanced production capacity, abolition of government industrial licencing, and the liberty to import goods.

- **Privatisation**: Privatisation refers to providing the private sector more opportunities to oversee various services, while limiting the role of the public sector. Privatisation introduced in India as a part of reform, invited more and more foreign participation and FDI flow, providing healthy competition to Indian goods and services.
- **Globalisation**: Globalisation in the context of economic reforms, refers to the integration of the Indian economy with the global economy. It signifies that India's economy will now be more dependent on the global economy and vice versa. It encourages FDI and international trade with various countries. Due to various globalisation policies, India could be able to **attract foreign capital, technology, and knowledge to boost its domestic capacity.**

Economic Transformation – Financial Sector

- **The primary goal of reform**: To establish an efficient, productive, and competitive financial services industry, functioning in an environment of operational flexibility and functional autonomy.
- **Banking sector reforms have aimed** at making the Indian financial sector efficient, competitive, and stable.

Until the 1990s, the Indian financial sector was characterised by

- Controlled interest rates,
- Significant pre-emption of resources by the government, and
- Extensive micro-regulations guiding the bulk of the flow of funds to and from financial intermediaries.

Banking Sector Reforms

Important Committee:

- Chakaravarti Committee on Monetary Policy (1985)
- Narsimham Committee-I on Financial Sector Reforms (1991),
- Padmanabhan Committee to Review Bank Supervision (1996),
- Narsimham Committee-II on the Review of Banking Sector Reforms (1997),
- Verma Committee on Weak Banks (1998),
- RH Khan Committee on Harmonisation of Role of FIs and Banks (1998).

Started with the introduction and phased implementation of prudential measures, implementation of competition-enhancing measures, augmentation of the role of market forces, introduction of institutional and legal measures like the formation of

- Lok Adalats,
- Debt Recovery Tribunals,

- Asset Reconstruction Companies,

- Introduction of supervisory measures, the introduction of technological advancements, etc.
- These reforms aimed at establishing a framework of prudential regulation and supervision.
- Non-Banking Financial Companies (NBFCs) have also been subjected to competition and efficiency enhancing policies.

First Phase of Reforms – The Narasimham Committee I (February 1992)

- **"The Committee on Financial System" (CFS**) under the **Chairmanship of M. Narasimham:** Appointed by GoI
- To rebuild the financial health of commercial banks and to make their functioning efficient and profitable.
- Based on the committee's recommendation, the RBI, in February 1992, issued the new guidelines on Income Recognition, asset classification and provisioning requirements. The new standards put the banking sector's attention to credit risk and recovery management.

Few of the important reforms that took place in 1992 were:

- Capital adequacy norms
- Progressive reduction of Cash Reserve Ratio and Statutory Liquidity Ratio
- Deregulation of Lending rates
- Credit delivery
- Debt Recovery Tribunal (DRT)
- Strong Supervisory System
- Entry of New Private Banks
- Mergers and Amalgamation.

Second Phase of Reforms – Narasimham Committee-II

- In 1998, the Government set up Committee on Banking Sector Reforms in India under **the chairmanship of M. Narasimham**
- **Purpose: T**o review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive. The benefits of the

Second Phase of Banking Sector Reforms

- Deregulation of Branch Licensing
- Prudential Norms and Disclosure Requirements
- Capital Adequacy

The following points are important milestones of banking sector reforms:

Prudential reforms

- Prudential reforms include the phased implementation of international best practices and rules, in order to lower the total risk of the banking system.
- Adoption of measures under Basel II are examples of such steps.

Focus areas:

i)NPAs

ii)Capital adequacy

iii) Diversification of operations

Measures:

- Risk-weighted CAR,
- Appropriate accounting norms,
- Recognition of different components of risk,
- Assignment of risk-weights to various asset classes,
- Application of the marked-to-market principle for investment portfolio
- Limits on fund deployment in sensitive activities, and migration to advanced methods
- With a view to directing the resources of banks to the niche areas and to sustain efficiency in the banking system a graded approach of bank licensing was introduced and creation of differentiated banks in India was announced in the Union Budget 2014.

Supervisory reforms

- **Several steps were taken to strengthen supervisory reforms in the banking sector, including:**
  - Establishment of the Board for Financial Supervision, as the apex supervisory authority, for commercial banks, FIs, and non-banking financial companies
  - Implementation of the CAMELS supervisory rating system, the transition to risk-based supervision,consolidated supervision of financial conglomerates;
  - Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
  - Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

Note:

- C—Capital adequacy,
- A—Asset quality,
- M- Management,
- E—Earnings,
- L—Liquidity

Competition reforms

- Prior to reform, banks in India were uncompetitive and inefficient, due to excessive government control and limited access for private and foreign sector banks. The government extended PSBs operational autonomy and lowered public ownership in such banks, through reform measures that allowed them to obtain capital from **the stock market, up to 49% of paid-up capital.**
- Private and international banks have been permitted to operate in India, in order to foster a culture of competition and greater choice.
- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of **Foreign Direct Investment (FDI) as well as portfolio investment (FPI)** permission to banks to diversify product portfolio and business activities.

Market reforms

- **Market reforms include the removal of administered interest rate measures, the reduction of CRR and SLR** rates from previously higher levels, the discontinuation of ad hoc treasury bills and market determined pricing for government securities, the establishment of a pure inter-bank call money market, the implementation of auction-based repos-reverse repos for short-term liquidity management, and the facilitation of improved payments and settlement mechanisms.
- **Sharp reduction in pre-emption** through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline.
- **Introduction of pure inter-bank call money market**, auction-based repos-reverse repos for shortterm liquidity management, facilitation of improved payments and settlement mechanism.

Institutional and legal reforms

Institutional reforms in Indian banking includes:

- **Establishment of the Credit Information Bureau :** for the information exchange on defaulters as well as other borrowers;
- **Establishment of the Clearing Corporation of India Limited (CCIL):** to act as a central counter party in the payments and settlement system for fixed income securities and money market instruments.

- **The Banking Ombudsman Scheme**: established in 1995, provides a quick and lowcost venue for bank clients to resolve grievances.
- **The enactment of the Insolvency and Bankruptcy Code, 2016** and the announcement of the recapitalization plan for the public sector banks are likely to have far-reaching implications for the banking sector. Both will likely contribute to a stronger and more resilient banking sector in India**.**

The establishment of

- Lok Adalats
- Debt Recovery Tribunals,
- Asset Reconstruction Companies,
- Settlement Advisory Committees,
- Corporate Debt Restructuring Mechanisms and so on

To facilitate faster recovery/restructuring.

- Adoption of **the Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI**) Act and
- Subsequent amendments to protect creditors' interests.

Technology reforms

- Technology improvements include the establishment of INFINET as the financial sector's communication backbone, as well as the implementation of the **negotiated dealing system (NDS**) for screen-based trading in government securities and the **real-time gross settlement (RTGS) system.**
- **The use of ATMs,** card-based transactions, internet banking, mobile banking, national electronic fund transfer, express cheque clearing process (ECCS), and other technologies has changed the role of Indian banking.
- **A High-Level Committee (chaired by Dr. K.C. Chakrabarty**) with representatives from IIT, IIM, IDRBT, banks, and the Reserve Bank created the "IT Vision Document—2011–2017" for the Reserve Bank and banks, which provided road map for increased IT usage in the banking industry.
- New age technologies such as Artificial Intelligence (AI) and Machine Learning (ML) have radically shifted the way banking works today. Thanks to AI, it is possible to conduct real-time data analysis from a large volume of data sets and provide customized solutions to banking customers
- While the Digital India revolution catalyzed by ***PMJDY, e-KYC and UPI*** has led a paradigm shift in the way India interacts with and consumes financial services. (PMJDY, launched in 2014, has witnessed 420 million bank accounts opened till date. 'JAM' (Jan Dhan-Aadhaar-Mobile) trinity has been a game changer for India, enabling them to take forward financial financial inclusion in a futuristic format.

- **Direct Benefit Transfer or DBT** has travelled a long path since its early initiation by **Government of India on 1 January 2013 to** change the mechanism of transferring cash subsidies and benefits with the help of technology.

Debt Market Reforms

Institutional measures include

- Integration of an auction system for price discovery,
- Addition of more instruments to the Government Securities Market,
- Enabling measures such as allowing foreign institutional investors (FIIs) to invest in Government Securities,
- Introduction of automated screen-based trading in Government Securities,
- Institutionalization of trading in government securities on stock exchanges,
- Formation of Primary Dealers in the government securities market.

91-day Treasury bill was introduced for managing liquidity and benchmarking.

- Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures were introduced.
- OTC interest rate derivatives like IRS/FRAs were introduced.

- **Foreign Institutional Investors (FIIs) :** Allowed to invest in government securities subject to certain limits.

Introduction of automated screen-based trading in government securities through Negotiated Dealing System (NDS).

- Setting up of risk-free payments and settlement system in government securities through Clearing Corporation of India Limited (CCIL).
- Phased introduction of Real Time Gross Settlement System

- **Introduction of trading of government securities on stock exchanges for promoting retailing in such securities, permitting non-banks to participate in repo market.**
- **For ensuring transparency in the trading of government securities, Delivery versus Payment (DvP) settlement system was introduced.**
  - **Repurchase agreement (repo) :** tool of short-term liquidity adjustment.
  - **Liquidity Adjustment Facility (LAF) was introduced.**
- LAF operates through repo and reverse repo auctions to set up a corridor for short-term interest rate.

  - Tool for both liquidity management and also signaling device for interest rates in the overnight market.

- **Market Stabilization Scheme (MSS):** expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system**.**

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Foreign Exchange Market Reforms

The most significant reform in the currency market was the transition from a single currency fixedexchange rate system to controlling the level of the rupee against a basket of currencies, then to a market-determined floating exchange rate system.

- Adoption of rupee convertibility for current account transactions, institutional framework by replacing the earlier **Foreign Exchange Regulation Act (FERA), 1973 with the Foreign Exchange Management Act, 1999,** increase in foreign exchange market instruments, development of the rupee-foreign currency swap market, introduction of additional hedging instruments, such as foreign currency-rupee options, and permission to various participants in the foreign exchange market.
- Banks are also permitted to fix interest rates on non-resident deposits, subject to certain specifications, use derivative products for asset-liability management and fix overnight open position limits and gap limits in the foreign exchange market, **subject to ratification by RBI.**
- Permission to various participants in the foreign exchange market, including exporters, Indians investing abroad, FIIs, to avail forward cover and enter into swap transactions without any limit subject to genuine underlying exposure.
- FIIs and NRIs permitted to trade in exchange-traded derivative contracts subject to certain conditions.

Insurance Sector Reforms

- Following the passing of the **Insurance Regulation and Development Act, in 1999,** various reforms were introduced in the domestic insurance sector, including the possibility for emerging players/ joint ventures to undertake insurance business on a risk-sharing/commission basis**. The Insurance Regulatory and Development Agency (IRDA)** was created, to govern and oversee the insurance industry.
- Along with the changing product profile, there have also been salutary improvements in consumer service in recent years, driven largely by the impact of new technology usage, better technical know-how consequent upon foreign collaboration and focused product targeting, dovetailed to specific segments of the populace as well as cross-**selling of products through Bancassurance**.
- Insurance companies are also taking active steps to venture into innovative distribution channels for their products over and above creating strong agency network.

Capital Market Reforms

- A package of reforms containing measures **to liberalize, regulate, and expand the capital market** was introduced with the goal of improving market efficiency, increasing transparency, integrating national markets, and preventing unfair trade practices.

- **Regulator**: Securities and Exchange Board of India (SEBI). Since 1992, stock market reforms have primarily focused on regulatory effectiveness, enhancing competitive environments, eliminating information asymmetry, developing modern technological infrastructure, minimizing transaction costs, and limiting speculation in the securities market.

- The liberalization and consequent reform measures have drawn the attention of foreign investors leading to a rise in portfolio investment in the Indian capital market.
- In 1992, the Indian stock market was opened to **foreign institutional investors (FIIs). Through American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs),** the Indian corporate sector was granted access to international capital markets.

Establishment of Creditors Rating Agencies;

- Increasing of Merchant Banking Activities;
- Rising Electronic Transactions;
- Growing Mutual Fund Industry;

Establishment of clearing house;

- Rolling Settlement;
- Investor's Protection;
- Growth of Derivative;
- Commodity Trading;
- IPO Grading;
- Migration of Mutual Funds from commission based system to free based system;
- Margin Trading are few of the important reforms that have taken place in the Capital Markets.

Economic Transformation Integration With The Global Economy

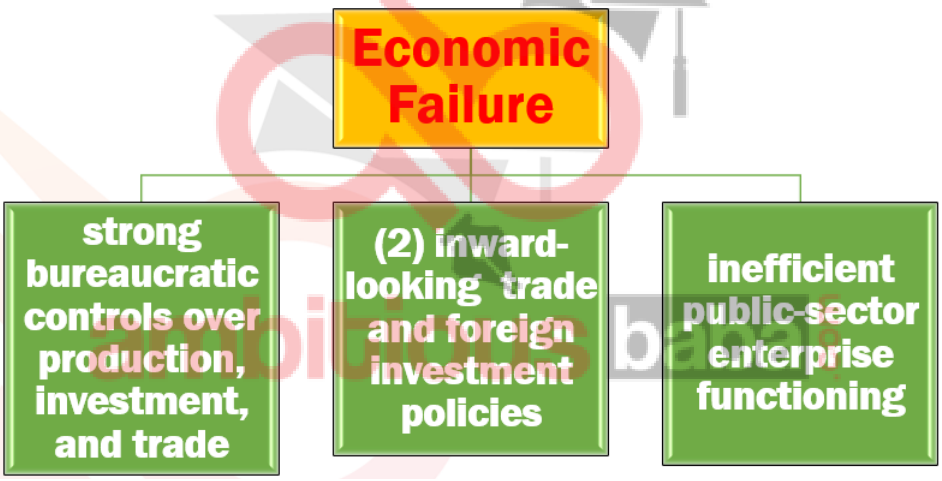
After nearly five decades of isolation from global markets, government controls, and slow growth, India started the process of economic reform and increasing integration with the **global economy in 1991**, to place its economy on a path of fast and sustainable growth. Despite major shifts in administration since then, the emphasis on reforms has persisted. Notwithstanding the perception of India as a relatively closed economy, India has made significant progress on the path of international integration in both trade and finance.

- **Since the early 1980s,** India's integration with the global economy has increased in line with the acceleration of economic growth.

- International trade (the sum of exports and imports of goods and services expressed in percentage of GDP) **has increased from 15.5 per cent of India's GDP in 1991 to 55.6 per cent in 2011.**
- As GDP growth has recently outpaced trade growth, the ratio has dropped to **37.9 per cent by 2020.**
- Meanwhile, net inflows of foreign direct investment (FDI) have risen **from 0.03 per cent of GDP in 1991 to 2.42 per cent in 2020.**
- The substantial inflow of foreign investment into India in recent years, reflects the country's strong economic potential and the execution of important policy reforms.

Economic Reforms In India

- Reforms in India have a history and reflect the Indian economy's poor upbringing over decades, which finally culminated to the 1990s economic catastrophe.
- The causes that underlie India's economic disaster have been clearly outlined by **Jagdish Bhagwati.**
- **He categorises India's economic failure into three categories:**



The following points can explain the economic crisis of 1990:

Higher fiscal deficit:

- An economy's fiscal health reflects the quantity and quality of government expenditure as well as revenues.
- **Overspending leads** to increased borrowing and interest costs. The government's ever-increasing non-developmental expenditure harmed its economic health, eventually increasing the fiscal deficit

Early 1980	**5.1% of GDP**

1990-91	**8.4% of GDP**

The government borrowed to reduce the fiscal deficit, causing the domestic debt to rise:

Early 1980	**33% of GDP**
1990-91	**Over 50% of GDP**

It increased the burden of debt payment from **2% to 3.8% of GDP**.

Adverse balance of payment situation: The current account deficit in India increased

1980-81:	**1.35% of GDP**
1990-91:	**3.69% of GDP**

Reasons:

- Poor economic policies, such as import substitution and trade restrictions.
- Drop in foreign remittances from Arabian nations as a result of the gulf crisis.
- The unstable coalition administration at the centre, as well as political instability, harmed the confidence of foreign creditors, particularly non-resident Indians (NRI), resulting in an outflow of NRI deposits.
- **To lower the foreign exchange deficit**, the government resorted to external borrowing, and as a result, India's external debt increased from

1980-81	**12% of GDP**
1990-91	**23% of GDP**

The increase in foreign borrowing increased the debt payment burden from

1980-81	**15% of Export revenue**

1990-91	**30% of Export earning**

Foreign exchange reserves fell to a low of US$1.2 billion (equivalent to two weeks' worth of imports). India faced bankruptcy, as it failed to satisfy its foreign debt obligations.

High inflation rates

- **Double-digit galloping inflation:** During 1990–1991, the Indian economy experienced

While the average annual rate of inflation

1980-89	**6.4%**
1990-91	**11.3%**

Cause: Huge increase in prices was the massive scale deficit financing (and subsequent increase in money supply) carried out throughout the 1980s**.**

Poor industrial and agricultural productivity also led to supply-side constraints and inflation.

Globalisation is genuinely helpful, but it must be properly controlled to reap the benefits. India's experience of gradual and calibrated capital account liberalisation has helped protect it against external shocks to a certain extent. International investors' growing trust in the Indian economy is a consequence of significant policy reforms, liberalisation of foreign investment laws, and improved fiscal and monetary management.

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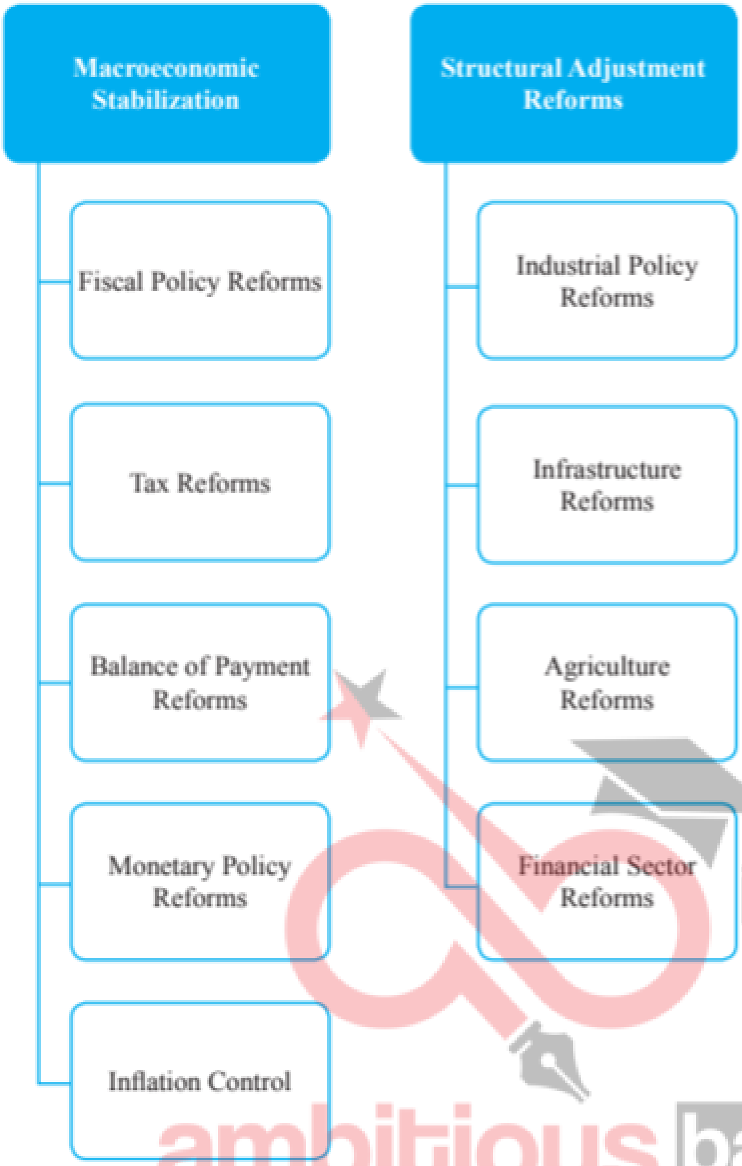


Paper IE and IFS Module A Unit 8 - Foreign Trade Policy Foreign Investments and Economic Development

Foreign Trade Policy, Foreign Investments And Economic Development

- Foreign trade policy refers to the economic policy that governs an **economy's export-import activity.**
- Economic policies, such as Foreign Trade Policy and Foreign Investment Policy, are critical components of the economic process.

- A well-planned foreign policy adds to the local economy's output and the nation's prosperity. India has had special policies promoting trade and investment from its inception.

Foreign Trade Policy: 2015-2020

On April 1, 2015, the Indian government **launched its Foreign Trade Policy 2015–20.**

In line with the '**Make in India' initiative, the FTP 2015-20** provides a framework for promoting goods and services exports, as well as employment generation and value addition in the economy.

Aims

- The new strategy aimed to help both the industrial and service sectors, with a specific emphasis on improving the ease of doing businesses. The FTP aimed to increase India's merchandise and services exports from $465 billion in 2013-14 to $900 billion by 2019-20.
- It also aimed to increase India's share of global exports from 2% to 3.5 per cent. The strategy seeks to empower India to adapt to external challenges, while keeping in step with a rapidly evolving external trade environment, and to make trade a significant contributor to the nation's economic growth and development.

The FTP 2015-20 included two new schemes:

i)The '**Merchandise Exports from India Scheme (MEIS)'** for exporting defined products to designated destinations,

ii)The **'Services Exports from India Scheme (SEIS)**' for promoting exports of designated services.

Salient features of FTP 2015–20

Simplification & Merger of Reward Schemes

Earlier there were **five different schemes** for rewarding merchandise exports, with different kinds of duty scrips with varying conditions attached to their use.

- **Focus Product Scheme,**
- **Market Linked Focus Product Scheme,**
- **Focus Market Scheme,**
- **Agricultural Infrastructure Incentive Scrip,**
- **Vishesh Krishi Gram Udyog Yojana - VKGUY**

All these schemes have been merged into a single scheme, namely **Merchandise Export from India Scheme (MEIS),** and there was no conditionality attached to the scrips issued under the scheme.

- **Served from India Scheme (SFIS)** has been replaced with Service Exports from India Scheme (SEIS).
- SEIS was applied to "**Service Providers located in India**" instead of "Indian Service Providers" regardless of the constitution or profile of the service provider.
- All scrips issued under MEIS, and SEIS and the goods imported against these scrips were fully transferable.

Scrips issued under Exports from India Schemes used for:

- Payment of customs duty for import of inputs/ goods,
- Payment of excise duty on domestic procurement of inputs or goods,
- Payment of service tax on procurement of services,
- Basic Customs Duty paid in cash or through debit under Duty Credit Scrip was allowed to be taken back as Duty Drawback, if inputs so imported are used for exports.

Privilege to Business leaders: Who have succeeded in international trade and effectively contributed **to their country's overseas trade are recommended to be recognised as status holders and given special treatment and privileges to facilitate their trade transactions, reducing transaction costs and time.**

- **Boost to "Make in India"** Special initiatives have been made to assist the indigenous capital goods manufacturing industry in order to boost the Make in India campaign.
- Under the Export Promotion Capital Goods (EPCG) plan, if capital goods were purchased from domestic producers, **the particular export obligation was decreased to 75%.**
- Export commodities with a strong domestic content and value addition had received greater levels of incentives, **under the MEIS**.
- **Less Hard Documents**: Trade Facilitation & Ease of Doing Business Hard copies of applications and specified papers, which were formerly required for incentive programmes and duty exemption schemes, were no longer required.
- **Landing paperwork for export** consignments were allowed to be submitted digitally as evidence, for designated markets.
- Once permanent records/ documents are uploaded in the exporter/importer profile, there was no need to provide copies with each application.

- Dedicated e-mail addresses were established for speedier and paperless contact with other DGFT groups, such as the **Norms Committee and the Exim Facilitation Committee.**

Highlights of the FTP 2015-2020

- FTP 2015-20 provided a **framework for increasing exports of goods and services** as well as generation of employment and increasing value addition in the country, in line with the '**Make in India'** programme.
- The **Policy aimed** to enable India to respond to the **challenges of the external environment**, keeping in step with a rapidly evolving international trading architecture and make trade a major contributor to the country's economic growth and development.

FTP 2015-20 introduced two new schemes:

I) **'Merchandise Exports from India Scheme (MEIS**)' for export of specified goods to specified markets

II) **Services Exports from India Scheme (SEIS**)' for increasing exports of notified services.

EPCG scheme

- Measures have been adopted to nudge procurement of capital goods from indigenous manufacturers under the EPCG scheme by reducing specific export obligation to **75% of the normal export obligation**.
- Measures have been taken to give a boost to exports of defense and hi-tech items.

E-Commerce

- E-Commerce exports of handloom products, books/periodicals, leather footwear, toys and customised fashion garments through courier or foreign post office would also be able to get benefit of **MEIS (for values up to INR 25,000).**

Manufacturers

- Manufacturers, who are also status holders, will now be able to self-certify their manufactured goods in phases, as originating from India with a view to qualifying for preferential treatment under various forms of bilateral and regional trade agreements. **This 'Approved Exporter System'** will help manufacturer exporters considerably in getting fast access to international markets.

EOU/EHTP/STPI/BTP Schemes

- A number of steps have been taken for encouraging manufacturing and exports under **100% EOU/EHTP/STPI/BTP Schemes**.
- The steps include a fast track clearance facility for these units, permitting them to share infrastructure facilities, permitting inter unit transfer of goods and services, permitting them to set up warehouses near the port of export and to use duty free equipment for training purposes.

Niryat Bandhu Scheme'

- 108 MSME clusters have been identified for focused interventions to boost exports. Accordingly, **Niryat Bandhu Scheme'** has been galvanised and repositioned to achieve the objectives of '**Skill India'**.

Facilitation

- Trade facilitation and enhancing the ease of doing business are the other major focus areas in this new FTP. One of the ***major objective of new FTP i***s to move towards paperless working in **24x7 environment**.

Challenges To Be Addressed In Upcoming FTP

The **Government of India extended the FTP 2015-20 for the third time, till March 2022** to provide stability to exporters during the pandemic. Recent trade protectionist incidents, as well as the disruptions induced by the pandemic, have proven that India's overdependence on a few items and fewer markets, has had a more severe negative impact on the country's international trade earnings.

Some of the issues that must be addressed in the new FTP are mentioned below.

- India's high export orientation in a few large trading partners and a few products preclude its ability to fully offset any sharp decline in exports.
- India needs to diversify its trading partners, both export markets and import sources, and find alternate high value products, due to scale, complementary economies and spreading risk. India may explore targeted geographies and product specific strategies.
- Exploring opportunities in new markets in Africa, South-East Asia and Latin America through strategic investments, where receptiveness towards non-Chinese trading partners is more is important and needs to be explored further.
- India may aim at diversifying its import suppliers. Products having high import orientation from few countries, especially China need to be diversified. The policy needs to ensure that product or market concentration of India's trade should not go beyond specific levels.
- Promoting efficacy of States in exports and exploring hitherto unexplored products are added areas to be considered for long long-term export growth.

FDIs, FIIs AND RECENT TRENDS

Foreign Direct Investment (FDI)

Foreign direct investment (FDI) is an investment made in a country, by a foreign investor, often a company, to control the ownership of an entity. FDI is a key engine of economic growth, assisting in maintaining high growth rates, enhancing productivity, and generate employment.

FDI Data

- Net FDI has increased from $3.7 billion in 2004-05 to $36.6 billion by 2021-22.
- However, in 2021-22 the Net Foreign Direct Investment in India reached $36.6 billion, 16.7 per cent lower compared to year earlier.

Note: FDI Data every year change (So Follow Ambitiousbaba.com Current affairs)

Routes of FDI in India

FDI enters the domestic economy through two channels

i) The RBI's automatic route

ii) The government route.

Automatic Route FDI

In the automatic route, the foreign entity does **not require the prior approval of the government or the RBI.**

Examples:

- Medical devices: up to 100%
- Thermal power: up to 100%

Government Route FDI

Under the government route, the foreign entity should compulsorily **take the approval of the government**. It should file an application through the Foreign Investment Facilitation Portal, which facilitates single-window clearance. This application is then forwarded to the respective ministry or department, which then approves or rejects the application after **consultation with the DPIIT.**

Examples:

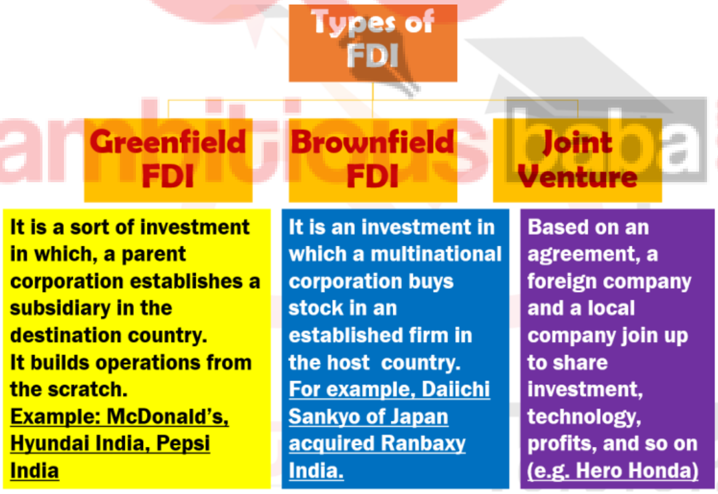
- Broadcasting Content Services: 49%
- Food Products Retail Trading: 100%

Sector wise FDI Flow routes and Limits to India

Sector wise FDI Flow routes and Limits to India			
Sl. No.	Sector	FDI Limit	Entry Route
1	Agriculture & Animal Husbandry	100%	Automatic
2	Plantation Sector	100%	Automatic
3	Mining	100%	Automatic
4	Mining (Coal & Lignite)	100%	Automatic
5	Petroleum & Natural Gas	100%	Automatic
6	Defence Manufacturing	100%	74% through the Automatic Route for new defence industrial license and up to 100% by government Route in access to modern technology
7	Broadcasting	100%	Automatic
8	Broadcasting Content Services	49%	Government
9	Up-linking of Non- 'News & Current Affairs' TV Channels/ Down-linking of TV Channels	100%	Automatic
10	Print Media	26%	Government
11	Civil Aviation – Airports	100%	Automatic
12	Civil Aviation – Air Transport Services	100%	Automatic up to 49% Above 49% under Government route 100% Automatic for NRIs
13	Civil Aviation	100%	Automatic
14	Construction Development: Townships, Housing, Built-up Infrastructure	100%	Automatic
15	Industrial Parks (new & existing)	100%	Automatic
16	Private Security Agencies	74%	Automatic up to 49% Above 49% & up to 74% under Government route
17	Satellites- establishment and operation, subject to the sectoral guidelines of Department of Space/ISRO	100%	Government
18	Telecom Services	100%	Automatic
19	Cash & Carry Wholesale Trading	100%	Automatic
20	E-commerce activities	100%	Automatic
21	Single Brand retail trading	100%	Automatic up to 49% Above 49% under Government route
22	Multi Brand Retail Trading	51%	Government

23	Duty Free Shops	100%	Automatic
24	Railway Infrastructure	100%	Automatic
25	Asset Reconstruction Companies	100%	Automatic
26	Banking – Private Sector	74%	Automatic up to 49% Above 49% & up to 74% under Government route
27	Banking- Public Sector	20%	Government
28	Credit Information Companies (CIC)	100%	Automatic
29	Infrastructure Company in the Securities Market	49%	Automatic
30	Insurance	74%	Automatic
31	Pension Sector	49%	Automatic
32	Power Exchanges	49%	Automatic
33	White Label ATM Operations	100%	Automatic
34	Financial services activities regulated by RBI, SEBI, IRDA or any other regulator	100%	Automatic
35	Pharmaceuticals (Green Field)	100%	Automatic
36	Pharmaceuticals (Brown Field)	100%	Automatic up to 74% Above 74% under Government route
37	Food products manufactured or produced in India	100%	Government

Types of FDI



FDI Prohibited Sectors

FDI in India is prohibited and not allowed to function in the following sectors:

- Lottery Business, which includes Government/private lottery, online lotteries, etc.
- Gambling, Betting as well as casinos, etc.
- Chit funds
- Nidhi company

- Trading in Transferable Development Rights (TDRs)
- Real Estate Business
- Construction of Farmhouses (Real estate business does not include development of townships, construction of residential/commercial premises, roads or bridges)
- Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
- Activities/sectors not open to private sector investment, e.g., Atomic Energy and Railway operations (other than permitted activities)

Foreign Institutional Investment (FII)

- **FII refers to short-term capital invested in stocks or hedge funds.** It is generally volatile, and the possibility of capital flight is always there in the case of an economic slump, political turmoil, or herd behaviour of short-term capital outflow**. Foreign institutional investors are companies, based outside India that offer investment proposals in India.**
- The **portfolio investment programme allows Foreign Institutional Investors**, Non-Resident Indians, and **Persons of Indian Origin to invest in India's primary and secondary capital markets.**
- **Under this arrangement**, FIIs/NRIs can acquire shares/debentures in Indian companies through Indian stock exchanges. They are registered as FIIs with SEBI and play an essential part in a country's capital market performance.

FII Recent Data

- FPIs/FIIs (Foreign Portfolio Investors/Foreign Institutional Investors) have been a major driver of India's financial markets.
- In **the financial year 2021-22**, net FPIs were negative $11.97 billion (FII outflows were $9.34 billion, and portfolio investment by India was $2.63 billion), compared to a net inflow of $ 36.14 billion in the previous year ($14.03 billion). Because of its well-developed primary and secondary markets, India has attracted FIIs/FPIs. However, geopolitical instability, the **Russia-Ukraine dispute, and COVID-related** uncertainties have resulting in a capital flight during 2021-22.

Note: FII Data every year change keep update

Difference Between FDI and FII

BASIS FOR COMPARISON	FDI	FII
Meaning	When a company situated in one country makes an investment in a company situated abroad, it is known as FDI.	FII is when foreign companies make investments in the stock market of a country.

Entry and Exit	Difficult	Easy
What it brings?	Long term capital	Long/Short term capital
Transfer of	Funds, resources, technology, strategies, know-how etc.	Funds only.
Economic Growth	Yes	No
Consequences	Increase in country's Gross Domestic Product (GDP).	Increase in capital of the country.
Target	Specific Company	No such target, investment flows into the financial market.
Control over a company	Yes	No

Economic Development vs Economic Growth

Economic Development

- **Economic development is defined** as a sustained improvement in a society's material well-being. Apart from national income growth, it encompasses social, **cultural, political, and economic developments** that contribute to material progress.
- It includes changes in available resources, capital formation rates, population size and composition**, technology, skills and efficiency, and organisational** and institutional architecture.

Economic Growth

- **Economic growth is defined** as the process by which, an economy's **actual national and per capita income grows over time.** When compared to economic development, economic growth is a restricted term.
- It entails a rise in output in quantitative terms, but it also includes qualitative changes such as social attitudes and behaviours, in comparison with the quantitative growth in output or national income.

Difference Between Economic Development and Economic Growth

Economic Growth	Economic Development
Definition	
It refers to the increase in the monetary growth of a nation in a particular period.	It refers to the overall development of the quality of life in a nation, which includes economic growth.
Span of Concept	

It is a narrower concept than that of economic development.	It is a broader concept than that of economic growth.
Scope	
It is a uni-dimensional approach that deals with the economic growth of a nation.	It is a multi-dimensional approach that looks into the income as well as the quality of life of a nation.
Term	
Short-term process	Long-term process
Measurement	
Quantitative	Both quantitative and qualitative
Applicable to	
Developed economies	Developing economies
Government Support	
It is an automatic process that may or may not require intervention from the government	It requires intervention from the government as all the developmental policies are formed by the government
Kind of changes expected	
Quantitative changes	Quantitative as well as qualitative changes
Examples	
GDP, GNP, per capita Income	• Human Development Index (HDI) • Human Poverty Index (HPI) • Gini Coefficient • Gender Development Index (GDI) • Balance of trade • Physical Quality of Life Index (PQLI)

Importance Of Economic Development As A Dimension, Etc.

Economic development

- **Economic development is defined** as a persistent increase in the material well-being of society. Economic development refers to a larger set of ideas than economic growth.
- **It comprises social, cultural, political, and economic** developments that contribute to material advancement, in addition to national income growth.
- Economic development includes the human capital growth, elimination of socioeconomic inequalities, and structural changes that improve the public's quality of life. To assess economic development, qualitative indicators such as the HDI (Human Development Index), gender-related indexes, Human Poverty Index (HPI), infant mortality, literacy rate, etc., are used.

Economic growth

- **Economic growth includes increases in income, savings, and investment**, as well as progressive changes in the country's socioeconomic structure, including both institutional and technical developments.

Paper IE and IFS Module A Unit 9: International Economic Organisations (WORLD BANK, IMF, ETC.)

International Monetary Fund (IMF)

About

- **The formation of the IMF was initiated in 1944 at the Bretton Woods Conference**.
- IMF came into operation on **27th December 1945** and is today an international organization that consists of **190 member countries**.
- **Headquartered**: Washington, D.C.,
- **IMF focuses on fostering global monetary** cooperation, securing financial stability, facilitating and promoting international trade, employment, and economic growth around the world. The IMF is a specialized agency of the United Nations.
- **The Fourteenth General Review of Quotas (2010) aimed** at realigning member country quota shares, emphasizing shifts to dynamic emerging market and developing countries (EMDCs) that were underrepresented earlier. It ensures safeguarding the voting share of the poorest members.

Formation of IMF

- The breakdown of international monetary cooperation during the Great Depression led to the development of the IMF, which aimed at improving economic growth and reducing poverty around the world. The International Monetary Fund (IMF) was initially formed at the Bretton Woods Conference in 1944. **45 government representatives** were present at the Conference to discuss a framework for postwar international economic cooperation.
- The **IMF became operational on 27th December 1945 with 29 member** countries that agreed to bound to this treaty. It began its financial operations on 1st March 1947. Currently, the IMF consists of 189 member countries.
- The IMF is regarded as a key organisation in the international economic system which focuses on rebuilding the international capital along with maximizing the national economic sovereignty and human welfare.

Organizational Structure of International Monetary Fund (IMF)

The United Nations is the parent organization that handles the proper functioning and administration of the IMF. The IMF is headed by a Managing Director who is elected by the **Executive Board for a 5-year term of office.** The International Monetary Fund (IMF) consists of the Board of Governors, Ministerial Committees, and the Executive Board.

Structure of the International Monetary Fund (IMF)	
Governing Bodies of IMF	**Roles and Responsibilities**

Board of Governors	• Each governor of the Board of Governors is appointed by his/her respective member country. • Elects or appoints executive directors to the Executive Board. • Board of Governors is advised by the International Monetary and Financial Committee (IMFC) and the Development Committee. • An annual meet up between the Board of Governors and the World Bank Group is conducted during the IMF–World Bank Annual Meetings to discuss the work of their respective institutions.
Ministerial Committees 1. International Monetary and Financial Committee (IMFC) 2. Development Committee	• It manages the international monetary and financial system. • Amendment of the Articles of Agreement. • To solve the issues in the developing countries that are related to economic development.
Executive Board	• It is a 24-member board that discusses all the aspects of the Funds. • The Board normally makes decisions based on consensus, but sometimes formal votes are taken.

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Functions of the IMF?

IMF mainly focuses on supervising the international monetary system along with providing credits to the member countries. **The functions of the International Monetary Fund can be categorized into three types:**

- **Regulatory functions**: IMF functions as a regulatory body and as per the rules of the Articles of Agreement, it also focuses on administering a code of conduct for exchange rate policies and restrictions on payments for current account transactions.
- **Financial functions**: IMF provides financial support and resources to the member countries to meet short term and medium term Balance of Payments (BOP) disequilibrium.
- **Consultative functions**: IMF is a centre for international cooperation for the member countries. It also acts as a source of counsel and technical assistance.

Objectives of the IMF

IMF was developed as an initiative to promote international monetary cooperation, enable international trade, achieve financial stability, stimulate high employment, diminish poverty in the world, and sustain economic growth. Initially, there were 29 countries with a goal of redoing the global payment system. Today, the organization has 189 members. **The main objectives of the International Monetary Fund (IMF) are mentioned below:**

- To improve and promote global monetary cooperation of the world.
- To secure financial stability by eliminating or minimizing the exchange rate stability.
- To facilitate a balanced international trade.
- To promote high employment through economic assistance and sustainable economic growth.
- To reduce poverty around the world.

India & IMF

India is a founder member of the IMF. India's Union Finance Minister is the Ex Officio Governor on the IMF's Board of Governors. Each member country also has an alternate governor. The alternate governor for India is the Governor of the RBI. There is also an Executive Director for India who represents the country at the IMF.

- India's quota in the **IMF is SDR 13,114.4 million** that gives India a shareholding of 2.76%. Read about the Special Drawing Rights **– Created in 1969 by International Monetary Fund (IMF) at the linked article**.
- This makes India the eight largest quota holding country at the organization.
- In 2000, India completed the repayment of all the loans it had taken from the IMF.
- Now, India is a contributor to the IMF.

The emerging economies have gained more influence in the governance architecture of the International Monetary Fund (IMF).

- The reforms were agreed upon by the then 188 members of the IMF in 2010, in the aftermath of the global financial meltdown.
- More than six percent of the quota shares will shift to emerging and developing countries from the U.S. and European countries.

Which countries gained?

India's voting rights increased to 2.63 percent from the current 2.3 percent, and China's to 6.08 percent from 3.8. Russia and Brazil are the other two countries that gain from the reforms.

Why delay the reforms?

- Among the reasons for the delay has been the time it took the U.S Congress to approve the changes.

- Though the country holds veto power, Republicans have been agitated over "declining U.S power."

Advantages

- For the first time, the Executive Board will consist entirely of elected executive directors, ending the category of appointed executive directors. Currently, the members with the five largest quotas appoint an executive director, a position that will cease to exist.
- The significant resource enhancement will fortify the IMF's ability to respond to crises more effectively.
- These reforms will reinforce the credibility, effectiveness, and legitimacy of the IMF.

Special Drawing Rights (SDR)

- The SDR is an international reserve asset created by the IMF to supplement the official reserves of its member countries.
- The SDR is not a currency. It is a potential claim on the freely usable currencies of IMF members. As such, SDRs can provide a country with liquidity.

Export criterion

- A currency meets the export criterion, if its issuer is an IMF member or a monetary union that includes IMF members and is also one of the top five world exporters.

Freely usable criterion

- For a currency to be determined '**freely usable' by the IMF**, it has to be widely used to make payments for international transactions and widely traded in the principal exchange markets. Freely usable currencies can be used in Fund financial transactions.

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World Bank

About

- With **189 member** countries, the World Bank Group is a unique global partnership: **five institutions** working for sustainable solutions that reduce poverty and build shared prosperity in developing countries.
- The Bank Group works with country governments, the private sector, civil society organizations, regional development banks, think tanks, and other international institutions on issues ranging **from climate change, conflict, and food security to education, agriculture, finance, and trade.**

World Bank Group consists of five development institutions.

International Bank for Reconstruction and Development (IBRD):

- Founded in 1944, the **International Bank for Reconstruction and Development (IBRD) — soon called the World Bank — has expanded to a closely associated group of five development institutions**.
- The two major accomplishments of the conference were the creation of the **International Bank for Reconstruction and Development (IBRD) and International Monetary Fund (IMF)**.
- Provides loans, credits, and grants.

International Development Association (IDA)

- Founding of the **International Development Association (IDA) in 1960** put greater emphasis on the poorest countries, part of a steady shift toward the eradication of poverty becoming the Bank Group's primary goal.
- Provides low- or no-interest loans to low-income countries.

International Finance Corporation (IFC)

- With the founding of the **International Finance Corporation (IFC) in 1956**, the institution became able to lend to private companies and financial institutions in developing countries.
- The **International Finance Corporation (IFC)** provides investment, advice, and asset management to companies and governments.

Multilateral Guarantee Agency (MIGA)

- **Multilateral Investment Guarantee Agency (MIGA)** founded in **1988** insures lenders and investors against **political risk such as war**.

- The **Multilateral Guarantee Agency (MIGA)** insures lenders and investors against political risk such as war.

International Centre for the Settlement of Investment Disputes (ICSID)

- **International Centre for Settlement of Investment Disputes (ICSID)** founded in **1966** settles **investment disputes** between investors and countries.

- The **International Centre for the Settlement of Investment Disputes (ICSID)** settles investment-disputes between investors and countries.

Note: All of these efforts support the **Bank Group's twin goals of ending extreme poverty by 2030** and boosting **shared prosperity** of the poorest 40% of the population in all countries.

What about the Coopeation between World Bank Group and India?

- **India was one of the forty-four original signatories** to the agreements reached at **Bretton Woods** that established the International Bank for Reconstruction and Development (IBRD) and the International Monetary Fund (IMF).

- It was also one of the **founding members of the IFC in 1956 and the IDA in 1960**. India later became a member of the MIGA in January 1994.

- **India is not a member of ICSID.** India claimed ICSID **Convention is not fair, convention's rules for arbitration leaned towards the developed countries**. In ICSID, the Chairman of the Centre is the Chairman of the World Bank. The Chairman appoints the arbitrators. If the arbitration award is not satisfactory, then the aggrieved party would appeal to a panel, which will also be constituted by the ICSID. There is **no scope for a review of the award by an Indian court, even if the award is against public interest**.
- IBRD lending to India commenced in 1949 with a loan to the **Indian railways,** the first investment by the IFC in India took place in 1959, and by IDA in 1961 **(a highway construction project)**.
- During the 1950s, the IBRD was India's sole source of World Bank borrowings.
- By the end of the decade, India's mounting debt problems became an important factor in the launch of the IDA, the soft loan affiliate of the World Bank (WB) group.
- By the end of the 1960s, the United States, until then India's largest source of external resources, sharply cut its bilateral aid program. Since then, the WB emerged as the most important source of official long-term finance.
- During the 1960s and 1970s, the IDA accounted for nearly three-fourths of all WB lending to India and, in turn, India was by far the largest recipient of IDA funds, accounting for more than two-fifths of all its lending.
- The subsequent decade, **with China joining the WB in 1980** and accordingly entering its own claims to limited IDA resources, the worsening economic fortunes of Africa, and India's better performance, saw a **sharp decline in India's share in IDA**.
- Instead, its share of **IBRD lending grew sharply in the 1980s,** buoyed by its improving **credit-worthiness** and the Indian government's **waning inhibitions** with regard to **non-concessional borrowing**.
- **During the 1980s,** while the WB shifted its emphasis to **stress** policy reforms and **greater economic liberalization,** it continued to **lend to poorly governed public sector institutions** in India and was muted in its criticism of India's closed economy.
- The **lending portfolio changed sharply after the 1991 macroeconomic crisis**. In the immediate aftermath, India became one of the last important WB borrowers to partake of **structural adjustment lending,** which **supported policy reforms in finance, taxation, and the investment and trade regime**.
- India is currently classified as a “blend” country — defined as one in **transition from lower middle-income to middle-income —** and is creditworthy for lending from both IDA and IBRD.
- India is the largest IBRD client of the World Bank. Between 2015 and 2018, the World Bank lent around $10.2 billion to India.

- The World Bank Group (WBG) has approved a $25-30 billion commitment plan for India for the period 2019-22.
- **MIGA Performance Standards** are environmental and social standards which help to structure and implement sustainable projects.
  For Indian market, one of the options is **a breach of contract insurance** which MIGA would offer to investors. **In case the government doesn't perform its obligation,** under the contract arrangement, **then MIGA can come and cover that risk for investment**.

Difference Between IMF and World Bank

BASIS FOR COMPARISON	IMF	WORLD BANK
Meaning	An international organization maintaining the global monetary system is the International Monetary Fund.	A global organization established to finance and advice the developing nations, in order to make them economically developed is World Bank.
Focus on	Economic Stability	Economic Growth
Organizational Structure	It is a single organization with four credit lines.	Comprises five institutions
Membership	190 countries	189 countries (IBRD) 174 countries (IDA)
Operations	Provides assistance	Facilitates lending
Objective	To deal with all the issues related to the financial sector and macroeconomics.	To lessen poverty and promote the long term development of the economy.

World Trade Organization (WTO)

- **Formation:** 1 January 1995
- **Purpose**: Reduction of tariffs and other barriers to trade
- **Headquarters:** Centre William Rappard, Geneva, Switzerland
- **Membership:** 164 members (160 UN member states, the European Union, Hong Kong, Macao, and Taiwan)

India and WTO

- India has been a member of the **WTO since January 1995** and also had been a member of the ***WTO's forerunner General Agreement on Tariffs and Trade (GATT)*** since July 1948. As a developing country, India has played a significant role in the proceedings of the WTO, especially in voicing its own concerns and also of the entire developing world.
- In the Doha WTO conference that took place in 2001, India emerged as the most outspoken of advocates for the developing bloc. The meeting was declared a success since the delegates of 142 countries agreed to a new round of trade talks, including topics such as environment, competition and investment.

Functions of WTO

The following are the six broader functions of WTO:

- Administering WTO trade agreements
- Providing forum for trade negotiations
- Handling trade disputes
- Monitoring national trade policies
- Technical assistance and training for developing countries and
- Cooperation with other international organisations.

Ministerial Conference of WTO

1	9th to 13th December 1996	Singapore
2	18th to 20th May 1998	Geneva, Switzerland
3	30th November to 3rd December 1999	Seattle, United States
4	9th 14th November 2001	Doha, Qatar
5	10th to 14th September 2003	Cancún, Mexico
6	13th 18th December 2005	Hong Kong
7	30th November to 2nd December 2009	Geneva, Switzerland
8	15th 17th December 2011	Geneva, Switzerland
9	3rd to 6th December 2013	Bali, Indonesia
10	15th to 18th December 2015	Nairobi, Kenya
11	10th to 13th December 2017	Buenos Aires, Argentina
12	12th to 16th June 2022	Geneva, Switzerland

Regional Economic Co-Operations

European Union:

- **Founded:** 1 November 1993, Maastricht, Netherlands
- **Awards:** Nobel Peace Prize (2012), Princess of Asturias Award for Concord, Bambi - Millennium Award
- **Subsidiary:** MEDIA sub-programme of Creative Europe
- **Member:** 28 (The EU countries are: Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and "**Croatia The country became the 28th EU member country on 1 July 2013"**.)

Eurozone

- **Currency:** Euro
- **Established:** 1 January 1999
- **Member:** Eurozone is an economic union comprised of 19 of the 28 EU member states

SAARC

- **SAARC Established in**: 1985 (December 8), Dhaka (Bangladesh)
- **Number of Member Countries in SAARC**: 8 Countries – India, Bangladesh, Nepal, Sri Lanka, Maldives, Bhutan, Afghanistan, Pakistan.
- **Number of Observers in SAARC**: 9 Observers – Australia, European Union (E.U), Iran, Japan, Mauritius, South Korea, United States of America (USA), China, Myanmar.
- **SAARC Headquarters**: Kathmandu, Nepal

ASEAN

- **Headquarters**: Jakarta, Indonesia
- **Founded:** 8 August 1967, Bangkok, Thailand
- **Members:** 10 (Indonesia, Philippines, Malaysia, Thailand, Singapore, Brunei, Vietnam, Laos, Cambodia, and Myanmar)

OPEC

- **Headquarters:** Vienna, Austria
- **Founded:** September 1960, Baghdad, Iraq
- **Current Members**: Algeria, Angola, UAE, Venezuela, Saudi Arabia, Republic of Congo, Libya, Nigeria, Kuwait, Iran, Iraq, Gabon, Equatorial Guinea
- The Organization of the Petroleum Exporting Countries is a cartel of 13 countries.

NAFTA (North American Free Trade Agreement)

- **Established:** 1994

- The North American Free Trade Agreement (NAFTA) trade between the **U.S., Mexico, and Canada.**
- NAFTA reduced or eliminated tariffs on imports and exports between the three participating countries, creating a huge free-trade zone.

APEC

- **Headquarters**: Jakarta, Indonesia
- **Founded:** 8 August 1967, Bangkok, Thailand
- **Members:** 10 (Indonesia, Philippines, Malaysia, Thailand, Singapore, Brunei, Vietnam, Laos, Cambodia, and Myanmar)
- APEC: The Asia-Pacific Economic Cooperation (APEC) is a regional economic forum, founded in 1989, to capitalise on the Asia-Pacific region's growing interconnectedness. The 21 members of APEC want
- to increase regional prosperity by fostering balanced, inclusive, sustainable, creative, and secure growth and by speeding regional economic integration.

G7

- **Established**: 1975
- **Members:** Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States
- **Goal:** The G-7's main goal is to debate, and occasionally act in concert to help resolve, global challenges, with a particular emphasis on economic difficulties.
- **Headquarters** No Permanent Secretariat or Office.

G-20:

- **Formed**:1999
- **Goal**: to bring governments from developed and developing countries together to address major issues concerning the global economy and financial stability.
- **Members**: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union are all members of the G20.
- The G-20 membership is made up of the world's greatest advanced and emerging nations, comprising over two-thirds of the global population, 85% of global GDP, and more than 75 per cent of global trade.

OECD:

- **Headquarters**: Paris
- **Established**: 1961
- **Members**: 36
- **Purpose**: The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organisation,to promote economic advancement and global commerce.

Mercosur:

- **About**: Mercosur is a Latin American trade bloc
- **Members**: Brazil, Argentina, Paraguay, Uruguay, and Venezuela.
- **Established**: 1995
- **Purpose**: A common space that provides business and investment possibilities via the competitive integration of national economies into the world market.

IORARC:

- **Established**: 1997
- **Members**: 22 member states and 9 conversation partners.
- **Purpose**: Vibrant inter-governmental organisation focused at fostering regional cooperation and sustainable development in the Indian Ocean area

RCEP:

- The Regional Comprehensive Economic Partnership (RCEP) is a free trade agreement (FTA) among the 10 ASEAN member countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam) and their five **FTA partners (Australia, China, Japan, New Zealand and Republic of Korea).**
- The RCEP was built upon the existing ASEAN+1 FTAs with the spirit to strengthen economic linkages and to enhance trade and investment related activities as well as to contribute to minimising development gap among the parties.

BIMSTEC:

- BIMSTEC is a multilateral regional organisation established with the **aim of accelerating shared growth and cooperation between littoral and adjacent countries in the Bay of Bengal region.** It has a total of seven member countries- five from South Asia, including Bangladesh, Bhutan, India, Nepal, and Sri Lanka, and two from Southeast Asia, including Myanmar and Thailand.
- It was founded as BISTEC, in June 1997 and with the adoption of the Bangkok Declaration, with Bangladesh, India, Sri Lanka and Thailand as members, it became BIMSTEC.

Paper IE and IFS Module A Unit 10: Climate Change, Sustainable Development Goals (SDGs)

Core Elements of Sustainable Development

In September 2015, the United Nations General Assembly announced a set of **17 Sustainable Development**. **Goals (SDGs) and 169 targets** to spur action, over the next 15 years. These goals were proposed in June 2012 at the United Nations Conference on Sustainable Development (Rio+20). These set of goals superseded the Millennium Development Goals (MDGs), which were slated to expire in 2015, and focused on areas that could not be fulfilled sooner. **The SDGs have a time frame of 2016–2030.**

The seventeen (17) Goals agreed under the SDGs are as follows:

1. No Poverty

2. Zero Hunger

3. Good Health and Well-being

4. Quality Education

5. Gender Equality

6. Clean Water and Sanitation

7. Affordable and Clean Energy

8. Decent Work and Economic Growth

9. Industry, Innovation and Infrastructure

10. Reduced Inequality

11. Sustainable Cities and Communities

12. Responsible Consumption and Production

13. Climate Action

14. Life Below Water

15. Life on Land

16. Peace, Justice and Strong Institutions

17. Partnerships to achieve the Goal

India's Progress In SDGs

- **India has witnessed significant progress toward achieving the Sustainable Development Goals (SDGs) of the United Nations.** According to the NITI Aayog's SDG India Index, which highlights the country's progress in social, economic, and environmental development during the previous year, India has achieved significant progress in the areas of health, energy, and infrastructure.
- **Since 2019, India's total SDG score has increased from 60 to 66 in 2021**, owing to nationwide improvements in 'clean water and sanitation' and 'affordable and clean energy,' respectively. Kerala ranked first on the Index, followed by Himachal Pradesh, Tamil Nadu, Andhra Pradesh, and Goa.

- The Indian government is firmly committed to the **2030 agenda, including the SDGs**. The task of coordinating the SDGs has been entrusted to NITI Aayog, the Government of India's premier think tank.
- State governments are crucial to India's progress on the SDG Agenda since they are best positioned to 'put people first' and ensure that 'no one falls behind.' Many of the government's flagship initiatives, including **'Swachh Bharat', 'Make in India', 'Skill India', and 'Digital India', are key to the SDGs.** Most of these programmes rely heavily on the initiatives and support of the state governments and municipal bodies.

India and SDG 13

Climate Action India is committed to SDG 13, which calls for climate action. **India pledged to achieve net-zero emissions by 2070,** during **the United Nations COP26 summit, in Glasgow** in November, 2021. India has made five 'Panchamrit' commitments to combat climate change.

- Achieving the target of net zero emissions, by the year 2070
- Achieving 500 Giga Watt non-fossil energy capacity, by 2030
- Fulfilling 50 per cent of its energy requirements from renewable energy sources, by 2030
- India will reduce the total projected carbon emissions by one billion tonnes from now onwards, till 2030
- By 2030, India will reduce the carbon intensity of its economy, by less than 45 per cent

At the COP26 meeting, India also announced **'One Sun, One World, One Grid' (OSOWOG),** with the goal of harnessing solar energy and ensuring that generated electricity gets to places that need it the most. India has also launched the 'Plastic Hackathon 2021' campaign to ensure that the country is free of single-use plastic by 2022.

The updated NDC aims "To put forward and further propagate a healthy and sustainable way of living based on traditions and values of conservation and moderation, including through a mass movement for **'LIFE'– 'Lifestyle for Environment'** as a key to combating climate change". The decision on enhanced NDCs demonstrates India's commitment at the highest level for decoupling of economic growth from greenhouse gas emissions.

Banks and Climate Change

Cl**imate change is a major economic concern. Even in the best-case scenario**, the climate crisis would have an impact on every sector of the Indian economy, in the coming years. As per projections, the Indian economy would face substantial economic challenges in the future. **Climate change is likely to lower India's GDP by 2.8 per cent, per year by 2050, according to the World Bank**. The Indian banking industry has a key role to play in responding to the climate crisis, both in terms of managing the risks that climate change poses to their operations and in funding India's energy transition.

The Financial Services Taskforce (FSTF) of Sustainable Markets Initiative suggests a gamut of strategies on how the banking sector can support these transitions, including.

- Benchmarking the definition of sustainable financing for further investments
- Undertaking scenario analysis
- Assessing the risks and opportunities in sustainable financing mechanisms, etc. It is crucial for banks to build resilience against the impact of environmental risk as part of their business and risk management strategies. Besides implementing robust environmental risk management policies and processes, banks can play a key role in the transition towards an environmentally sustainable economy by channeling capital through their green financing and investment activities.

Progress in India

India has started emphasizing on green finance as early as 2007. In December 2007, the Reserve Bank issued a notification on **"Corporate Social Responsibility, Sustainable Development and Non- Financial Reporting – Role of Banks**" and mentions the importance of global warming and climate change in the context of sustainable development.

In 2008, **The National Action Plan on Climate Change (NAPCC)** was formulated with a vision to outline the broad policy framework for mitigating the impact of climate change (Jain, 2020). The Climate Change Finance Unit (CCFU) was formed in 2011 within the Ministry of Finance as a coordinating agency for the various institutions responsible for green finance in India.

The major strategic move since 2012 included implementation of the sustainability disclosure requirements. Security and Exchange Board of India (SEBI) made it mandatory for top 100 listed entities based on market capitalization at BSE and NSE to publish annual business responsibility reports since 2012 revised it from time to time. In May 2017, SEBI issued guidelines for green bond issuance specifying the disclosure requirements.

Progress and Challenges of Green Finance in India

Improvements in general awareness

There is a paucity of data for assessing the awareness regarding green finance and sustainable development from conventional sources. In this regard, Google Trends can be a powerful tool for understanding the pattern of google searches made in different locations at different point in time. It can help us understand the interest on a given topic, based on the number of searches made in Google.

Green lending

As part of the green finance initiative, the Reserve Bank has included the small renewable energy sector under its Priority Sector Lending (PSL) scheme in 2015. As at end-march 2020, the aggregate outstanding bank credit to the non-conventional energy sector was around `36,543 crore, constituting 7.9 per cent of the outstanding bank credit to the power generation compared to 5.4 per cent in March 2015.

Green bonds

Green bonds are the bonds issued by any sovereign entity, inter-governmental groups or alliances and corporates with the aim that the proceeds of the bonds are utilised for projects classified as environmentally sustainable.

There have been several fiscal and financial incentives at work in India. These incentives are in line with India's commitments under the 2015 Paris Agreement to reduce greenhouse gas emission intensity by 33 to 35 per cent below 2005 levels, and to achieve 40 per cent of installed electric power capacity from non-fossil sources by 2030.

Corporate Social Responsibility (CSR) Activities

- The aim of CSR is to voluntarily incorporate economic, social, and environmental obligations into business operations, in order to achieve long-term growth and demonstrate a beneficial impact on the environment, employees, consumers, shareholders, and communities.
- **Section 135 of the Companies Act 2013** provides legal support for CSR in India. Both the SDGs and the Indian CSR rule were adopted around the same time and appear to have enormous potential for developing a unified sustainable growth strategy.
- **Schedule VII provides the overall direction for CSR efforts.** SDGs are measurable targets that result from CSR programmes. Businesses, through CSR, play a key role in facilitating SDG implementation.

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Paper IE and IFS Module A Unit 11: Issues Facing Indian Economy

- India will be the **world's fastest-growing major economy**. The ongoing COVID-19 pandemic has triggered a long-term **health crisis, both globally and in India.**
- Though economic activity was slowing prior to the pandemic, **successive COVID waves have resulted** in a profound and widespread economic slowdown, with the potential for long-term repercussions.
- **Fiscal (Government) authorities have responded**, by implementing flexible fiscal policies, including greater support to vulnerable groups. Similarly, the RBI has eased liquidity provision and maintained a prolonged easy monetary policy.

- Some of India's perplexing economic issues encompass weak demand, jobless economic growth, rising COVID infections, with multiple virus mutations, chronic unemployment and under-employment, burgeoning disparities in wealth distribution, poor human capital quality, infrastructure bottlenecks, overdependence on agriculture, rising government debt, urban migration, etc.

Poverty Alleviation

- According to the Planning Commission of India's 2011-12 estimates, 25.7 per cent of the rural population and 13.7 per cent of the urban population were below the poverty line.
- Rural poverty rates are higher than urban poverty rates, owing to **a lack of decent infrastructure, inadequate food supply, and a weak labour market.**
- **Poverty eradication is a major challenge** of planned economic development.

Rising Inequalities

- While India has one of the **world's fastest growing economies, it also has one of the most unequal societie**s. Inequality has been steadily increasing over the previous few decades, and it has been especially pronounced after the 1991 economic reforms.
- The affluent have amassed a large portion of the wealth generated by crony capitalism and inheritance. The **rich are growing richer at a much faster rate, while the poor continue to struggle to earn a living** wage and get access to quality education and healthcare facilities, which continue to suffer from persistent underinvestment.

Migration And Excessive Pressure On Resources

- **Migration is the movement of people from one location to another**, in order to take advantage of better economic possibilities in the receiving location.
- Migration is a worldwide phenomenon that is influenced by numerous aspects, **including social, political, cultural, environmental, health, and education**. The linkages between environmental changes and migration are very complex.
- Migration is often the outcome of a series of factors — economic, social, and political – that are worsened by changing environmental conditions as well as developmental and demographic situations. Because of the strong links between environmental conditions and the political, economic, and social forces that drive migration, it is difficult to distinguish 'pure' environment-induced migration.

Possible Remedies

- The **migration issue will worsen in the coming years, as climate change-related** migration flows increase, particularly in middle-income economies like India.
- This is due to the fact that climate change is expected to increase the frequency and intensity of extreme environmental events, **such as drought, sea level rise, flooding, and cyclones.**

- The migration of people from rural regions to cities is rising. A new middle class is forming, with hopes for better living standards.
- Promoting agriculture and agri-businesses will be extremely beneficial in this regard. A concerted effort is needed in the direction of making farmers get non-farm sector job.

Pandemic Situation

- The COVID-19 pandemic was the first of its kind to hit the world in the **twenty-first century, hitting all economies, in varying degrees.**
- Repeated waves of infections, supply-**chain disruptions, inflation, and massive unemployment have made policymaking challenging**.
- The cyclical slowdown that already had commenced in India before the breakout of pandemic, was worsened by the epidemic.
- The pandemic has taken a significant toll on livelihoods and production capabilities, with far-reaching economic and social consequences, and the post-pandemic new normal may be very different from the pre-pandemic situation.
- The **Russia-Ukraine war has also delayed the recovery's momentum**, with its consequences reflecting in record-high commodity prices, an even weaker global growth outlook, and tighter global financial conditions.

JAIIB IE and IFS Module B: Economic Concepts Related to Banking

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Unit 5	Business Cycles
Unit 6	Monetary policy and Fiscal policy
Unit 7	System of National Accounts and GDP Concepts
Unit 8	Union Budget

JAIIB IE and IFS Module B Unit 1: Fundamentals Of Economics, Microeconomics, And Macroeconomics And Types Of Economies

Economics – An Introduction

Economics is a social science that focuses on the **production, distribution, and consumption** of goods and services, and analyzes the choices that individuals, businesses, governments, and nations make to allocate resources.

The term 'economy' is derived from the Greek word 'oikonomia', which is made up of two words: 'oikos', which is commonly translated **as 'home', and 'nemein'**, which means 'management and dispensation'. Thus, the term '**oikonomia'** referred to 'household management'.

Adam Smith's Definition

Adam Smith, the father of modern Economics, in his book **entitled an Enquiry into the Nature and Causes of the Wealth of Nations (1776) defined** Economics as a study of wealth. According to him, the subject matter of Economics is the study of how wealth is produced and consumed. Smith's definition is known as wealth definition.

Marshall's Definition

- **According to Prof. Alfred Marshall, the well-known English economist, 'Economics is a study of man in the ordinary business of life.** It is on the one side, the study of wealth and on the other and more important side, the study of man.' Wealth here means any commodity, which gives man satisfaction or utility or welfare.
- Wealth is the means to welfare. The ultimate purpose or objective of Economics is to promote well-being or welfare. He viewed Economics as a science of human welfare. Hence, his definition is known as welfare definition. **Marshall's Principles of Economics (1890)** is a very important contribution to economic literature.

Robbins' Definition

According to Lionel Robbins, 'Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.'This definition presents Economics as a study of **'means' and 'ends'**. The means or resources are less in relation to their demand. How human beings use the scarce resources to fulfil their desires is the subject matter of Economics. **Robbin's definition is known as scarcity definition. The definition of Robbins can be analysed as follows:**

Unlimited Wants

- According to Prof Robbins definition, human wants are unlimited. On satisfaction of one wants, another want arises immediately, and this sequence continues forever.

Scarce Means

- Robbin's definition stated that on one side human needs are unlimited yet on the other side, the means to satisfy these wants, like- time, power, money, etc. are also limited. Due to this, many of man's needs remain unsatisfied.

Alternative Use of Scarce Means

- In Robbins's view though the to 'satisfy man's needs are scarce, yet he has alternative uses. In other words, he can use every resource in various objectives and activities. For example – such a resource like land can be use in many ways, such as it can be used for agriculture or for building a house or to establish a factory etc.

Variation in the Intensity of wants

- Robbins definition states that the intensity of man's needs is different. Some wants are more intense than the others. Since our means are limited and all wants cannot be satisfied with the limited means; as a result, we have to select some more intense wants from our unlimited wants and the less intense wants have to be either dropped or postponed to a future date.

Microeconomics and Macroeconomics

Microeconomics

- **Microeconomics is the study of decisions** made by people and businesses regarding the allocation of resources and prices of goods and services. The government decides the regulation for taxes. **Microeconomics focuses on the supply that determines the price level of the economy.**
- It uses the bottom-up strategy to analyse the economy. In other words, microeconomics tries to understand human's choices and allocation of resources. It does not decide what are the changes taking place in the market, instead, it explains why there are changes happening in the market.
- The key role of microeconomics is to examine how a company could maximise its production and capacity, so that it could lower the prices and compete in its industry. A lot of microeconomics information can be obtained from the financial statements.

The key factors of microeconomics are as follows:

- Demand, supply, and equilibrium
- Production theory
- Costs of production
- Labour economics

Examples: Individual demand, and price of a product.

Macroeconomics

- **Macroeconomics is a branch of economics that depicts a substantial picture**. It scrutinises itself with the economy at a massive scale, and several issues of an economy are considered. The issues confronted by an economy and the headway that it makes are measured and apprehended as a part and parcel of macroeconomics.
- Macroeconomics studies the association between various countries regarding how the policies of one nation have an upshot on the other. It circumscribes within its scope, analysing the success and failure of the government strategies.
- In macroeconomics, we normally survey the association of the nation's total manufacture and the degree of employment with certain features like cost prices, wage rates, rates of interest, profits, etc., by concentrating on a single imaginary good and what happens to it.

The important concepts covered under macroeconomics are as follows:

- Capitalist nation
- Investment expenditure
- Revenue

Examples: Aggregate demand, and national income.

Differences Between Microeconomics and Macroeconomics

BASIS FOR COMPARISON	MICROECONOMICS	MACROECONOMICS
Meaning	The branch of economics that studies the behavior of an individual consumer, firm, family is known as Microeconomics.	The branch of economics that studies the behavior of the whole economy, (both national and international) is known as Macroeconomics.
Deals with	Individual economic variables	Aggregate economic variables
Business Application	Applied to operational or internal issues	Environment and external issues
Tools	Demand and Supply	Aggregate Demand and Aggregate Supply
Assumption	It assumes that all macro-economic variables are constant.	It assumes that all micro-economic variables are constant.
Concerned with	Theory of Product Pricing, Theory of Factor Pricing, Theory of Economic Welfare.	Theory of National Income, Aggregate Consumption, Theory of

		General Price Level, Economic Growth.
Scope	Covers various issues like demand, supply, product pricing, factor pricing, production, consumption, economic welfare, etc.	Covers various issues like, national income, general price level, distribution, employment, money etc.
Importance	Helpful in determining the prices of a product along with the prices of factors of production (land, labor, capital, entrepreneur etc.) within the economy.	Maintains stability in the general price level and resolves the major problems of the economy like inflation, deflation, reflation, unemployment and poverty as a whole.
Limitations	It is based on unrealistic assumptions, i.e. In microeconomics it is assumed that there is a full employment in the society which is not at all possible.	It has been analyzed that 'Fallacy of Composition' involves, which sometimes doesn't proves true because it is possible that what is true for aggregate may not be true for individuals too.

Fundamental Questions In Economic Organisation

Economists address these three questions:

(1)What goods and services should be produced to meet consumer needs?

The answers to these questions depend on a country's economic system. The primary economic systems that exist today are planned and free market systems.

(2)How should they be produced, and who should produce them?

Ans. In a planned system, such as communism and socialism, the government exerts control over the production and distribution of all or some goods and services.

(3)Who should receive goods and services?

Ans. In a free market system, also known as capitalism, business is conducted with only limited government involvement. Competition determines what goods and services are produced, how they are produced, and for whom.

Market, Command And Mixed Economies

Market Economy/Capitalist Economy

- Capitalism is often thought of as an economic system in which private actors own and control property in accord with their interests, and demand and supply freely set prices in markets in a way that can serve the best interests of society. The essential feature of capitalism is the motive to make a profit.

Socialist Economy/Command Economy

- In socialist countries, the state centralizes and controls economic decisions. A dictator or central planning committee decides what goods will be made, who will make it, how much to make, and who will buy it. The state does not control labor.

Mixed Economic

- A mixed economic system is a system that combines aspects of both capitalism and socialism. A mixed economic system protects private property and allows a level of economic freedom in the use of capital, but also allows for governments to interfere in economic activities in order to achieve social aims.

JAIIB IE and IFS Module B Unit 2: Demand and Supply

Demand

- The amount of a commodity people buy depends on its price. The higher the price of an article, other things held constant; fewer the units consumers are willing to buy. This relationship between price and quantity bought is called the demand schedule, or the demand curve.
- **Theory of Supply and Demand** shows how consumer preferences determine consumer demand for commodities, while business costs determine the supply of commodities.

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Demand Schedule or the Demand Curve

- **A demand schedule** is a table that shows the **quantity demanded** at **different prices in the market.** A **demand curve** shows the **relationship between quantity demanded and price in a given market on a graph.** The law of demand states that a higher price typically leads to a lower quantity demanded.

Law of Downward – sloping demand

- When the Price of a commodity is raised (and other things being constant), buyers tend to buy less of the commodity. Similarly, when the price is lowered, other things being constant, quantity demanded increases.

Factors influences the Demand Curve

- Average levels of income

- The size of market/population
- The prices and availability of related goods
- Tastes or Preferences - Special Influences

There are two types of Demand Schedules:

- Individual Demand Schedule
- Market Demand Schedule

Individual Demand Schedule

It is a demanding schedule that depicts the demand of an individual customer for a commodity in relation to its price. Let us study it with the help of an example.

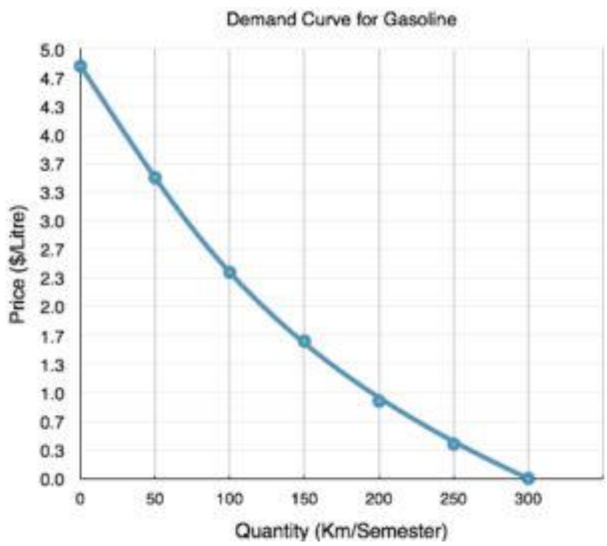
Price per unit of commodity X (Px)	Quantity demanded of commodity X (Dx)
100	50
200	40
300	30
400	20
500	10

The above schedule depicts the individual demand schedule. We can see that when the price of the commodity is ₹100, its demand is 50 units. Similarly, when its price is ₹500, its demand decreases to 10 units.

Thus, we can conclude that as the price falls the demand increases and as the price raises the demand decreases. Hence, there exists an inverse relationship between the price and quantity demanded.

Individual Demand Curve

It is a graphical representation of the individual demand schedule. The X-axis represents the demand and Y-axis represents the price of a commodity.



The above demand curve shows the demand for Gasoline. When the price of gasoline is $3.5 per litre, its demand is 50 litres and when the price is $0.5 per litre, its demand is250 litres.

Market Demand Schedule

It is a summation of the individual demand schedules and depicts the demand of different customers for a commodity in relation to its price. Let us study it with the help of an example.

Price per unit of commodity X	**Quantity demanded by consumer A (Q_A)**	**Quantity demanded by consumer B (Q_B)**	**Market Demand $Q_A + Q_B$**
100	50	70	120
200	40	60	100
300	30	50	80
400	20	40	60
500	10	30	40

The above schedule shows the market demand for commodity X. When the price of the commodity is ₹100, customer A demands 50 units while the customer B demands 70 units.

Thus, the market demand is 120 units. Similarly, when its price is ₹500, Customer A demands 20 units while customer B demands 30 units.

Thus, it's market demand decreases to 40 units. Thus, we can conclude that whether it is the individual demand or the market demand, the law of demand governs both of them.

Market Demand Curve

It is a graphical representation of the market demand schedule. The X-axis represents the market demand in units and Y-axis represents the price of a commodity.

Supply

Supply

The supply schedule (or supply curve) for a commodity shows the relationship between its market price and the amount of that commodity that producers are willing to produce and sell, other things being constant.

A firm sell 1000 units of a commodity at Rs 10 per unit. Its price elasticity of supply is 3. Number of units the firm will offer for sale if price falls to Rs 7.5 will be ......

Friends, please don't get confused with Price Elasticity of Demand. In Price Elasticity of Demand, when the price is increased, the quantity demanded will be decreased. But in Price Elasticity of supply, when the price is increased, quantity supplied will be increased. Because, the supplier will supply more quantity of item when the price is increased.

Let us solve this one.

Price Elasticity of supply = percentage change in quantity supplied/percentage change in price

3 = ((1000-x)*100/1000)/((10-7.5)*100/10)
= ((1000-x)/10)/(2.5*10)
= ((1000-x)/10)/25
75 = (1000-x)/10
750 = 1000-x
x = 1000-750
= 250

Forces behind the supply Curve

- Cost of Production
- Prices of inputs and technological advances
- Government Policy
- Prices of related goods
- Special Factors like weather influence on farming and agro-industry

Supply Schedule

- It is a statement in the form of a table that shows the different quantities of a commodity that a firm or a producer offers for sale in the market at different prices.
- It denotes the relationship between the supply and the price, while all non-price variables remain constant.

There are two types of Supply Schedules:

- Individual Supply Schedule
- Market Supply Schedule

Individual Supply Schedule

- It is a supply schedule that depicts the supply by an individual firm or producer of a commodity in relation to its price. Let us understand it with the help of an example.

Price per unit of commodity X (Px)	Quantity supplied of commodity X (Dx)
100	1000
200	2000
300	3000
400	4000
500	5000

- The above schedule depicts the individual supply schedule. We can see that when the price of the commodity is ₹100, its supply is 1000 units. Similarly, when its price is ₹500, its supply increases to 5000 units.
- Thus, we can conclude that as the price falls the supply decreases and as the price rises the supply also increases. Hence, there exists a direct relationship between the price and quantity supplied.

Individual Supply Curve

- It is a graphical representation of the individual supply schedule. The X-axis represents the supply and Y-axis represents the price of a commodity. There exists a direct relationship between price and quantity supplied of a commodity.

Market Supply Schedule

- It is a summation of the individual supply schedules and depicts the supply of different customers for a commodity in relation to its price. Let us understand it with the help of an example.

Price per unit of commodity X	Quantity supplied by firm A (Q_A)	Quantity supplied by firm B (Q_B)	Market Supply $Q_A + Q_B$
100	1000	3000	4000
200	2000	4000	6000
300	3000	5000	8000
400	4000	6000	10000
500	5000	7000	12000

- The above schedule shows the market supply of commodity X. When the price of the commodity is ₹100, firm A supplies 1000 units while the firm B supplies 3000 units.
- Thus, the market supply is 4000 units. Similarly, when its price is ₹500, firm A supplies 5000 units while firm B supplies 7000 units. Thus, it's market demand increases to 12000 units.
- Thus, we can conclude that whether it is the individual supply or the market supply, the law of supply governs both of them.

Market Supply Curve

- It is a graphical representation of the market supply schedule. The X-axis represents the market supply in units and Y-axis represents the price of a commodity.

Important Point

- Supply increases (or Decreases) when the amount supplied increases (or Decreases) at each **market price.**
- **Supply and demand interacts** to produce equilibrium price and quantity or market equilibrium.
- **The Market Equilibrium** comes at that price and quantity where the forces of supply and **demand are in balance.**

- **At the Equilibrium price**, the amount that buyers want to buy is just equal to the amount that sellers want to sell.
- **A Market equilibrium** comes at the price at which quantity demanded equals quantity supplied.
- The Equilibrium Price is also called as the **Market Clearing Price.**

JAIIB IE and IFS Module B Unit 3- Money Supply and Inflation

Money

Money is anything which performs the following four functions:

- **Medium of exchange:** Individual goods and services; and other physical assets, are 'priced' in terms of money and are exchanged using money.
- **A measure of value**: Money is used to measure and record the value of goods or services.
- **A store of value over time**: Money can be held over a period of time and used to finance future payments.
- **Standard for deferred payments**: Money is used as an agreed measure of future receipts and payments in contracts.

Money Supply

Money supply refers to the stoke of money available in the economy at a given point of time. Money supply date are recorded and published by the RBI on a **fortnightly basis**. Money supply affects the price level, exchange rates and business cycles in the economy. It may also affect the growth of GDP. The ratio between nominal GDP and money supply is called "**Velocity of Money**".

Measures of Money supply

There are four common measures of Money supply, commonly used in India:

- Narrow Money (M1)= Currency with Public Demand Deposits with Banking System + 'Other" Deposits with the RBI

- M2 = M1+ Savings deposits of Post Office Savings Banks

- M3 = M1+ Time Deposits with the Banking System

- M4 = M3+ All Deposits with post office savings banks (Excluding NSCs)

Currency with Public = Currency in circulation - Cash held by banks.

Demand Deposits include all liabilities which are payable on demand and they include current Deposits, demand liabilities portion of saving Banks Deposits, margins held Against LC/BG, Balance in OD FDs, Cash Certificates and Cumulative/RDs etc.

"Time Deposits" are those which are payable otherwise than on demand and they include fixed Deposits, Cash Certificates, Cumulative and recurring Deposits, time Liabilities portion of savings bank deposits, etc.

Sources versus components of money supply

Money supply (M3) is derived on the basis of a balance sheet approach. It follows from the balance sheets of RBI and the rest of the banking sector. The components of the money supply are drawn from the liability side of the balance sheet of the banking sector (i.e., RBI + banks), and the various uses of the funds as obtained from the asset side constitute the sources of M3.

Money Supply (M3): Components Side	Money Supply (M3): Sources Side
Currency with the public + Demand deposits with banks + Time deposits with banks + 'Other' deposits with RBI	Net bank credit to the government + Bank credit to the commercial sector + Net foreign exchange assets of the banking sector + Government's currency liabilities to the public – Net non-monetary liabilities of the banking sector

Money Multiplier

- The Money Multiplier approach to money supply was pronounced by **Milton Friedman and Anna Schwartz (1963).** Money multiplier explains the process through which, the "**base money (M0)"** created by a central bank multiplies in the banking system to the stock of broad money (M3), at any point of time. There are three important determinants of money multiplier.
- Currency to deposit ratio (which depends on the behaviour of the public), required reserves to total deposits (which depends on the central bank policy) and excess reserves maintained by banks with the central bank, as percentage of total deposit liabilities (which depends on the behaviour of commercial banks) are the key determinants of money multiplier.
- The money multiplier is the link between the **'broad money' (M3) and the 'reserve money' (M0). Money multiplier could be derived as "broad money/reserve money" (M3/M0).**

Velocity Of Money

The velocity of money is the frequency with which, one unit of currency is used on domestically produced goods and services, in a specific time period. In other words, it is the number of times a money is spent to purchase goods and services in a unit of time.

The ratio between nominal GDP and money supply is called **'Velocity of Money'.** Velocity is the link between **"broad money" and "nominal GDP"** and is derived as "nominal GDP/broad money".

Inflation

The concept of Inflation refers to **a sustained rise** in the **general level of prices of goods and services in an economy over a period of time.**

Causes of Inflation

Demand – pull Inflation: Demand – pull Inflation is a rise in general prices caused by increasing aggregate demand for goods and services.

Cost- Push Inflation: Cost- Push Inflation is a type of inflation caused by substantial increases in the cost of production of important goods of services, where no suitable alternative is available.

Measure of Inflation:

Calculating inflation with Price Indexes

Inflation = (Price Index in Current Year–Price index in Base Year) X 100/Price index in Base Year

There are Important Price Indexes

- Wholesale Price Index (WPI)

- Consumer Price Index (CPI)

- GDP Deflator

Wholesale Price Index (WPI)

Wholesale Price Index, or WPI, measures the changes in the prices of goods sold and traded in bulk by wholesale businesses to other businesses. WPI is unlike the Consumer Price Index (CPI), which tracks the prices of goods and services purchased by consumers. What do you mean by the Wholesale Price Index? To put it simply, the WPI tracks prices at the factory gate before the retail level.

New series of WPI

With an aim to align the index with the base year of other important economic indicators such as GDP and IIP, the base year was updated to 2011-12 from 2004-05 for the new series of Wholesale Price Index (WPI), effective from April 2017.

How do you calculate Wholesale Price Index?

The monthly WPI number shows the average price changes of goods usually expressed in ratios or percentages.

The index is based on the wholesale prices of a few relevant commodities available.

The commodities are chosen based on their significance in the region. These represent different strata of the economy and are expected to provide a comprehensive WPI value.

The advanced base year 2011-12 adopted recently uses 697 items.

Consumer Price Index

Consumer Price Index or CPI as it is commonly called is an index measuring retail inflation in the economy by collecting the change in prices of most common goods and services used by consumers. Called market basket, CPI is calculated for a fixed list of items including food, housing, apparel, transportation, electronics, medical care, education, etc. Note that the price data is collected periodically, and thus, the CPI is used to calculate the inflation levels in an economy. This can be further used to compute the cost of living. This also provides insights as to how much a consumer can spend to be on par with the price change.

Remember, CPI is different from WPI, or Wholesale Price Index, which measures inflation at the wholesale level.

How is Consumer Price Index calculated?

The CPI is calculated with reference to a base year, which is used as a benchmark. The price change pertains to that year. Remember, when you calculate the CPI, note that the price of the basket in 1 year has to be first divided by the price of the market basket of the base year. Then, it is multiplied by 100.

Consumer Price Index formula:

CPI = (Cost of basket divided by Cost of basket in the base year) multiplied by 100

CPI's annual percentage change is also used to assess inflation. In India, the base years of the current series of CPI(IW), CPI(AL) and CPI(RL), are 1982, 1986-87 and 1984-85, respectively.

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GDP Deflator

GDP deflator is a measure of the level of prices of all new, domestically produced, final goods and services in an economy.

JAIIB IE & IFS Module B Unit 4: Theory of Interest

Interest

Interest is a payment made by a borrower for the use of a sum of money for a period of time; it is one of the **four types of income, the others being rent, wages, and profit**. **Three elements can be distinguished in interest:**

- Payment for the risk involved in making the loan;
- Payment for the trouble involved;
- Pure interest, that is a payment for the use of the money.

Theory of Interest

It is also known as the demand and supply theory. It was developed and modified by various renowned economists like Marshall, Fisher, and Pigou. According to this theory, rate of interest is determined by the equilibrium of demand and supply of savings. The classical economists maintained that interest is a price paid for the supply of savings, to meet the demand for investment.

Demand for Savings

- **Demand for savings comes from investors for investment in business activities**. The demand for investment is high when the capital, as a factor of production, give high returns.
- The demand for capital, or investment demand, is determined by the productivity of capital, or returns on investment, on the one hand, and the rate of interest, or the cost of investment, on the other.

Supply of Savings

- The supply of capital is determined by savings, which are determined by a **range of psychological, economic, and institutional elements.** Savings depend on various factors like capacity to save, willingness to save, income level, etc.
- Saving entails reducing consumption or deferring current spending. Saving entails, a sacrifice, abstinence, or patience. As savings is an incentive to follow the act of savings or refrain from current spending, when selecting between present consumption (which requires no saving) and future consumption (which requires saving), the person must consider the opportunity cost of each choice, which is quantified by the rate of interest.

Equilibrium of Demand and Supply of savings

- For a particular level of income, the supply of savings increases with increase in interest rate but this **increase in interest rates decreases the demand for saving by the borrowers.**
- This decrease in demand results in interest rates going down, which in turn, reduces the supply.

Criticism to the Classical

- **Theory of Interest Keynes questioned the classical theory of interest on several grounds**. Interest, according to Keynes, is not a reward for saving, rather, it is a monetary phenomenon, and the rate of interest is defined as a reward for parting with liquidity (or cash balances), rather than a reward for saving.
- Keynes objected to the classical theory that saving and investment are interest elastic. He stated that, in actuality, investment is more dependent on the marginal efficiency of capital and future expectations than on interest rates, particularly during times of economic slowdown.

Keynes' Liquidity Preference Theory Of Rate Of Interest

Liquidity Preference Theory suggests that investors demand progressively higher premiums on medium and long-term securities as opposed to short-term securities. According to the theory, which was developed by **John Maynard Keynes in support of his idea that the demand** for **liquidity holds speculative power, liquid investments are easier to cash in for full value.**

Cash is commonly accepted as the most liquid asset. According to the liquidity preference theory, interest rates on short-term securities are lower because investors are not sacrificing liquidity for greater time frames than medium or longer-term securities.

Special Considerations

- Keynes introduced Liquidity Preference Theory in his book The General Theory of Employment, Interest and Money. Keynes describes the theory in terms of three motives that determine the demand for liquidity:
- The transactions motive states that individuals have a preference for liquidity to guarantee having sufficient cash on hand for basic day-to-day needs. In other words, stakeholders have a high demand for liquidity to cover their short-term obligations, such as buying groceries and paying the rent or mortgage. Higher costs of living mean a higher demand for cash/liquidity to meet those day-to-day needs.

Precautionary motive

- The precautionary motive relates to an individual's preference for additional liquidity if an unexpected problem or cost arises that requires a substantial outlay of cash. These events include unforeseen costs like house or car repairs.

Speculative Motive

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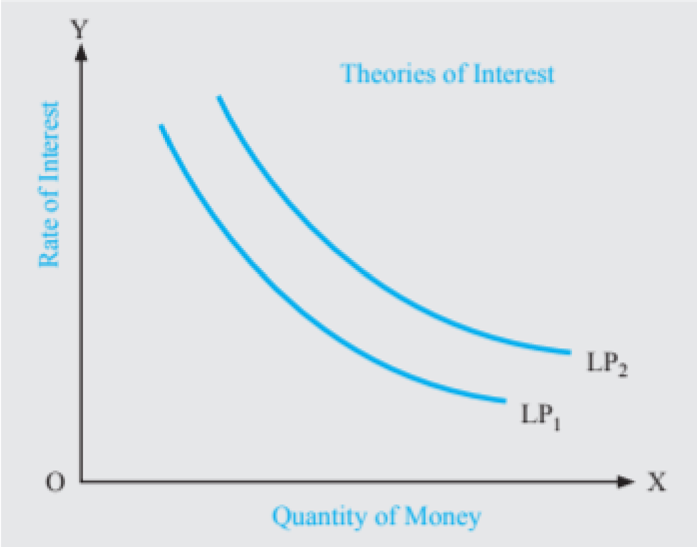
- Stakeholders may also have a speculative motive. When interest rates are low, demand for cash is high and they may prefer to hold assets until interest rates rise. The speculative motive refers to an investor's reluctance to tying up investment capital for fear of missing out on a better opportunity in the future.

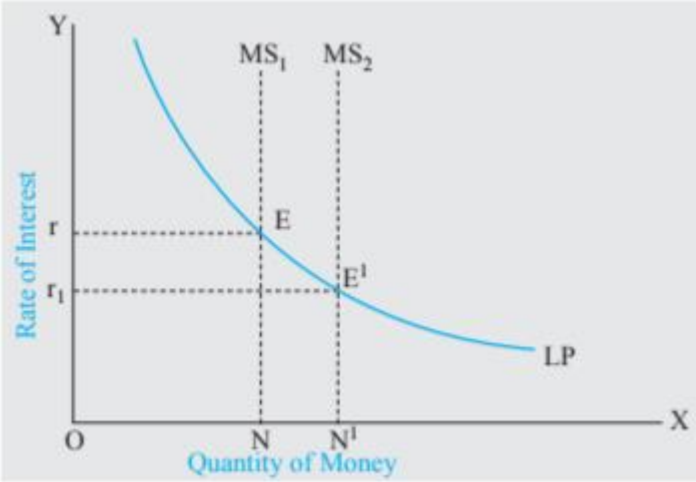
Money Demand Curve

- It follows from above that quantity of money demanded increases with the fall in the rate of interest or with the increase in level of nominal income. At a given level of nominal income, we can draw a money demand curve showing the quantity of money demanded at various rates of interest.
- As demand for money is inversely related to the rate of interest, the money demand curve at a given level of income, will be downward-sloping, as is shown by the curve LP1 in Figure. When the level of money income increases, the curve of demand for money shifts upward to the new position LP2.



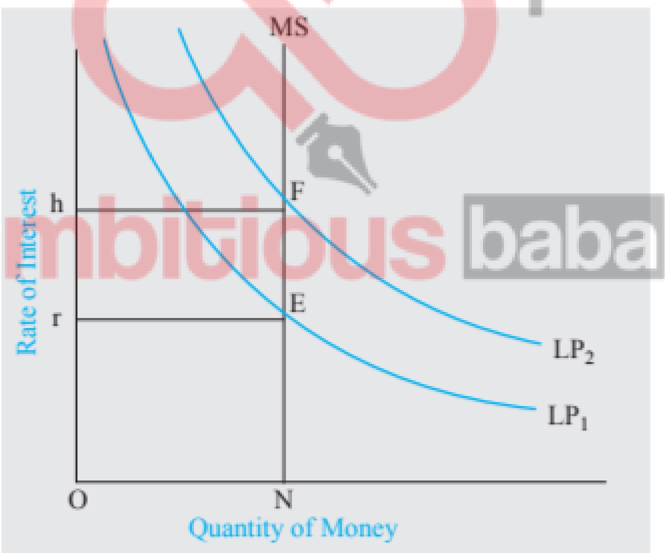
Effect Of An Increase In The Money Supply

Let us now examine the effect of increase in money supply on the rate of interest. In Figure, LP is the money demand curve for satisfying various motives. To begin with, ON is the quantity of money available. Rate of interest will be determined where the demand for money is in balance or equal to the fixed supply of money ON. It is clear from the figure that demand for money is equal to ON quantity of money at 'Or' rate of interest. Hence, 'Or' is the equilibrium rate of interest. Assuming no change in expectations and nominal income, an increase in the quantity of money (through buying securities by the central bank of the country from the open market), will lower the rate of interest. In Figure, when the quantity of money increases from ON to ON1, the rate of interest falls from Or to Or1, because the new quantity of money ON1 is in balance with the demand for money at Or1 rate of interest. In this case, we move down on the curve. Thus, given the money demand curve or curve of liquidity preference, an increase in the quantity of money brings down the rate of interest. Let us see how increase in money supply leads to the fall in the rate of interest. With initial equilibrium at Or, when the money supply is expanded from ON to ON1, there emerges excess supply of money at the initial 'Or' rate of interest. The people would react to this excess quantity of money supplied by buying bonds. As a result, the bond prices will go up which implies that the rate of interest declines. This is how the increase in money supply leads to the fall in rate of interest.



Shifts In Money Demand Or Liquidity Preference Curve

The position of money demand curve depends upon two factors: (1) the level of nominal income and (2) the expectations about the changes in bond prices in the future, which implies change in rate of interest in future. As has been explained above, a money demand curve is drawn by assuming a certain level of nominal income. With the increase in nominal income, money demand for transactions and precautionary motives increases, causing an upward shift in the money demand curve.



Shifts in money demand curve (or what Keynes called liquidity preference curve) can also be caused by changes in the expectations of the people, regarding changes in bond prices or movements in the rate of interest, in future. If some changes in events lead the people on balance to expect a higher rate of interest in the future than they had previously supposed, the money demand or liquidity preference for speculative motive will increase, which will bring about an upward shift in the money demand curve or liquidity preference curve and this will raise the rate of interest. In Figure, assuming that the quantity of money remains unchanged at ON, the rise in the money demand or liquidity preference curve from LP1 to LP2, the rate of interest rises from Or to Oh because at Oh, the new speculative demand for money is in equilibrium with the supply of money ON. It is worth noting that when the liquidity preference curve rises from LP1 to LP2, the amount of money held does not increase; it remains ON as before. Only the rate of interest rises from Or to Oh to equilibrate the new liquidity preference or money demand with the available quantity of money ON.

Hansen Synthesis: IS-LM Curve Model

Renowned economists, Sir John Richard Hicks and Alvin Hansen, have brought about a synthesis between the Classical and Keynes' theories of interest and have thereby succeeded in propounding an adequate and determinate theory of interest. This involves three steps viz.

I) Using Classical Theory, to derive a curve called IS Curve. (IS- Investment Savings)

II)Using Keynes' Theory, to derive a curve called LM curve (LM-Liquidity-Preference-Money Supply)

III)Combining IS and LM curves.

Using Classical Theory to Derive IS Curve

From the classical theory we get a family of saving curves at various income levels, as shown in Fig 1. These are represented by S1Y1, S2Y2, S3Y3, S4Y4 and S5Y5. As the income rises, the savings curve shifts to the right, which means that as the income rises, the savings also rise, provided the interest remains constant. The other curve shown in Fig. 15.5 is the investment curve and is marked as I. It shows that the investment demand increases as the interest rate falls. This investment curve intersects the savings curves and the points of intersection represent the rates of interest, which equalise savings and investment at various income levels. Thus, when income is Y2, the relevant savings curve is S2Y2 and the corresponding rate that equalises savings and investment is r4. Similarly, for other levels of income rates of interest that equalise savings and investment can be obtained. We observe that the interest rate which equalises savings and investments, keeps on falling as the income level increases. In Fig.2, we plot this co-relation between income (on the X-axis) and the corresponding rates of interest determined by the equality of savings and investment (on the Y-axis), by taking these points of intersection from Fig.1. The resulting curve is marked as IS curve. Since, as income increases, rate of interest falls, the IS curve slopes downward. Fig.1 and Fig.2 are both based on the Classical Theory explained earlier. The steepness of the IS curve depends upon the elasticity or sensitiveness of investment demand to the changes in rate of interest. When investment demand is greatly elastic or highly sensitive to the rate of interest, the IS curve will be flat (i.e., less steep). On the other hand, when investment demand is not very sensitive to the changes in rate of interest, the IS curve will be relatively steep.

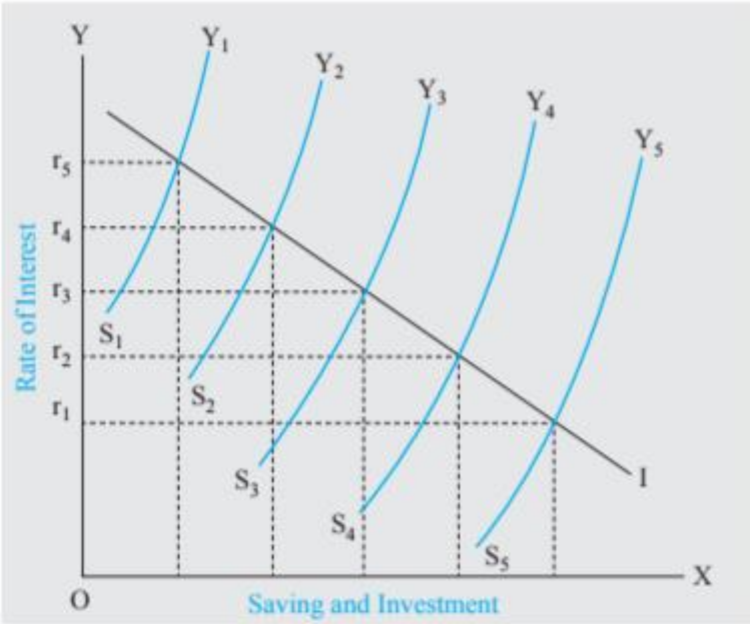


Figure 1: Derivation of IS Curve – Interest Rate vs Saving and Investment

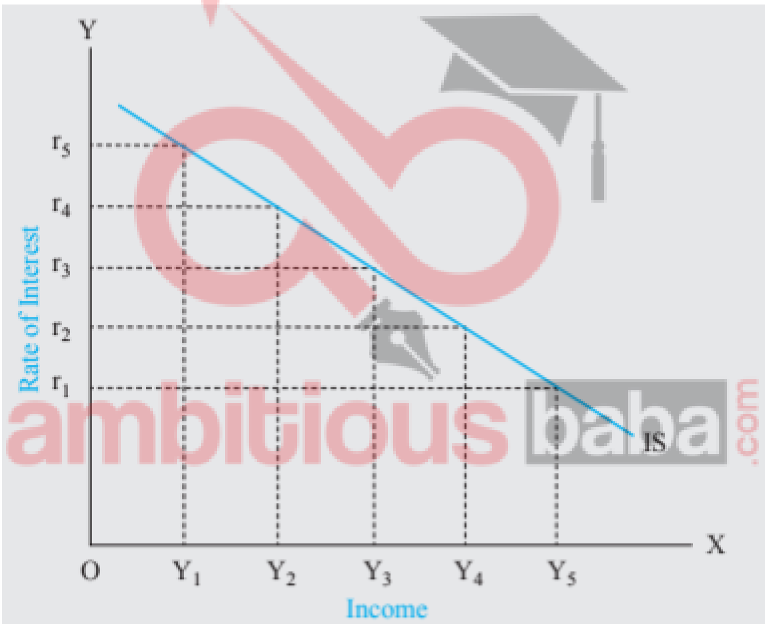


Figure 2: Derivation of IS Curve – Interest Rate vs Income

Using Keynes' Theory to Derive LM Curve

The LM curve is derived from the Keynesian liquidity preference theory of interest. This is depicted in Fig. (a) and (b). Fig. (a) shows various liquidity preference curves at various levels of income. The greater the level of income, the greater is the amount of money held for transactions motive and, herefore, the higher the level of liquidity preference curve. Now, the intersection of these various liquidity preference curves, with the supply curve of money supply fixed by the monetary authority (represented by line NS), would give us the rates of interest which equalise the demand for money (liquidity preference) to the supply of money at various levels. We observe from Fig.(a) that the interest rate at which the equilibrium of liquidity preference and money supply is achieved, keeps on increasing as the income level goes up. All these points of intersection in Fig. (a) are used to plot curve shown as LM in Fig. (b). Each point on the LM curve points to a rate of interest at which, the equilibrium of liquidity preference and money supply is achieved, at a particular level of income. Figure (b) shows that the LM curve slopes upward to the right. This is because with higher levels of income, demand for money (that is, the liquidity preference) is higher and consequently, the moneymarket equilibrium, that is, the equality of the given money supply with liquidity preference curve occurs, at a higher rate of interest. This implies that rate of interest varies directly with income. It is important to know which factors determine the slope of the LM curve. There are two factors on which the slope of the LM curve depends. First, the responsiveness of demand for money (i.e., liquidity preference) to the changes in income. As the income increases, say from Yl to Y2, the liquidity preference curve shifts from LPl to LP2, that is, with an increase in income, demand for money would increase for being held for transactions motive, L = f(Y). This extra demand for money would disturb the money-market equilibrium, and in order to restore the equilibrium, the rate of interest will rise to the level where the given money supply curve intersects the new liquidity preference curve corresponding to the higher income level.

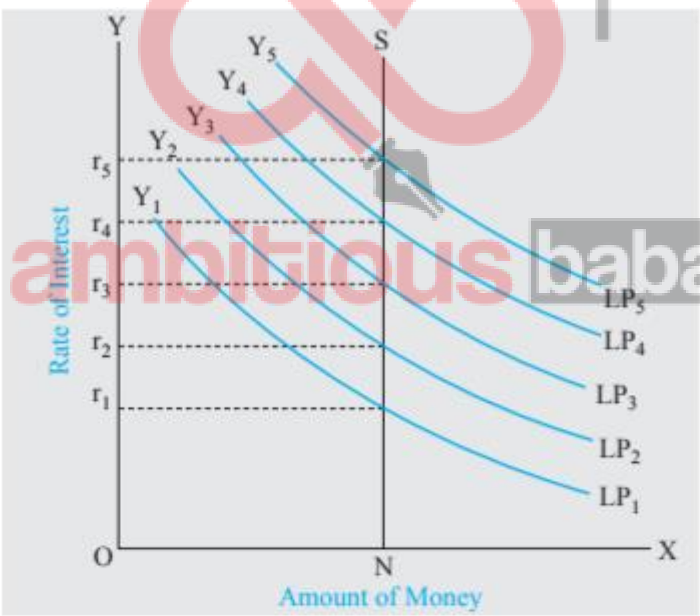


Figure (a) Determination of LM Curve from Keynes' Liquidity Preference Curves – Interest Rate vs Income

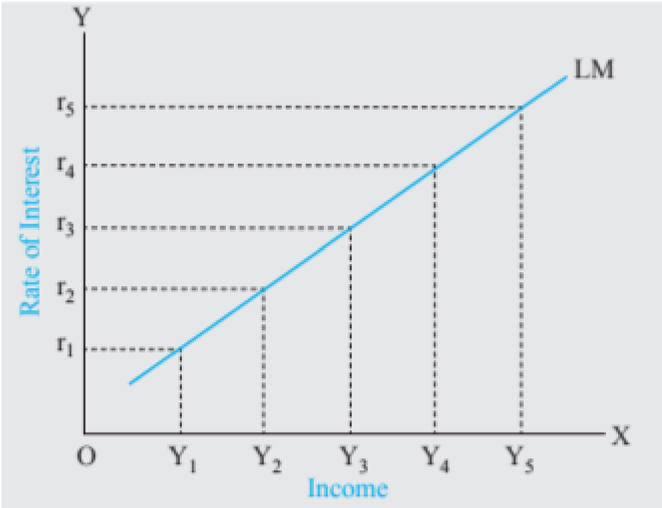


Figure (b): **Determination of LM Curve from Keynes' Liquidity Preference Curves – Interest Rate vs Income**

Combining IS and LM Curves

The IS curve and the LM curve relate the two variables: (a) income, and (b) the rate of interest. These curves are plotted in Fig.2 We note that the IS curve, which represents Classical Theory, slopes downwards while the LM curve, which represents the Keynes' Theory, moves upwards. The intersection of these two curves represents the synthesis of the two theories. The point of intersection of these two curves, i.e., E in Fig. 2, represents the equilibrium rate of interest.

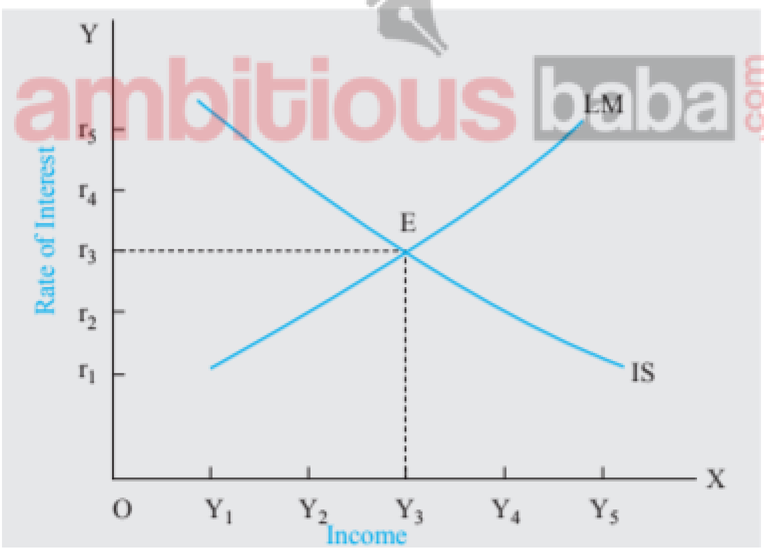


Figure 2: Intersection of the IS and LM Curves

The equilibrium rate of interest thus determined is Or3 and the level of income determined is OY3. At this point, income and the rate interest stand in relation to each other such that (1) investment and saving are in equilibrium, and (2) the demand for money is in equilibrium with the supply of money (i.e., the desired amount of money is equal to the actual supply of money). It should be noted that LM curve has been drawn by taking the supply of money as fixed. Thus, a determinate theory of interest is based on: (1) the investment-demand function, (2) the saving function (or, conversely, the consumption function), (3) the liquidity preference function, and (4) the quantity of money supply. We see, therefore, that according to Hicks and Hansen, both monetary and real factors, namely, productivity, thrift, and the monetary factors, that is, the demand for money (liquidity preference) and supply of money play a part in determining of the rate of interest. Any change in these factors will cause shift in IS or LM curve and will, therefore, change the equilibrium level of the rate of interest and income.

JAIIB IE and IFS Module B Unit 5: Business Cycles

Business Cycles

- The term Business cycle **refers to economy-wide fluctuations in production or economic activity over several months or years.**
- Business Cycle is also known as **Economic Cycle.**
- Business Cycle simply means **the whole course of business activity which passes through the phases of prosperity and depression.**
- A business Cycle is **not a regular, predictable, or repetitive phenomenon** like the swing of the pendulum of a clock. Its timing is random and, to a large degree, unpredictable.

Characteristics of a Business Cycle:

- **A business cycle is synchronic:** The upward and downward movements tend to occur at almost the same period in all industries. The wave of prosperity or depression in one industry will soon generate a wave in other industries.
- **A business cycle show a wave like movement**: The period of prosperity and depression can be alternatively seen in a cycle.
- **Cyclical fluctuations are recurring in nature**: The various phases are repeated. A boom is followed by depression and the depression again is followed by boom.
- There can be no indefinite depression or eternal boom period
- Business cycles are pervasive in their effects.
- The up and down movements are not symmetrical. The Downward movement is more sudden and violent than the upward movement.

Phases of Business Cycle:

A business cycle is identified as a sequence of four phase. Boom, Recession, Depression and Recovery

Boom:

- During the Boom phase production capacity is fully utilized and also products fetch an above normal price which gives higher profit.
- In Boom period, consumption will be decreased as prices are going up.
- The Demand is more or less stagnant or it even decreases.

A boom has the following important economic characteristics:

- An accelerated and prolonged increase in demand
- Demand peaks to levels that exceed sustainable output/production levels
- Economy heats up and a demand-supply lag becomes apparent
- Market forces mismatch (i.e., demand and supply disequilibrium) and tend to create a situation in which inflation begins to rise
- The economy may suffer fundamental problems such as a shortage of investible capital, decreased savings, a declining standard of living, and the emergence of a sellers' market.

Recession:

- A downward tendency in demand is observed. The supply exceeds demand
- Desire for liquidity increases all around.
- Producers are compelled to reduce price so that they can find money to meet their obligations.
- This Phase of the business cycle is known as the Crisis.

The following are the major characteristics of recession,

- There is a general decline in demand as economic activity slows down
- Inflation remains low or shows further signs of falling
- Employment falls/unemployment rises
- Industries resort to price cuts to stay in business.

Depression:

- Underemployment of both men and materials is a characteristic of this phase. General Demand falls faster than production
- Volume of Production will be reduced.
- The demand for the bank credit is at its lowest which results in idle funds.
- The interest rates are decline regime.

Some of the primary features of depression are as follows:

- An extremely low aggregate demand in the economy causes activity to slow down.
- Inflation is comparatively lower

- Employment avenues begin to close, forcing the unemployment rate to rise rapidly
- To keep the business running, production houses resort to forced labour cuts or retrenchment (to reduce production costs and remain competitive in the market), and so on.

Recovery:

- Depression phase done not continue indefinitely.
- Wages will be paid low.
- Prices are at the lowest, the consumers, who postponed their consumption expecting a still further fall in price, now start consuming.
- As demand increases, the stocks of goods become insufficient.

The recovery business cycle may exhibit the following major economic characteristics:

- An increase in aggregate demand, which must be accompanied by an increase in the level of production
- The production process expands and new investments become appealing
- As demand rises, inflation rises as well, making borrowing cheaper for investors As production rises, new employment avenues are created and the unemployment rate begins to fall and so on.

JAIIB IE & IFS Module B Unit 6: Monetary Policy and Fiscal Policy

Monetary Policy

Monetary Policy is the process by which the Government, Central Bank controls

- The money supply
- Availability of money
- Cost of money or rate of interest

In order to attain a set of objective oriented towards the growth and stability of the economy. Monetary policy is referred to as either being **expansionary policy or a contractionary policy.**

Expansionary policy

- An expansionary policy increases the total supply of money in the economy. This is used to combat unemployment in a recession by lowering interest rates.

Contractionary policy

- A contractionary policy decreases the total money supply. This is used to combat inflation by raising the interest rates.

Tools of Monetary policy:

- Bank Rate
- Cash Reserve Ratio
- Statutory Liquidity Ratio
- Market Stabilization Scheme
- Repo Rate
- Reverse Repo Rate
- Open Market Operations

- Marginal Standing Facility (MSF)
- Standing Deposit Facility (SDF)
- Base Rate
- Marginal Cost of Funds based Lending Rate (MCLR)
- External Benchmark Lending Rates (EBLR)

Bank Rate

- **Section 49 of the RBI act, 1934 is as follow**s: "**Publication of bank rate**. The Bank shall make public from time to time the standard rate at which, it is prepared to buy or re-discount bills of exchange or other commercial papers eligible for purchase under this Act." Simplistically put, it is the rate of interest paid by banks to RBI, on their long-term borrowings.
- **I**t is also referred as Discount rate, is the rate of interest which a central bank charges on the loans and advances that it extends to commercial banks and other financial intermediaries.

Bank Rate as an instrument of Monetary policy has been very limited in India because of these basic factors:

- The Structure of interest rates is not automatically linked to the bank rate
- Commercial banks enjoy specific refinance facilities, and not necessarily rediscount their eligible securities with RBI at Bank rate
- The bill market is under-developed and the different sub-markets of the money market are not influenced by the bank rate.

Marginal Standing Facility (MSF)

- It is a facility under which, scheduled commercial banks can borrow additional amount of overnight money from the **RBI, by dipping into their SLR portfolio**, up to a limit (currently two per cent of their NDTL outstanding at the end of the second preceding fortnight) at a penal rate of interest (**currently 25 basis point above the repo rate**).
- This provides a safety valve against unanticipated liquidity shocks to the banking system. MSF rate and reverse repo (presently SDF (Standing Deposit Facility Rate is the lower band of the LAF corridor) rate determine the corridor for the daily movement in short-term money market interest rates.

Different Between Bank Rate and MSF

BASIS FOR COMPARISON	BANK RATE	MSF RATE
Meaning	Bank Rate is a discount rate at which RBI grants long term loans to commercial banks.	MSF Rate is a rate at which the commercial banks borrow funds overnight from the central bank.

Eligibility	All commercial banks.	All Scheduled Commercial Banks (SCBs) having their current account and Subsidiary General Ledger (SGL) with an RBI.
Meant for	Long term Lending	Overnight Lending
Collateral	The loan can be raised without pledging the securities.	The loan is given against security within the limits of SLR and up to a certain percentage of NDTL.
Objective	To manage and control credit supply in the country.	To provide funds to the banks overnight, when they face an acute shortage of funds.

Cash Reserve Ratio (CRR):

- The present banking system is called a "**Fractional Reserve Banking System,** as the banks are required to keep only a fraction of their deposit liabilities in the form of liquid cash with the central bank for ensuring Safety and liquidity of deposits.
- **CRR was introduced in 1950** primarily as a measure to ensure safety and liquidity of bank deposits.
- This **minimum ratio** (that is the part of the total deposits to be held as cash) is **stipulated by the RBI and** is known as the CRR or Cash Reserve Ratio.
- **The 2006 amendment bill to the Reserve Bank of India Act** for providing flexibility to the RBI, in fixing the CRR removed the cap and the range of CRR between **3% and 20% of a bank's NDTL.**

Statutory Liquidity Ration (SLR):

- **SLR refers to the amount that all banks requires maintaining in cash or in the form of Gold or approved securities**. Approved securities mean dated securities, government bonds, and share of different companies.
- The SLR is determined as % of **Total Demand and Time Liabilities**
- **SLR defined by RBI as All Scheduled Commercial Banks**, in addition to the average daily balance which they are required to **maintain under Section 42 of the RBI Act, 1934**, are required to maintain in India, in cash, or in gold valued at a price not exceeding the current market price, or in unencumbered approved securities valued at a price as specified by the RBI from time to time.
- An amount of which shall not, at the close of ***the business on any day***, **be less than 18%** or such other percentage **not exceeding 40% as the RBI** may from time to time, by notification in gazette of India, specify, of the total of its demand

and time liabilities in India as on the last **Friday of the second preceding fortnight**.

- At present **(1st June 2022), all Scheduled Commercial Banks** are required to maintain a uniform **SLR of 18 per cent of the total of their demand and time liabilities in India as on the last Frida**y of the second preceding **fortnight which is stipulated under section 24 of the B.R. Act, 1949.**

Demand Liabilities

- Demand Liabilities' include all liabilities which are payable on demand and they include current deposits, demand liabilities portion of savings bank deposits, margins held against letters of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, outstanding Telegraphic Transfers (TTs), Mail Transfer (MTs), Demand Drafts (DDs), unclaimed deposits, credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand. Money at Call and Short Notice from outside the Banking System should be shown against liability to others.

Time Liabilities.

- Time Liabilities are those which are payable otherwise than on demand and they include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit if not payable on demand, deposits held as securities for advances which are not payable on demand and Gold Deposits.

Different between CRR and SLP

BASIS FOR COMPARISON	CRR	SLR
Meaning	CRR is the amount of money that the banks are obligated to park with the central bank, in the form of cash.	SLR is the amount of funds which the banks are required to maintain as liquid assets, i.e. cash, gold, approved securities. etc.
Regulates	Monetary stability in the country	Bank's leverage for credit expansion
Use	To drain out excess money out of the economic system.	To ensure the solvency of the commercial bank.
Maintenance with	Central Bank of India i.e. RBI	Bank itself
Form	Cash and cash equivalents	Liquid Assets

Return	Banks **don't earn any interest** as return on the money kept as CRR.	Banks usually **earn interest** as return on the funds kept as SLR.

Standing Deposit Facility (SDF)

- The **SDF allows banks to deposit money with the RBI on an overnight basis**. But the RBI has the option, should the need arise, to absorb liquidity for longer tenors under the SDF with proper pricing. The SDF scheme would be open to all participants in the liquidity adjustment facility (LAF). **In 2018, the amended Section 17 of the RBI Act** empowered the Reserve Bank to introduce the Standing Deposit Facility (SDF).

Note: Deposits under the **SDF is not considered as balances eligible for the maintenance of the CRR under Section 42 of the RBI Act, 1934**, but shall be an eligible asset **for maintenance of the SLR under Section 24 of the Banking Regulation Act, 1949.**

Market Stabilization Scheme:

- RBI introduced Market Stabilization Scheme after consulting GOI for mopping up liquidity of a more enduring nature. Under this scheme, the **GOI issue existing instrument, such as Treasury Bills/ and or dated securities** by way of auctions under the MSS, in addition to the normal borrowing requirements, for absorbing liquidity form the system.

Base Rate:

- The RBI has introduced the Base Rate system with **effect from July 1, 2010**, by replacing the Benchmark Prime Lending Rate (BPLR) system.
- **Base rate is defined as the minimum interest rate set by the RBI below which Indian banks are not permitted to lend to their customers.** Unless there is a government mandate, the RBI rule specifies that no bank may offer loans at an interest rate lower than the base rate.

Marginal Cost of Funds based Lending Rate (MCLR)

- **Marginal Cost of Funds based Lending Rate (MCLR) is the minimum lending rate below** which a bank is not permitted to lend. MCLR replaced the earlier base rate system to determine the lending rates for commercial banks.
- **RBI implemented MCLR on 1 April 2016** to determine rates of interests for loans.

External Benchmark Lending Rates (EBLR)

- Based on the recommendations of the Internal Study Group (ISG) to Review the Working of the **Marginal Cost of Funds Based Lending Rate (MCLR) System** headed by **Dr. Janak Raj**, that was formed by the RBI to examine various aspects of the MCLR system.

- It was noticed that internal benchmarks such as the Base rate/MCLR have not delivered effective transmission of monetary policy. As a result, the Study Group advised a time-bound transition to an external benchmark. The RBI has recommended banks to benchmark all new floating rate personal or retail loans (housing, vehicle, etc.)
- Foating rate loans to Micro and Small Enterprises extended by banks beginning **October 1, 2019**.

To one of the following;

- Reserve Bank of India policy repo rate
- Government of **India 3-Months Treasury Bill yield**, published by the Financial Benchmarks India Private Ltd (FBIL)
- Government of **India 6-Months Treasury Bill yield, published by the FBIL**
- Any other benchmark market interest rate, published by the FBIL.

Repo Rate:

- **Repo (Repurchase) rate is the rate at which RBI lends short-term money** to the banks. Bank lending rates are determined by the movement of Repo Rate.

Reverse repo: "Reverse repo" is an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.

Tri-party repo or TREPS : Tri-party repo or TREPS is a type of repo contract where a third entity (apart from the borrower and lender), called a tri-party agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.

Triparty repo was introduced on November 5, 2018. CBLO has been discontinued from November 2018.

Special long term repo operation (SLTRO)

The Reserve Bank of (RBI) will be conducting one special long term repo operation (SLTRO) for small finance banks (SFB) for **each month, totalling Rs 10,000 crore.**

About

- To provide further support to small business units, micro and small industries, and other unorganised sector entities adversely affected during the current wave of the pandemic, the RBI has decided to conduct **SLTRO of ₹10,000 crore at the repo rate for the SFBs, to be deployed for fresh lending of up to ₹10 lakh per borrower.**
- The SLTRO will be valid for three years. All SFBs will be eligible to participate in the scheme.

- The SFBs will have to ensure that the amount borrowed from the RBI should at all times be let to the specified segments, namely small business units and other unorganised sectors impacted by the pandemic.
- SLTROs will be conducted on CBS (E-KUBER) platform. The operations would be conducted at a fixed rate. Banks would be required to place their requests for the amount sought under SLTRO during the window timing at the prevailing policy repo rate. Bids below or above policy rate will be rejected.

Term Repo

- Since October 2013, the RBI has introduced term repos (of different tenors, such as, 7/14/28 days), to inject liquidity over a period that is longer than overnight.
- **The aim of term repo** is to help develop interbank money market, which in turn can set market-based benchmarks, for pricing of loans and deposits, and through that improve transmission of monetary policy.
- **During 2019, to ensure the smooth transmission** of monetary policy and flow of credit to the economy, **RBI introduced Long-Term Repo Operations (LTROs)** of one-year and three-year tenors. When longterm repo operations (LTROs) were introduced to facilitate monetary transmission and support credit offtake, RBI has also used another unconventional tool i.e., targeted long-term repo operations (TLTROs) to provide liquidity to specific sectors and entities experiencing liquidity stress.

Reverse Repo Rate:

- **Reverse Repo Rate** is the rate at which banks park their **short term excess liquidity with the RBI.** The RBI uses this tool when it feels there is too much money floating in the Banking System.

- An **Increase in Reverse Repo means** that the **RBI will borrow money from the Banks at a higher rate of interest**, so banks would prefer to keep their money with the RBI.

Variable Rate Reverse Repo (VRRR)

- The VRRR is usually undertaken to reduce the money flow by taking out existing cash present in the system. The central bank has been rebalancing the surplus liquidity in the system by shifting it out of the fixed-rate overnight reverse repo window to VRRR auctions of longer maturity.

Open Market Operations:

- Under this, RBI buys or sells government bonds in the secondary market. By absorbing bonds, it drives up bond yields and injects money into the market. When it sells the bonds, it done so to such the money out of the system.

Refinance Facilities:

RBI Provide Sector- specific refinance facilities aimed at achieving **sector specific objectives through provision of liquidity at a cost linked** to the policy repo rate.

Liquidity Adjustment facility (LAF):

- A LAF is a monetary policy tool used in India by the RBI through which it injects or absorbs liquidity into or from the banking system.
- It was introduced as a part of the outcome of the **Narasimham Committee on Banking Sector Reforms of 1998.**
- LAF has two components - repo (repurchase agreement) and reverse repo. When banks need liquidity to meet its daily requirement, they borrow from RBI through repo. The rate at which they borrow fund is called the repo rate. When banks are flush with fund, they park with RBI through the reverse repo mechanism at reverse repo rate.
- It can manage inflation in the economy by increasing and reducing the money supply.

RBI's monetary policy's objectives:

- Monitor the global and domestic economic conditions and respond swiftly as required.
- Ensure higher bank credit expansion to achieve higher growth but at the same time protect the credit quality
- Maintain price stability and financial stability
- Give thrust on Interest Rate Management, Inflation Management and Liquidity Management.

Reserve Bank's Monetary Policy

What is Monetary Policy Framework?

About:

- In May 2016, the **RBI Act was amended to provide a legislative mandate** to the central bank to operate the country's monetary policy framework.

Objective:

- The framework **aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation**, and modulation of liquidity conditions to anchor money market rates at or around the repo rate.
- **Reason for Repo Rate as Policy Rate:** Repo rate changes **transmit through the money market to the entire financial system**, which, in turn, influences aggregate demand.
- Thus, it is a key **determinant of inflation and growth.**

What is the Monetary Policy Committee?

- **Origin:** Under Section 45ZB of the amended (in 2016) RBI Act, 1934, the central government is **empowered to constitute a six-member Monetary Policy Committee** (MPC).

- **Objective**: Further, Section 45ZB lays down that "the Monetary Policy Committee shall determine the Policy Rate required to achieve the inflation target". The decision of the Monetary Policy Committee shall be binding on the Bank.
- **Composition:** Section 45ZB says the MPC shall **consist of 6 members:**
    - RBI Governor as its ex officio chairperson,
    - Deputy Governor in charge of monetary policy,
    - An officer of the Bank to be nominated by the Central Board,
    - Three persons to be appointed by the central government.

Note: This category of appointments must be from "persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy".

What are the Instruments of Monetary Policy?

- Repo Rate
- Standing Deposit Facility (SDF) Rate
- Marginal Standing Facility (MSF) Rate
- Liquidity Adjustment Facility (LAF)
- LAF Corridor
- Main Liquidity Management Tool
- Fine Tuning Operations
- Reverse Repo Rate
- Bank Rate
- Cash Reserve Ratio (CRR)
- Statutory Liquidity Ratio (SLR)
- Open Market Operations (OMOs)

What is an Expansionary Monetary Policy?

About:

- An expansionary monetary policy is **focused on expanding (increasing) the money supply** in an economy. This is also known as Easy Monetary Policy.
- It is implemented by **lowering key interest rates thus increasing market liquidity** (money supply). High market liquidity usually encourages more economic activity.
- When RBI adopts **Expansionary Monetary Policy,** it decreases **Policy Rates (Interest Rates) like Repo, Reverse Repo, MSF, Bank Rate etc.**

Implications:

- Causes an **increase in bond prices** and a reduction in interest rates.
- Lower interest rates lead to **higher levels of capital investment.**
- The lower interest rates **make domestic bonds less attractive**, so the demand for domestic bonds falls and the demand for foreign bonds rises.

- The **demand for domestic currency falls** and the demand for foreign currency rises, causing a decrease in the exchange rate. (The value of the domestic currency is now lower relative to foreign currencies)
- A lower **exchange rate causes exports to increase,** imports to decrease and the balance of trade to increase.

What is Contractionary Monetary Policy?

About:

- A contractionary monetary policy **is focused on contracting (decreasing) the money supply** in an economy. This is also known as **Tight Monetary Policy.**
- A contractionary monetary policy is implemented **by increasing key interest rates thus reducing market liquidity (money supply)**. Low market liquidity usually negatively affects production and consumption. This may also have a negative effect on economic growth.
- When RBI adopts a contractionary monetary policy, it increases Policy Rates (Interest Rates) like Repo, Reverse Repo, MSF, Bank Rate etc.

Implications:

- Contractionary monetary policy **causes a decrease in bond prices** and an increase in interest rates.
- Higher interest rates **lead to lower levels of capital investment.**
- The higher interest rates make domestic bonds more attractive, so the demand for domestic bonds rises and the demand for foreign bonds falls.
- The demand for domestic currency rises and the demand for foreign currency falls, causing an increase in the exchange rate. (The value of the domestic currency is now higher relative to foreign currencies)
- A **higher exchange rate causes exports to decrease**, imports to increase and the balance of trade to decrease.

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Fiscal Policy

- In economics and political science, **fiscal policy** is the **use of government revenue collection and expenditure to influence a country's economy**.

- Fiscal policy can be contrasted with the other main type of economic policy, monetary policy, which attempts to stabilize the economy by controlling interest rates and supply of money. **The two main instrument of fiscal policy are government spending and taxation**. Changes In the level and composition of taxation and government spending can have impact on the following variable in the economy**. J. M. Keynes was the first economist to propose a theory that linked fiscal policy and economic performance.**

- Aggregate demand and the level of economic activity
- The pattern of resources allocation
- The distribution of income

- Fiscal Policy is the use of government spending and revenue collection the economy. Fiscal Policy refers to the overall effect of the budget outcome on economic activity.

Taxation and its impact on the Economy

Taxes have a direct impact on people'sincome, influencing their levels of disposable income, expenditure on goods and services, consumption, and, ultimately, their standard of living.

- Taxes directly affect the savings of individuals, families, and firms, which affect investment in the economy—as investment affects output, influencing per capita income.
- Taxes impact the prices of goods and services because they alter production costs, which affect incentives and economic activity behaviour, among other things.

Objectives of Fiscal Policy in India

Primary objectives

- Promoting economic growth
- Maintaining price stability in the economy

Additional objectives

- Mobilizing resources
- Promoting allocative efficiency
- Reducing inequality in income and wealth
- Promoting private sector investment

FRMB Act

- **Fiscal Responsibility and Budget Management Act – 2003. Dr E A S Sharma Committee** January, 2000 recommended draft legislation on fiscal responsibility.

FRBM requirements are

- The Government to place before Parliament 3 statement each year along with Budgets, Covering Medium Term Fiscal Policy, Fiscal Policy Strategy and Macroeconomic Framework

- Center to reduce the fiscal deficit (Generally 3% of GDP) and more categorically to "Eliminate revenue deficit' by 31-03-2008. Government to set a ceiling on guarantee (0.5% o GDP)

- Act prohibits the Center form borrowing from the RBI, i.e. it bans 'Deficit financing' through money creation. The RBI is also barred from subscribing to primary issues of Central Government Securities.

- The Finance Minister is required to keep Parliament informed through quarterly review on the implementation, and to take corrective measure.
- The main theme of the FRBM Act is to reduce the dependence of the Government on borrowings and help to reduce the fiscal deficit in a phased manner.

The main objectives of the FRBM Act were

- To achieve long-term macro-economic stability, while generating budget surpluses
- To introduce prudential debt management
- To introduce transparent fiscal management systems in the country and
- To remove fiscal impediments and providing a medium-term framework for budgetary implementation.

N.K. Singh Committee on FRBM

Government of India appointed **a high-level committee to review the FRBM Act, 2003.** The committee submitted its report in January 2017. **Following are the important recommendations of the committee.**

- Debt should be used as the primary target for fiscal policy. **A debt-to-GDP ratio of 60% should be targeted with a 40% limit for the center and 20% limit for the states and the targets should be achieved by 2023.** To achieve the targeted debt-to-GDP ratio, the committee proposed yearly targets to progressively reduce the fiscal and revenue deficits, till 2023.
- An autonomous Fiscal Council must be created with a chairperson and two members appointed by the center. The role of the Council would include (i) preparing multi-year fiscal forecasts, (ii) recommending changes to the fiscal strategy, (iii) improving quality of fiscal data, (iv) advising the government if conditions exist to deviate from the fiscal target, and (v) advising the government to take corrective action for non-compliance with the Bill.
- The government may be allowed to deviate from the specified targets upon the advice of the Fiscal Council in the following circumstances: (i) considerations of national security, war, national calamities and collapse of agriculture, affecting output and incomes, (ii) structural reforms in the economy, resulting in fiscal implications, or (iii) decline in real output growth of at least 3% below the average of the previous four quarters. These deviations cannot be more than 0.5% of GDP, in a year.
- The 15th Finance Commission should be asked to recommend the debt trajectory for individual states. This should be based on their track record of fiscal prudence and health.
- Government cannot borrow from the RBI except when (i) the center has to meet a temporary shortfall in receipts, (ii) the RBI subscribes to government securities to finance any deviations from the specified targets, or (iii) the RBI purchases government securities from the secondary market.

JAIIB IE and IFS Module B Unit 7: System Of National Accounts And GDP Concepts

System of National Accounts (SNA)

The **System of National Accounts (SNA)** is a coherent, consistent, and integrated collection of **macroeconomic accounts, balance sheets, and tables that are based on a set of internationally agreed concepts, definitions, classifications**, and accounting principles. It provides a complete accounting framework, within which, economic data may be collected and presented in a way suitable for economic research, decision-making, and policymaking.

The System of National Accounts is an international standard system of national accounts, the **first international standard being published in 1953**. Handbooks have been released for the **1968 revision, the 1993 revision, and the 2008 revision.**

SNA Framework 2008

The three major components influencing the present revision exercise include;

- Revision of base year to a more recent year (for meaningful analysis of structural changes in the economy in real terms)
- Complete review of the existing data base and methodology employed, in the estimation of various macro-economic aggregates, including choice of the alternative databases on individual subjects
- To the extent feasible, implementing the international guidelines on the compilation of national accounts, the System of National Accounts (SNA), 2008 prepared under the auspices of the Inter Secretariat Working Group on National Accounts comprising of the European Communities (EUROSTAT), International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), United Nations and the World Bank.

India & System of National Accounts (SNA), 2008

The CSO issued fresh and amended National Accounts data in January 2015, resulting in two changes:

- The Base Year has been changed from 2004–05 to 2011–12. This was done, in compliance with the National Statistical Commission's (NSC) proposal to change the base year of all economic indicators, every five years.
- The technique for calculating the National Accounts has also been revised this time, to meet the standards of the System of National Accounts (SNA)-2008, an internationally recognised standard.

The major changes incorporated in the revision of SNA 2008 are as follows:

- The headline growth rate will henceforth be measured by GDP at constant market prices, which will be referred to as 'GDP' from here on (as is the practice internationally). Previously, growth was assessed in terms of GDP growth rate, at factor cost and constant prices.
- Estimates of Gross Value Added (GVA) each sector will now be provided, at basic prices rather than factor cost.
- Comprehensive coverage of the corporate sector in both manufacturing and services by inclusion of annual accounts submitted with the Ministry of Corporate Affairs (MCA), as part of their MCA21 e-governance project. The use of the MCA21 database by manufacturing enterprises has aided in accounting for non-manufacturing activities done by these companies.
- Inclusion of information from the accounts of stockbrokers, stock exchanges, asset management companies, mutual funds, and pension funds, as well as regulatory bodies such as the Securities and Exchange Board of India (SEBI), Pension Fund Regulatory and Development Authority (PFRDA), and Insurance Regulatory and Development Authority (IRDA), provides comprehensive coverage of the financial sector.
- Coverage of operations of local bodies and autonomous institutions has been improved, with around 60% of grants/transfers paid to these organisations covered.

Choice of 2011-12 as the Base Year

The **Ministry of Statistics and Programme Implementation (MOSPI)** is considering changing of **base year** for GDP calculation from **2011-12 to 2017-18.**

Base Year

- The base year of the national accounts is chosen to enable inter-year comparisons. It gives an idea about changes in purchasing power and allows calculation of inflation-adjusted growth estimates.
- The last series has changed the **base to 2011-12 from 2004-05.**

Need for Change

- **Accuracy:** Change of base year to calculate GDP is done in line with the global exercise to **capture economic information accurately.**
- **Globally Aligned:** GDP based on 2011-12 did not reflect the current economic situation correctly. The new series will be in compliance with the **United Nations guidelines in System of National Accounts-2008.**
    - Ideally, the base year should be changed after every five years to capture the changing economy.

GDP Concepts

- **Gross Domestic Product (GDP):** It is the total market value of all the final goods and services produced within the territorial boundary of a country, using domestic resources, during a given period of time, usually 1 year.
- **Gross national Income at Market Price =** GDP at Market Price + Taxes less subsidies on production and imports (net receivable from abroad + Compensation of Employees (Net Receivables from abroad) + Property income (Net receivables from abroad)
- **Gross National Product (GNP) =** GDP + Total Capital gains from overseas investment (-) income earned by foreign nationals domestically

GNP= GDP+NR (Net Income from assets abroad (Net Income Receipts))

GDP Computation

According to the National Income Accounting, there are **three ways to complete GDP:**

- Expenditure wise
- Income wise
- Product wise

Expenditure Method

GDP= Consumption + Gross Investment + Government Spending + (Exports- Imports)
GDP = C+I+G+(X-M)

- **Consumption:** This included personal expenditures pertaining to food, households, medical expenses, rent, etc
- **Gross Investment** : Business Investment as capital which includes construction of a new mine, purchase of machinery and equipments for a factory, purchase of software, expenditure on new houses, buying goods and services but investments on financial products is not included as it falls under savings.
- **Government spending**: It is the sum of government expenditures on final goods and services.

i)Exports: This includes all goods and services produced for overseas consumptions.

ii)Imports: This includes any goods or services imported for consumption and it should be deducted to prevent from calculating foreign supply as domestic supply.

Income Approach

GDP from the income is the sum of the following major components:

i)Compensation of employees

ii)Property income

iii)Production taxes and depreciation on capital

- **Compensation of Employees**: It represents wages, salaries and other employee supplements.
- **Property Income:** It constitutes corporate profits, proprietor's income, interests and rents.
- **GDP at market price** measures the value of output at market prices after adjusting for the effect of indirect taxes and subsidies on the prices. Market price is the economic price for **which a good or service is offered in the market place.**
- **GDP at factor cost** measures the value of **output in terms of the price of factors used in its production.**
- GDP at factor cost = **GDP at Market Price – (Indirect taxes – Subsidies)**

Product Approach

In India we have getting **GDP product wise belongs to 8 sectors.**

- **Real GDP or GDP at constant price**: It means the value of today's output at yesterday price. Real GDP is calculated by tracking the volume or quantity of production after removing the influence of changing prices or inflation.
- **Normal GDP or GDP at Current prices**: It represents the total money value of final goods and services produced in a given year, where the values are expressed in terms of the market prices of each year.
- **Factors of production are** : Land, Labour, Capital and Entrepreneur

Basic Concept of National Income

Net Domestic Product (NDP):

- **NDP=** GDP- Depreciation
- **GDP=** NDP **+** Depreciation

Gross National Product (GNP):

- **GNP=** GDP+ NFIA (Net factor income from aborad)
- **GDP=** GNP- NFIA

Net National Product (NNP):

- **NNP=** GNP- Depreciation

Net Domestic Product (NDP):

- **NDP=** NNP – NFIA
- **NNP=** NDP + NFIA

Economic performance Indicators

Indicators	Interpretation

GDP growth rate	The performance of the economy
GDP per capita	The level of economic development in comparison to other countries
Compensation of employees per work hour	Labour cost
Compensation of employees/gross value added	Income shares of employees in GDP
Operating surplus/ gross value added	Income shares of capital in GDP
Gross fixed capital formation/GDP	Share of investment in capital goods in GDP
Saving/GDP	Saving rate of the nation
Saving/gross fixed capital formation	Domestic funding of investment
Saving of an institutional sector/ total saving	Contribution of each sector to total saving
Saving of households/ disposable income of households	Saving rate of households

Important Variants Of National Product Aggregates

Gross Domestic Productrefersto the value of the final goods and services produced, within the geographical borders of an economy. It does not differentiate between the owners of the factors of production. On the other hand, Gross National Product measures the value of the final goods and services produced by the nationals of an economy, regardless of where the production takes place. The only restriction is that it should be produced by the domestic factors of production.

The possible variants of national product aggregates are as given below:

- Gross Domestic Product (GDP) at MP – net indirect taxes = GDP at FC
- Gross National Product (GNP) at MP – net indirect taxes = GNP at FC
- Net Domestic Product (NDP) at MP – net indirect taxes = NDP at FC
- Net National Product (NNP) at MP – net indirect taxes = NNP at FC

NDP at Factor Cost and NDP at Market Price

Net Domestic Product at Factor cost (NDPfc): It refers to the total value of earnings received by all the factors of production in the form of wages, profits, rent, interest, etc. within the domestic territory of a country during a year. NDP at Factor cost includes cost of Compensation of Employees + Operating Surplus + Mixed income.

Net Domestic Product at Market Price (NDPmp): It refers to the market value of all the final goods and services produced within the domestic territory of a country during a year. For a stable economy the NDP at Factor cost and NDP at Market price must be equal.

- **NDPfc =** NDPmp – Indirect taxes + Subsidies
- **NDPmp** = NDPfc + Indirect taxes – Subsidies

Personal Income: It is the income actually received by the individuals or households in a country during one accounting year, but undistributed profits of enterprises and taxes are deducted from private income as they are not distributed.

Personal income = Private Income – Undistributed profits – Corporate Profits – Retained earnings of Foreign companies – Taxes

Private Income: Private Income = National Income – Income from Property, Entrepreneurship, commercial and administrative enterprises – savings of non-departmental enterprise of the Government + Interest on National Debt + Net current transfers from Government + Current Transfers from Abroad

Personal Disposable Income (PDI): Portion of Income from Personal Income that is available for Individuals for actual consumption.

PDI = Personal Income – Personal Taxes – Direct Taxes – Fines, fees, receipts of Govt.

Other: Real Income – National income expressed in terms of general level of prices.
Real NNP = NNP for the Current Year × (Base Year Index/Current Year Index)
Operating Surplus = Rent Interest + Profit + Dividend and Other similar income.

Mixed Income = Labour Income + Property Income

Net Indirect Taxes = Indirect taxes + Subsidies

Some useful National Income Aggregates

- National Income – NNPfc or NIfc = NImp – Indirect taxes + subsidies
- NIfc = NImp – Net Indirect Taxes
- GDPmp = GNPmp – NFIA
- GDPfc = GDPmp – Net Indirect Taxes
- NDPmp = GDPmp – Depreciation
- NIfc or NNPmp = GNPmp – Depreciation
- Gross National Disposable Income (GNDI) = GNPmp + Net Current transfers from rest of the world
- Net National Disposable Income (NNDI) = NINPmp + Net Current Transfers from rest of the world
- To get from GDP to NDP deduct (–) Depreciation)
- To get from NDPmp to NDPfc deduct (–) net indirect taxes
- To get from GDPmp to GNPmp deduct (–) Net Factor Income from Abroad On 23rd May 2019, the Indian government passed the order to merge the NSSO with the Central Statistics Office (CSO) to form the National Statistical Office (NSO) and is headed by the Ministry of Statistics and Programme Implementation (MoSPI).

JAIIB IE & IFS Module B Unit 8: Union Budget

Union Budget

The annual budget of the country is called the Union Budget.

- Revenue Concept
- Expenditure Concept
- Deficit Concept

Receipts

Revenue Receipts

Tax Revenue

Gross Tax Revenue

- Corporation tax
- Income tax
- Other Taxes & Duties
- Customs
- Union Excise Duties
- Service Tax
- Taxes of the Union Territories

Net Tax Revenue = Gross Tax Revenue (-) NCCD transferred to the National Calamity Contingency fund (-) States' share

Total Non- Tax Revenue

- Interest Receipts
- Dividend and Profits
- External Grants
- Other Non-Tax Revenue
- Receipts of Union Territories

Total Revenue Receipts = Net Tax Revenue + Total Non- Tax revenue

Capital Receipts = Non- debt receipts + Debt Receipts

Non- debt Receipt

- Recoveries of loans & Advances
- Miscellaneous Capital receipts

Debt Receipts

- Market Loans
- Short Term Borrowings
- External Assistant (Net)
- Securities issued against small saving
- State provident funds (Net)
- Other Receipts (Net)

Expenditure

Non- Plan Expenditure

Non- Plan Expenditure = Revenue Non- Plan Expenditure + Capital Non-plan Expenditure

Revenue Expenditure

- Interest Payments and Prepayment Premium
- Defence
- Subsidies
- Grants to state and U.T govt.
- Pension
- Police
- Assistance of states from national calamity contingency fund
- Economic Services (Agri, Industry, Power, Transport, technology etc)
- Social Services (Education, health, broadcasting etc)
- Postal Deficit
- Grants to foreign govt.

Capital Expenditure

- Defence
- Other Non-plan capital Outlay
- Loans to Public Enterprises
- Loan to state and U.T govt.
- Loans to foreign govt.

Plan Expenditure

Revenue Expenditure

- Central Plan
- Central Assistance for State & U.T Plans

Capital Expenditure

1.Central Plan

2.Central Assistance for State & Union Territory Plans

- **Plan Expenditure** = Revenue Expenditure + Capital Expenditure
- **Total Expenditure** = Total Non-plan Expenditure + Total Plan Expenditure

Deficit Concepts

- **Revenue Deficit** is the excess of revenue expenditure over revenue receipts.
- **Financing of Fiscal Deficit**: Debt Receipts + Draw-down of cash balance
- **Gross Fiscal Deficit** is the excess of total expenditure including loans, net of recoveries over revenue receipts (including external grants) and non- debt receipts
- **Net Fiscal deficit** = The gross fiscal deficit (-) interest payments
- **Net Primary deficit** = Net fiscal deficit (–) net interest payments
- **NCCD:** National Council on Crime and Delinquency.

JAIIB IE and IFS Module C: Indian Financial Architecture

Index

No. of Unit	Unit Name
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Unit 6	Non-Banking Financial Companies (NBFCs)
Unit 7	Insurance Companies

Unit 8	**Indian Financial System — Regulators and Their Roles**
Unit 9	**Reforms & Developments in the Banking Sector**

JAIIB IE and IFS Module C Unit 1: Indian Financial System

Financial System

- For the growth of any economy, capital formation is essential.
- Capital is the source of funds with which, an entrepreneur is able to take the risk of setting up and operating a business enterprise
- The capital is available, instead, with persons with wealth who have savings. These persons with wealth, howsoever little it may, needs to be able to make the wealth available with the entrepreneurs, who can invest the savings made available to them.
- Examples of wealth possessors are individuals, firms, corporates and government.
- These entities are also those who require finance for producing goods and services, in the role of entrepreneur and businesses.
- Wealth must, therefore, flow from pockets of surplus to pockets of deficit.
- It is for that purpose the financial and banking systems are required.

Types Of Financial Systems

In all economies, financial systems are of two basic types

- Informal System
- Formal System

Informal Financial System

Evolved: As an extension of the social structure and

Characteristics:

- lack of regulations,
- low transaction cost,
- Unstructured procedures,
- No transparency and
- low default rates.

Typical examples components:

- Individual money lenders who could be traders, relatives, neighbours, etc.

- Groups of persons who could be operating as associations and funds
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.
- **Although informal and unregulated, this section of financial system has its own importance, especially in the earlier days and in rural and lesser developed geographies.**

Formal Financial System

Characteristics:

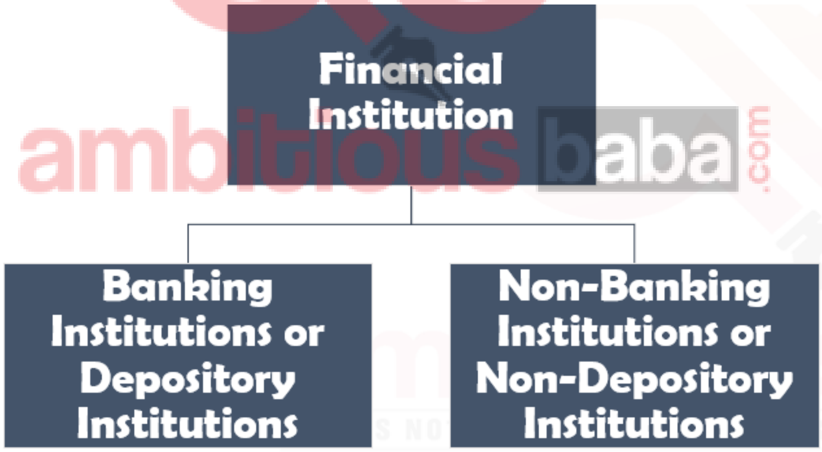
- Presence of an organised, institutional and regulated system, which caters to the financial needs of the modern spheres of economy.
- Forms the backbone of any economy and one of the most important systems in the growth of any nation.

Components:

- The financial institutions,
- Financial instruments
- Financial markets.

Financial Institutions

While on one hand, cater to the entities who possess wealth, on the other hand, they cater to those entrepreneurs and businesses who require the wealth in the form of capital, for their investments.



Examples

- Financial Regulators
- Commercial and Cooperative Banks
- Non-Banking Financial Companies (NBFCs)
- Development Financial Institutions (DFIs)
- Insurance companies
- Insurance brokers

- Mutual Funds
- Pension Funds The financial institutions

Banking Institutions or Depository Institutions –

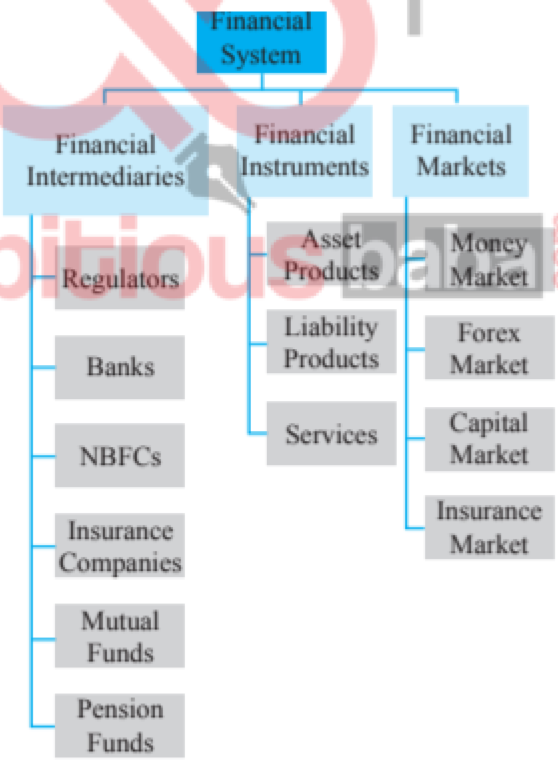
- This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need.

Non-Banking Institutions or Non-Depository Institutions –

- Insurance, mutual funds and brokerage companies fall under this category.
- They cannot ask for monetary deposits but sell financial products to their customers.

Further, Financial Institutions can be classified into three categories:

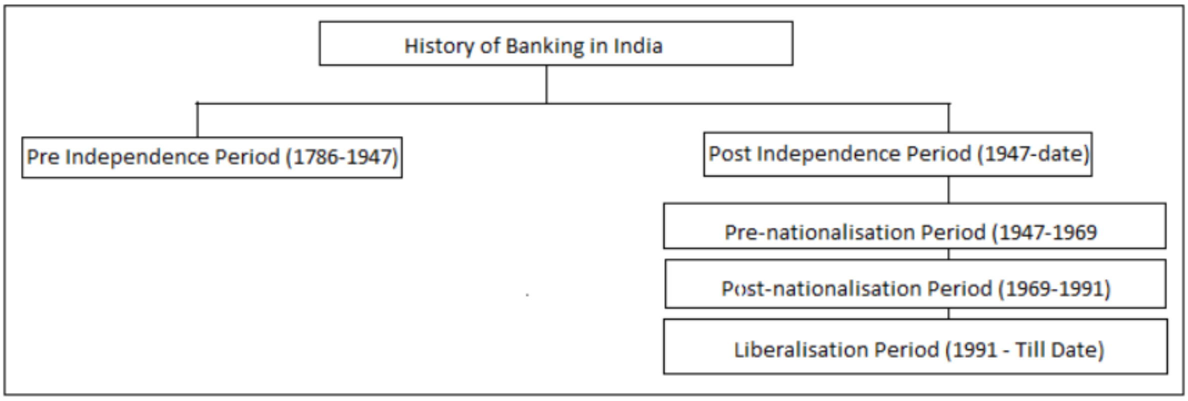
- **Regulatory –** Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.
- **Intermediates –** Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.
- **Non Intermediates –** Institutions that provide financial aid to corporate **customers.**
- It includes NABARD, SIBDI, etc.



History Of Banking In India

The banking sector development can be divided into three phases:

- **Phase I:** The Early Phase which lasted from 1770 to 1969
- **Phase II:** The Nationalisation Phase which lasted from 1969 to 1991
- **Phase III:** The Liberalisation or the Banking Sector Reforms Phase which began in 1991 and continues to flourish till date



Pre Independence Period (1786-1947)

The first bank of India was the "***Bank of Hindustan***", established **in 1770** and located in the then Indian capital, Calcutta. However, this bank failed to work and **ceased operations in 1832.**

During the Pre Independence period over 600 banks had been registered in the country, but only a few managed to survive.

Following the path of Bank of Hindustan, various other banks were established in India. They were:

- The General Bank of India (1786-1791)
- Oudh Commercial Bank (1881-1958)
- Bank of Bengal (1809)
- Bank of Bombay (1840)
- Bank of Madras (1843)

During the British rule in India, The East India Company had established three banks: Bank of Bengal, Bank of Bombay and Bank of Madras and called them the Presidential Banks. **These three banks were later merged into one single bank in 1921**, which was called the "***Imperial Bank of India.***"

The Imperial Bank of India was later nationalised in 1955 and was named The State Bank of India, which is currently the largest Public sector Bank.

Indepence Banks in India	
Bank Name	**Year of Establishment**
Allahabad Bank	1865
Punjab National Bank	1894
Bank of India	1906
Central Bank of India	1911
Canara Bank	1906

Bank of Baroda	1908

Post Independence Period (1947-1991)

- At the time when India got independence, all the major banks of the country were led privately which was a cause of concern as the people belonging to rural areas were still dependent on money lenders for financial assistance.
- With an aim to solve this problem, the then Government decided to nationalise the Banks. These banks were nationalised under the **Banking Regulation Act, 1949.** Whereas, the **Reserve Bank of India was nationalised in 1949.**

Candidates can check the list of Banking sector reforms and Acts at the linked article.

- Following it was the formation of **State Bank of India in 1955 and the other 14 banks were nationalised** between the time duration of **1969 to 1991**. These were the banks whose national deposits were more than 50 crores.

Given below is the list of these 14 Banks nationalised in 1969:

1.Allahabad Bank

2.Bank of India

3.Bank of Baroda

4.Bank of Maharashtra

5.Central Bank of India

6.Canara Bank

7.Dena Bank

8.Indian Overseas Bank

9.Indian Bank

10.Punjab National Bank

11.Syndicate Bank

12.Union Bank of India

13.United Bank

14.UCO Bank

In the year 1980, another 6 banks were nationalised, taking the number to 20 banks. These banks included:

- Andhra Bank
- Corporation Bank
- New Bank of India
- Oriental Bank of Comm.
- Punjab & Sind Bank
- Vijaya Bank

Apart from the above mentioned 20 banks, there were seven subsidiaries of SBI which were nationalised in 1959:

- State Bank of Patiala
- State Bank of Hyderabad
- State Bank of Bikaner & Jaipur
- State Bank of Mysore
- State Bank of Travancore
- State Bank of Saurashtra
- State Bank of Indore

All these banks were later merged with the State Bank of India in 2017, except for the State Bank of Saurashtra, which merged in 2008 and State Bank of Indore, which merged in 2010.

Note: The Regional Rural Banks in India were established in the year 1975 for the development of rural areas in India.

Liberalisation Period (1991-Till Date)

Once the banks were established in the country, regular monitoring and regulations need to be followed to continue the profits provided by the banking sector. The last phase or the ongoing phase of the banking sector development plays a hugely significant role.

To provide stability and profitability to the Nationalised Public sector Banks, the Government decided to set up a committee under the leadership of **Shri. M Narasimham** to manage the various reforms in the Indian banking industry.

The biggest development was the introduction of Private sector banks in India. RBI gave license to 10 Private sector banks to establish themselves in the country. **These banks included:**

- Global Trust Bank
- ICICI Bank
- HDFC Bank
- Axis Bank
- Bank of Punjab
- IndusInd Bank
- Centurion Bank
- IDBI Bank
- Times Bank
- Development Credit Bank

The Firsts In Indian Banking System:

- First bank in India was Bank of Hindustan (1770)
- First Bank managed by Indians was Oudh Commercial Bank
- First Bank with Indian Capital was Punjab National Bank (Founder of the Bank is Lala Lajpat Rai)
- First Foreign Bank in India is HSBC
- First bank to get ISO certificate is Canara Bank
- First Indian bank outside India is Bank of India
- First Bank to introduce ATM is HSBC (1987, Mumbai)
- First Bank to have a joint-stock public bank (Oldest) is Allahabad Bank
- First Universal bank is ICICI (Industrial Credit and Investment Corporation of India)
- First bank to introduce saving account is Presidency Bank (1833)
- First Bank to Introduce Cheque system is Bengal Bank (1833)
- First bank to give internet banking facility is ICICI
- First bank to sell mutual funds is State Bank of India
- First bank to issue credit cards is Central Bank of India
- First Digital Bank is Digibank
- First Rural Regional Bank (Grameen Bank) is Prathama Bank (sponsored by Syndicate Bank)
- First bank to get 'in principle' banking license is IDFC and Bandhan Bank
- First Bank to introduce merchant banking in India is Grind lays bank
- First bank to introduce blockchain technology is ICICI
- First bank to introduce voice biometric is Citi Bank
- First bank to introduce robot in banking service is HDFC

Important Legislations Affecting Establishment Of Banks

Important legislations affecting the establishment of banking institutions are the following:

- The Reserve Bank of India Act, 1934
- The Banking Regulation Act, 1949
- The State Bank of India Act, 1955
- The State Bank of India (Subsidiary Banks) Act, 1959
- The Deposit Insurance and Credit Guarantee Corporation Act, 1961
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- The State Banks (Repeal and Amendment) Act, 2018

Narasimham Committee – I (1991)

The recommendations of the Narasimham Committee – I were as follows:

- Establishment of a 4-tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at the top and, at the bottom, rural banks engaged in agricultural activities.
- The supervisory functions over banks and financial institutions to be assigned to a quasi-autonomous body sponsored by RBI.
- A phased reduction in Statutory Liquidity Ratio.
- Phased achievement of 8% Capital Adequacy Ratio.
- Abolition of branch licensing policy.
- Proper classification of assets and full disclosure of accounts of banks and financial institutions.
- Deregulation of interest rates.
- Setting up an Asset Reconstruction Fund to take over a portion of the stressed asset loan portfolio of banks.

Based on the above-listed recommendations of the Narasimham Committee -I, the government implemented the following measures:

Lowering SLR and CRR:

- The high SLR and CRR reduced the profits of the banks.
- This measure has resulted in increase in loanable funds with banking system for allocation to agriculture, industry, trade, etc.

Prudential Norms:

- Introduced by RBI, in order to impart professionalism in commercial banks.

Capital Adequacy Norms:

- Ratio of minimum capital to risk
- Weighted assets.
- In April 1992, RBI fixed CAR at 8%, and by March 1996, all public sector banks had attained the ratio of 8%.

Deregulation of Interest Rates:

- The Narasimham Committee advocated that the interest rates should be allowed to be determined by the market forces.
- Since 1992, interest rates were freed, in stages, both for deposits as well as for advances

Recovery of Debts:

- GOI passed the "Recovery of Debts due to Banks and Financial Institutions Act 1993" in order to facilitate and speed up the recovery of debts due to banks and financial institutions, and six Special Debt Recovery Tribunals were set up.

Competition from New Private Sector Banks:

- Banking was opened to the private sector and new private sector banks were licensed and started functioning.

- These new private sector banks are allowed to raise capital contribution from foreign institutional investors up to 20% and from NRIs up to 40%. Freeing of the banking space to private banks, led to increased competition.

Access to Capital Market:

- The Banking Companies (Acquisition and Transfer of Undertakings) Act was amended, in order to enable the banks raise capital through public issues.
- This was, subject to the provision that the holding of Central Government would not fall below 51% of paid-up capital.

Freedom of Operation:

- Scheduled Commercial Banks are given freedom to open new branches and upgrade their extension counters, after attaining the required capital adequacy ratio and adhering to the prudential accounting norms.
- The banks are also permitted to close non-viable branches, in centres other than those in rural areas.

Local Area Banks (LABs):

- In 1966, RBI had issued guidelines for setting up Local Area Banks, and it gave its approval for setting up 7 LABs in the private sector.
- LABs were instrumental in mobilizing rural savings and in channelling them into investments, in the designated local areas.

Supervision of Commercial Banks:

- The RBI had set up a Board for Financial Supervision (BFS) with an Advisory Council to strengthen the supervision of banks and financial institutions.
- In 1993, RBI established a new department known as Department of Supervision, as an independent unit for supervision of commercial banks.

Narasimham Committee – II (1998)

- In 1998, the government appointed yet another committee under the chairmanship of Shri Narasimham.
- Known as the Committee on Banking,
- To review the progress in banking reforms and to recommend a path, for further strengthening the financial system in India.
- submitted its report to the government in April 1998, with the following recommendations.

Strengthening of Banks in India:

- The committee considered a stronger banking system, in the context of the Current Account Convertibility.

- It postulated that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of the convertibility.
- Recommended the MERGER OF STRONG BANKS which could have a 'multiplier effect' on the industry.

Narrow Banking:

- In those days, problems of high non-performing assets (NPAs). Some of them had gross NPAs that were as high as 20% of their assets. Thus, for successful rehabilitation of these banks, it recommended the '**Narrow Banking Concept'**

Capital Adequacy Ratio:

- Committee recommended that the Government should raise the prescribed minimum capital adequacy norms to 9%. This would further improve their loss absorption capacity also.

Bank ownership:

- The committee opined that government control over the banks in the form of management and ownership and bank autonomy did not go hand in hand and thus, it recommended a review of the functioning of Boards of Banks so as to enable them to adopt professional corporate strategies.

Review of banking laws:

- The committee considered that there was an urgent need for reviewing and amending major laws governing the Banking Industry like R**BI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc.** These modifications would bring them in line with the obtaining needs of the banking sector in India.

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JAIIB IE and IFS Module C Unit 2: Indian Banking Structure

Banking

What Is Banking?

- Banking is classically defined in the **Banking Regulations Act, 1949 (BR Act).** As per **Section 5(1) (b) of the BR Act, banking is 'the accepting**, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.'
- **Section 5(l)(c), further defines** a banking company as any company which transacts the business of banking in India. **Section 6 of the BR Act defines**, in detail, the types of activities that banks are authorised to carry out, although under modern day banking, banks have embraced many other types of activities, too. The traditional types of businesses that banks.

- Another important aspect on banking in India is that, **in terms of Section 7 (1)** of the **BR Act,** 'No company other than a banking company shall use as part of its name any of the words "**bank", "banker" or "banking**" and no company shall carry on the business of banking in India, unless it uses as part of its name at least one of such words.'
- Further, **Section 7(2) states 'No firm**, individual or group of individuals shall, for the purpose of carrying on any business, use as part of its or his name any of the words **"bank", "banking" or "banking company".'**

Important Legislations Affecting Establishment Of Banks

Important legislations affecting the establishment of banking institutions are the following:

- The Reserve Bank of India Act, 1934
- The Banking Regulation Act, 1949
- The State Bank of India Act, 1955
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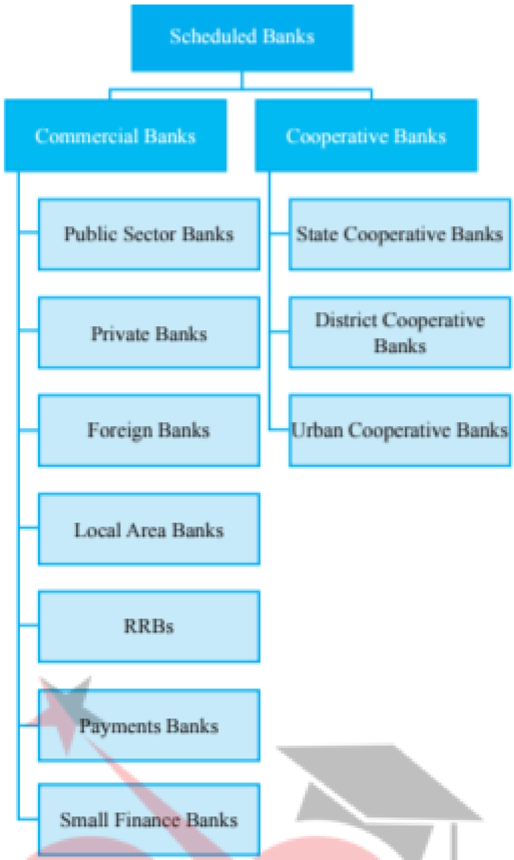
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- The State Banks (Repeal and Amendment) Act, 2018

Types Of Banks

Scheduled Banks?

- By definition, any bank which is listed in the **2nd schedule of the Reserve Bank of India Act, 1934 is considered a scheduled bank.**
- The Schedule consists of those banks which satisfy various parameters, criteria **under clause 42 of this act.**
- The list includes the State Bank of India and its subsidiaries (like State Bank of Travancore), all nationalised banks (Bank of Baroda, Bank of India etc), regional rural banks (RRBs), foreign banks (HSBC Holdings Plc, Citibank NA) and some co-operative banks.
- These also include private sector banks, both classified as old (Karur Vysya Bank) and new (HDFC Bank Ltd).
- To qualify as a scheduled bank, the **paid-up capital and collected funds of the bank must not be less than Rs5 lakh.**
- Scheduled banks are eligible for loans from the Reserve Bank of India at bank rate, and are given membership to clearing-houses.



Non-Scheduled Banks?

- Non-scheduled banks by definition are those which are **not listed in the 2nd schedule of the RBI act, 1934.**
- They don't conform to all the **criteria under clause 42,** but dully follow specific guidelines as laid down by RBI.
- Banks with a **reserve capital of less than 5 lakh** rupees qualify as non-scheduled banks.
- The minimum capital requirement of non-scheduled banks is governed by Section 11 (1) of the Banking Regulation Act, 1949, whereas the capital requirement of the scheduled banks are governed by Section 42(6) of the Reserve Bank of India Act, 1934; the non- scheduled banks are not eligible to effect borrowing from RBI for their normal operations.
- Unlike scheduled banks, they are not entitled to borrow from the RBI for normal banking purposes, except, in an emergency or abnormal circumstances.
- Bangalore City Co-operative Bank Ltd. Bangalore, Baroda City Co-op. Bank Limited are a few examples

Commercial Banks

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

- Commercial banks operate on a 'for-profit' basis.
- They primarily engage in the acceptance of deposits and extend loans to the public, businesses and the government.
- Nowadays, some commercial banks are also providing housing loans on a long-term basis to individuals.

Types of Commercial Banks

Commercial banks are of three types-

- Public sector Banks
- Private sector Banks
- Foreign Banks.

Public Sector Banks

- Public Sector Banks (PSBs) are banks where a common stake (**i.e. more than 50%) is held by a government.**
- The shares of these banks are listed on stock exchanges.
- Example- State Bank of India, Corporation Bank, Bank of Baroda, Punjab National Bank, Canara Bank, Bank of India.

Private Sectors Banks

- In the case of private sector banks, the majority of the share capital of the Bank is held by private individuals.
- These Banks are registered as companies with limited liability.
- Example- ICICI Bank Ltd, ING Vysya Bank.

Pursuant to the guidelines issued in **January 1993, the old private sector** banks having **net worth of less than Rs 50 crore** were advised to attain the level **of Rs 50 crore by March 31, 2001,** and prepare action plans for augmenting capital funds to the **level of Rs100 crore.** The minimum capital requirement for **Private Sector Banks was thereafter raised to the present requirement of Rs 500 crores**. Some of the guidelines presently in force for setting up Universal banks in the Private Sector space (as against Differentiated Banks like Payments Banks and Small Finance Banks) are listed here:

- Initial minimum paid **up capital of Rs 500 crores**.
- The bank should maintain **a minimum net worth of Rs 500 crores**, at all times.
- Resident individuals having 10 years' experience in banking and finance would also be eligible to establish such banks.
- Large industrial houses are not eligible to set up banks, but can invest up to 10% in the banks.
- Foreign shareholding limit would be as per FDI guidelines of Government of India (presently maximum of 74%).
- The business plan submitted by the applicant should be viable and bring out how the bank intends to achieve financial inclusion.
- The bank should have its shares listed on the Stock Exchange, within a period of 6 years, from the time it commences its business.
- The bank should open at least 25% of its branches in unbanked rural areas. • The bank should achieve its priority sector targets and sub-targets, as applicable to scheduled commercial banks.

Foreign Banks

- These banks are registered and have their headquarters in a foreign country but operate their branches in our country.
- Some foreign banks operating in our country are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank, Standard & Chartered Bank.
- The number of foreign banks operating in our country has increased since the financial sector reforms of 1991.

The factors which are considered, while granting approval to a foreign bank for operating in India are:

- Economic and political linkages of India with the home country of the foreign bank
- Reciprocity of trade and other business with the home country of the foreign bank
- Financial soundness of the applicant foreign bank
- Ownership pattern of the applicant bank
- International/ home country ranking and rating of applicant bank
- International presence of the applicant bank
- Adequate risk management & control systems of the applicant bank.

The capital requirements of the applicant bank are as follows:

- Minimum paid up capital of Rs 500 crore
- Capital to be brought in upfront capital, by remittance from the parent bank
- The applicant must comply with Basel- III requirements, on a continuous basis
- Minimum CRAR should not be less than 10% for initial three years
- The WOS can raise non-equity rupee resources like domestic banks in India
- Core management functions of the foreign applicant bank cannot be outsourced including to group entities, either in India or overseas.

Local Area Banks

Local Area Banks were set up, as per **Government of India's Scheme announced in August 1996.** The intention of the government was to set up new private local banks, with jurisdiction over two or three contiguous districts. The objective of establishing the local area banks was to enable to mobilization of the rural savings by local institutions and making them available for investments in local areas.

The key features of the local area banks are as under:

- Each local Area bank is registered as a public limited company, under the Companies Act. However, they are licensed under the **Banking Regulation Act, 1949.**
- The Local Area Banks are non-scheduled banks.
- Local Area Banks have jurisdiction over a maximum of three contiguous districts, and their basic function is to mobilise funds in rural and semi-urban areas.
- The minimum start-up capital of an **LAB was fixed at Rs.5 crores and the** promoters were directed to bring entire minimum share capital, up-front. The promoters could be individuals, firms or societies. The family of the individual promoters was not allowed to keep more than 40% of the equity capital of the banks, and NRI promoters could not exceed more than 20% of total number of promoters.
- The Local Area banks are subject to prudential norms, accounting policies and other policies, as stipulated by the RBI.
- Each Local Area Bank is allowed to open branch in only one urban centre per District and rest of the branches were required to be opened in the rural and semi urban centres, subject to requisite clearance in respect of rural branches from the District Consultative Committee.

The functions of Local Area Banks are as under:

- Whilst Local Area Banks can undertake all normal banking business, their major function was to finance agriculture and allied activities, small scale industries, agro -industries and trading/ non-farm activities, in the rural and semi-urban areas.

- **These banks have to lend at least 40%** of their total credit to priority sectors, of which, 12% will have to be provided for the weaker sections of the society, by 2023-24.

Regional Rural Banks

- **Established:** 1975, based on the recommendations of Narasimham Committee.
- **The Committee view:** RRBs would be much better suited than the commercial banks or co-operative banks, in meeting the needs of rural areas.
- Government of India promulgated an ordinance for establishing the Regional Rural Banks in the year 1975 and the Regional Rural Banks Act, was enacted in the year 1976.
- After passing the Act, within a year, at least 25 RRBs were established in different parts of the country.
- Regional Rural Banks were established with a view to developing such type of banking institutions which could function as a commercial organization in rural areas.
- The Regional Rural Banks Act, 1976, provides for incorporation and regulation of Regional Rural Banks, with a view to developing the rural economy by providing credit for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs and individuals.

Objectives :

- **Bridging the credit gaps in rural areas**: To develop such measures which could restrict the outflow of rural deposits to urban areas,
- **Employment generation activities in rural areas**: For achieving these objectives, the RRBs provide financial assistance to different segments of rural population engaged in rural activities.

Area of Functioning of Regional Rural Banks

- An RRB can open its branches and operate only in the jurisdiction of such districts/state, which have been notified by the Central Government.
- Head Office in its operational area only (Section 4 of the Regional Rural Banks Act).
- The branch expansion is done, as per the specific branch licensing policy of RBI prescribed for RRBs, from time to time, keeping in view the provisions of Section 23 of the Banking Regulation Act, 1949.

Capital Structure of RRBs:

- **As per Section 5 of the Regional Rural Banks (Amendment) Act, 2015:**

- Authorized share Capital : Rs. 2000 crore.
- out of the capital issued by a RRB,
    - 50% : by the Central Government,
    - 15% : by the concerned State Government
    - 35% : by the Sponsor Bank.

Amendment: in the recent period, contains an enabling provision for raising share capital from sources other than the Central Government, State Governments and Sponsor Banks, provided, the share capital held by the Central Government and the Sponsor Bank together, cannot be less than 51 per cent of the paid- up capital.

Further, if the shareholding of the state government in a RRB is to be reduced below 15%, the Union government would have to consult the concerned state government.

For raising share capital from sources other than Central/State Governments and Sponsor Bank, a RRB needs to adhere to the

Payments Banks

Objective : To take forward financial inclusion by offering banking and financial services to the unbanked and underbanked areas, helping the migrant labour force, low-income households, small entrepreneurs etc.

Registered: Under the Companies Act 2013, but are governed by a host of legislations such as Banking Regulation Act, 1949, RBI Act, 1934, Foreign Exchange Management Act, 1999, Payment and Settlement Systems Act, 2007, etc.

Features:

- They are differentiated banks and not universal banks.
- These operate on a smaller scale.
- Minimum paid-up capital: Rs. 100 crores.
- **Minimum initial contribution of the promoter to the paid-up equity capital is required to be at least be 40% for the first 5 years from the commencement of its business**

The activities performed

- Can accept deposits of up to Rs. 2 lakhs per customer.
- They can accept demand deposits in the form of savings and current accounts.
- The money received as deposits can be invested in government securities which are eligible for inclusion in Statutory Liquidity Ratio (SLR).
- This must amount to 75% of the demand deposit balance.
- The remaining 25% can be placed as deposits with other scheduled commercial banks.
- Payments banks are permitted to make personal payments and **receive cross border remittances on individual accounts.**
- Permitted to issue debit cards, although not credit cards.

- Permitted to handle third party products like distribution of insurance and mutual funds.

Activities Cannot be Undertaken:

- Cannot lend.
- Cannot issue credit cards.
- Cannot accept term deposits or deposits from NRI customers.
- Cannot set up subsidiaries to undertake non-banking financial activities.
- **Advantages:**
- Expansion of rural banking and financial inclusion.
- Expansion of the formal financial system.
- Effective alternative to commercial banks.

Small Finance Banks

- **OBJECTIVE:** Further financial inclusion by provision of savings vehicles, and supply of credit to small business units, small and marginal farmers, micro and small industries and other unorganised sector entities, through high technology – low- cost operations.

FEATURES:

Eligible promoters

- Resident individuals/professionals with 10 years of experience in banking and finance;
- Companies and societies owned and controlled by residents will be eligible to set up small finance banks.
- Existing Non-Banking Finance Companies (NBFCs), Micro Finance

Capital requirement

- **Minimum paid-up equity capital :** Originally fixed at Rs 100 crores**.**
- **Increased:** To Rs 200 crores, except for those Urban Cooperative Banks that get converted themselves into Small Finance Banks.

Promoter's contribution

- **Minimum initial contribution to the paid-up voting equity capital is least first 5 years:** 40% at all times during the from the date of commencement of business of the bank which should be brought down within a period of 10 years : to a maximum of 30% of the paid-up voting equity capital of the bank,
- **Within 15 years:** To a maximum of 15%.

Maximum loan size and investment limit exposure :

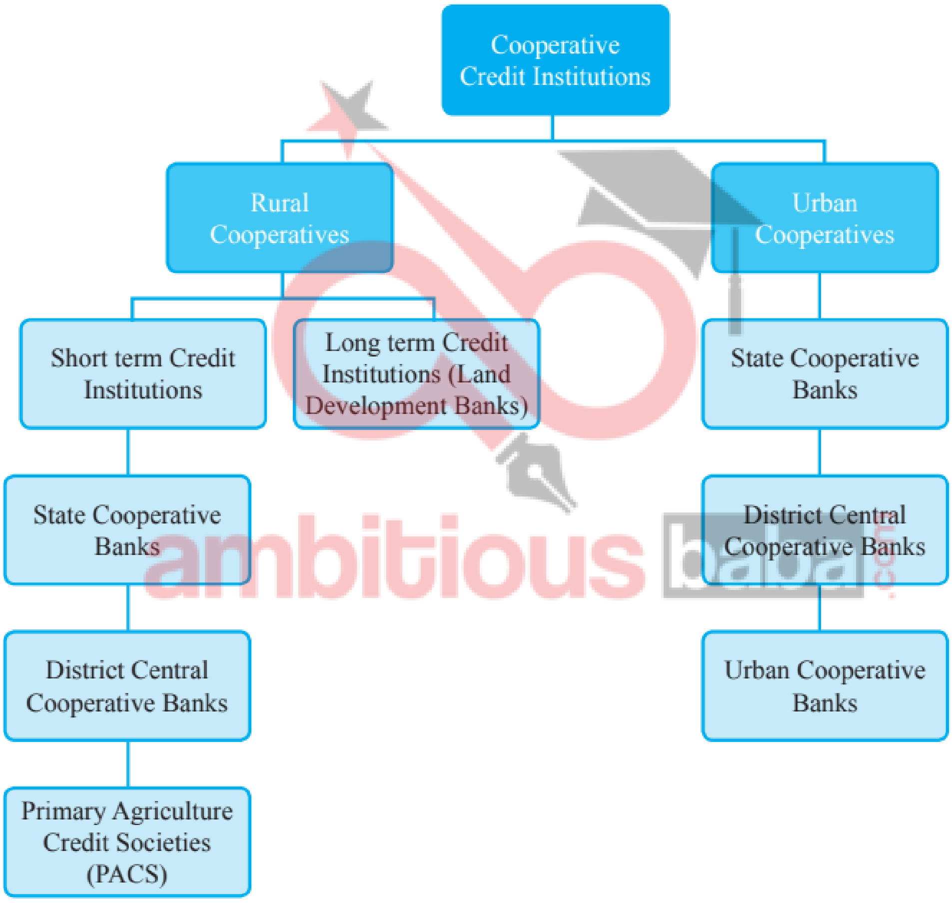
- **Single :** Restricted to 10% of its capital funds
- **Group :** 15% of its capital funds**.**

Cooperative Banks

- **Existence:** with the enactment of the Cooperative Credit Societies Act of 1904, which provided for the formation of cooperative credit societies.
- Subsequently, in 1912, a new Act was passed, which provided for the establishment of cooperative central banks.
- Cooperative credit institutions play a pivotal role in the financial system of the economy, in terms of their reach, volume of operations, and the purpose they serve.

These organisations were a system consisting of :

- Primary Cooperative Credit Societies,
- Central Cooperative Banks
- State Cooperative Banks.



Differences between Cooperative Banks and Commercial Banks

BASIS FOR COMPARISON	COMMERCIAL BANK	COOPERATIVE BANK
Meaning	A bank, that offers banking services to individuals and businesses is known as a commercial bank.	A bank set up to provide finance to agriculturists, rural industries and to trade and industry of urban areas (but up to a limited extent).
Governing Act	Banking Regulation Act, 1949	Cooperative Societies Act, 1965

Area of operation	Large	Small
Motive of operation	Profit	Service
Borrowers	Account holders	Member shareholders
Main function	Accepting deposits from public and granting loans to individuals and businesses.	Accepting deposits from members and the public, and granting loans to farmers and small businessmen.
Banking service	Offers an array of services.	Comparatively less variety of services.
Interest rate on deposits	Less	Slightly higher

JAIIB IE and IFS Module C Unit 3: Banking Laws – Reserve Bank of India Act, 1934 & Banking Regulation Act, 1949

Part – I Reserve Bank of India (RBI) Act, 1934

Background Of Enactment

The genesis of the RBI Act started in 1926, when the Royal Commission on Indian Currency and Finance suggested the estd. of a central bank for India

- **1927**: a bill to set up a central bank was placed in the Legislative Assembly. However, it was later withdrawn
- **1933:** A White Paper on Indian Constitutional Reforms suggested the setting up of a Reserve Bank and a new bill was presented in the Legislative Assembly After 1 year, the Bill was passed with the Governor General's consent.
- **1st April, 1935**: RBI was set up and it commenced business as India's central bank - as a private bank with a paid-up capital of Rs 5 crores
- When established, the RBI functioned as the central bank, both for undivided India and British Colony of Burma (now known as Myanmar).
- **1942**: RBI ceased to be the central bank for Burma, after Burma was separated from British run-state of India.
- After the partition of India and independence, RBI operated as the central bank for the newly formed Pakistan also and it was only the next
- **1948:** RBI ceased to supervise the banking system in Pakistan, which was thereafter taken over by State Bank of Pakistan, which is the central banker in that country.
- **1 Jan 1949:** Government of India nationalized RBI, under the Reserve Bank (Transfer of Public Ownership) Act, 1948, and all its shares were transferred to the Central Government.

Objective And Structure Of The RBI Act 1934

The preamble of the RBI Act describes the following:

- It is an Act to constitute a Reserve Bank of India, in order to regulate the issue of Bank notes and the keeping of reserves, with a view to securing monetary stability in the country and generally to operate the currency and credit system of the country to its advantage.
- It is also in order to have a modern monetary policy framework to meet the challenges of an increasingly complex economy.
- Primary objective of the monetary policy: maintain price stability with objective of growth

The RBI Act is divided into five chapters which are:

Chapter I – Preliminary

Chapter II – Incorporation, Capital, Management and Business

Chapter III – Central Banking Functions

- Chapter III A – Collection and Furnishing of Credit Information
- Chapter III B – Provisions Relating to Non-Banking Finance Companies
- Chapter III C – Prohibition of Acceptance of deposits by Unincorporated Bodies
- Chapter III D – Regulation of Transactions in Derivatives, Money Market Instruments, Securities, etc.
- Chapter III E – Joint Mechanism
- Chapter III F – Monetary Policy

Chapter IV – General Provisions

Chapter V – Penalties

In addition to the above chapters, the Act also has two schedules, Schedules I and II.

Chapter I - Preliminary

- **Section 1 –** This Act will be called the Reserve Bank of India Act and will be valid for the whole of India.
- **Section 2** – Definitions – section 2(e) – a "scheduled bank" means a bank included in the Second Schedule of the Act.

Chapter II- Incorporation Capital, Management and Business

- **Section 3** – Establishment and incorporation of the RBI A bank to be called the Reserve Bank of India shall be constituted for the purposes of taking over the management of the currency from the Central Government and of carrying on the business of banking, in accordance with the provisions of the Act. The Bank shall be a body corporate by the name of the Reserve Bank of India, having perpetual succession and a common seal.
- **Section 4** – Capital of RBI The capital of the Bank shall be Rs 5 crores. This is the paid-up capital of RBI and it may be noted that, as per the Annual Report of RBI as on 31st March 2022, the total capital reserves of RBI stood at Rs 6,741 crores.

Sections 7 and 8 – Management and Central Board

Section 7: The general superintendence and direction of the affairs and business of the Bank are entrusted to a Central Board of

However, the Board has to abide by any directions that may be given by the Central Government after consultation with the Governor of the Bank.

The Central Board shall consist of :

- Governor,
- Not more than 4 Deputy Governors, to be appointed by the Central Government and other directors to be nominated by the Central Government**, as under:**

i)4 directors to be nominated by Central Government, one each from the Local Boards constituted under Section 9 of the Act.

ii)10 directors to be nominated by Central Government from various fields.

iii)2 Government official to be nominated by the Central Government **(amendment 2012)**

iv)The Governor and Deputy Governors are whole time officials of the Bank.

v)A term fixed by the Central Government at the time of appointment, not exceeding 5 years and are eligible for reappointment.

Section 8(1)(d):

- The Government official nominated hold office, at the pleasure of the Government.
- The directors nominated from the Local Board shall continue during their membership of the Local Boards.
- The other directors shall hold office for 4 years and thereafter until their successors are nominated.

Section 9

Deals with details of the Local Boards and Members of the Local Boards.

- A Local Boards are specified in the 1st Schedule of the Act and shall consist of 5 members, to be appointed by the Central Government.
- These members will represent, as far as possible, territorial and economic interests and the interests of co-operative and indigenous banks.
- **Tenure**: 4 years and can be re-appointed for a maximum of 2 terms totalling 8 years.

Section 11_– Removal from Office

- The Central Government may remove, from office, the Governor, a Deputy Governor or any other Director or any member of a Local Board**.**

Section 13 –

- Meetings of the Central Board Meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter.
- The Governor, or if for any reason, he is unable to attend, the Deputy Governor authorised by the Governor to vote for him, shall preside at meetings of the Central Board, and, in the event of an equality of votes, shall have a second or casting vote.

Section 17 –

Business Permitted to be Conducted by RBI The business that can be undertaken by RBI includes the following:

- Acceptance of deposit without interest from Central/State governments, Banks, local authorities and any other person/institutions,
- Purchase/sell foreign exchange, securities, rediscount the bills/promissory notes, grant loans to banks, etc.
- Accepting of money as deposits, repayable with interest, from banks or any other person under the Standing Deposit Facility Scheme, as approved by the Central Board, from time to time, for the purposes of liquidity management

Section 18A –

- Validity of a Loan Not to be Questioned Notwithstanding anything to the contrary contained in any other law for the time being in force, the validity of any loan or advance granted by RBI, in pursuance of the provisions of the RBI Act shall not be called in question, merely on the ground of non-compliance with the requirements of such other law, or of any resolution, contract, memorandum, articles of association or other instrument:
- Provided that nothing in this clause shall render valid any loan or advance obtained by any company or co-operative society, where such company or co-operative society is not empowered by its memorandum to obtain loans or advances.

Section 19 –

Business that RBI cannot Transact In terms of the Act, the following business may not be transacted by RBI:

- Engage in trade or otherwise have a direct interest in any commercial, industrial, or other undertaking;
- Purchase the shares of any banking company or of any other company, or grant loans upon the security of any such shares;
- Advance money on mortgage of, or otherwise on the security of, immovable property or documents of title relating thereto, or become the owner of immovable property, except so far as is necessary for its own business premises and residences for its officers and employees;
- Make loans or advances;

- Draw or accept bills payable otherwise than on demand, and
- Allow interest on deposits or current accounts.

Chapter III – Central Banking Functions

- **Section 20** – Banker to the Central Government The Bank shall undertake to accept monies for account of the Central Government and to make payments up to the amount standing to the credit of its accounts, and to carry out its exchange, remittance and other banking operations, including the management of the public debt of the Union.
- **Section 21A** – Banker to State Governments based on Agreement The RBI may, by agreement with the Government of any State, undertake all its money, remittance, exchange and banking transactions in India, including in particular, the deposit, free of interest, of all its cash balances with the Bank; and the management of the public debt and issue of loans by that State.
- **Section 22** – Right to issue Bank (Currency) Notes The RBI shall have the sole right to issue bank notes in India and, from the date of implementation of this Section, The Central Government will cease to issue any currency notes.
- **Section 24** – Denomination of Currency Notes The currency notes shall be of the denominations of two rupees, five rupees, ten rupees, twenty rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees, five thousand rupees and ten thousand rupees or of such other denominational values, not exceeding ten thousand rupees, as the Central Government may, on the recommendation of the Central Board, specify. The Central Government may, on the recommendation of the Central Board of RBI, direct the non-issue or the discontinuance of issue of currency notes of such denominations, as it may specify in this behalf.
- **Section 26** – Legal Tender Character of Currency Notes Every bank note shall be legal tender at any place in India, in payment for the amount expressed therein and shall be guaranteed by the Central Government. On recommendation of the Central Board of RBI, the Central Government may declare that, with effect from such date as may be specified, any series of bank notes of any denomination shall cease to be legal tender, except at such office of the RBI and to such extent, as may be specified in the notification.
- **Section 27** – Re-issue of Notes not to be Done The RBI shall not re-issue bank notes which are torn, defaced or excessively soiled.
- **Section 28** – Recovery of lost, stolen, mutilated or imperfect Notes No person shall, as a matter of right, be entitled to recover from the Central Government or the RBI, the value of any lost, stolen, mutilated or imperfect currency note of the Government of India or bank note. However, the RBI may, with the previous sanction of the Central Government, prescribe the circumstances subject to which, the value of such currency notes may be refunded.
- **Section 29** – Currency Notes Exempted from Stamp Duty The RBI shall not be liable to the payment of any stamp duty under the Indian Stamp Act, 1899, in respect of bank notes issued by it.

- **Section 30 –** Powers of the Central Government to Supersede the Central Board of RBI If in the opinion of the Central Government, the RBI fails to carry out any of the obligations imposed on it by or under this Act, the Central Government may, by notification in the Gazette of India, declare the Central Board to be superseded. Thereafter, the general superintendence and direction of the affairs of the RBI shall be entrusted to such agency as the Central Government may determine, and such agency may exercise the powers and take all action as may have been exercised by the Central Board of RBI, under the Act.
- **Section 33 –** Assets of the Issue Department The assets of the Issue Department shall consist of gold coin, gold bullion, foreign securities, rupee coins and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department.
- **Section 34** – Liabilities of the Issue Department The liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and bank notes, in circulation.
- **Section 40** – Transaction in Foreign Exchange The RBI shall sell to or buy from any Authorised Person, foreign exchange at such rates of exchange and on such conditions as the Central Government may from time to time by general or special order determine, having regard so far as rates of exchange are concerned to its obligations to the International Monetary Fund. This is provided that no person shall be entitled to demand to buy or sell foreign exchange of a **value less than Rs 2 lakhs.**
- **Section 42** – Scheduled Banks to Keep Cash Reserves with RBI (Cash Reserve Ratio – CRR) Every bank included in the 2nd Schedule of the Act shall maintain with RBI, an average daily balance - the amount of which shall not be less than such percentage of the total of the demand and time liabilities (DTL) in India of such bank, as the RBI may from time to time, having regard to the needs of securing the monetary stability in the country, notify in the Gazette of India. The operative provision of the Act necessitates banks to maintain their CRR funds with the RBI. The RBI can decide on the percentage of DTL, at which, CRR should be maintained and there is no mention of minimum or maximum percentage, in the Act.

Chapter III – A Collection and Furnishing of Credit Information

Sections 45A to 45 G

It includes any information related to-

- The amount or nature of loan or advances and other credit facilities that are given by the banking companies to their borrowers,
- The nature of security given by the borrowers for such credit facilities,
- The guarantee granted by the banking company to its customers,
- The antecedents, means, credit worthiness and history of financial transaction to the borrowers,
- Any such information that the RBI may consider to be relevant.

Power of RBI to collect credit information

- It can be collected in such a manner as the RBI thinks fit.
- It may direct any bank to submit to it the statements related to such credit information.

All banking companies are bound to comply with the regulations of the Reserve Bank of India.

Procedure for granting credit information to banking companies

- On request of a banking company, the RBI shall furnish the applicant with that credit information related to the matters stated in the application. However, the information so furnished will not disclose the names of banking companies who have submitted such application to the RBI.
- It is at the discretion of the RBI to levy fees for furnishing credit information and that amount would not exceed to Rs 25.

Disclosure of information prohibited

Any credit information contained in any statement should be kept confidential and should not be published or disclosed except for the purpose of this Chapter.

Those exceptions are-

- Disclosure made by any banking company with the prior permission of the RBI.
- If the bank thinks fit, it may publish the credit information for benefit of public interest.
- The disclosure or publication can be done, as per the practice and usage customary among bankers or permitted by any other law.
- It can be done under the Credit Information Companies (Regulation) Act, 2005.

Chapter III-B - Provisions Relating to operations of Non-Banking Institutions Receiving Deposits and Financial Institutions

This Chapter deals with various aspects of Non-Banking Financial Companies (NBFCs). A non-banking financial company has been defined vide **clause (b) of Section 45–1 of Chapter IIIB of the Reserve Bank of India Act, 1934, as**

- A financial institution, which is a company;
- A non-banking institution, which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner or lending in any manner;
- Such other non-banking institutions or class of such institutions, as the bank may with the previous approval of the central government and by notification in the official gazette, specify.

In terms of Section 45-IA of the RBI Act, a non-banking financial company can commence or carry on the business of non-banking financial institution subject to

- Obtaining a certificate of registration from the Bank (RBI), and
- having the net owned fund of twenty-five lakh rupees or such other amount, not exceeding hundred crore rupees, as the Bank may, by notification in the Official Gazette, specify (amended 2019). Provided that the Bank may notify different amounts of net owned fund for different categories of non-banking financial companies

Some of the other sub-sections of section 45, relating to functioning and supervision of NBFCs are tabulated here.

Section	Particulars
45 IB	Maintenance of percentage of assets
45 IC	Reserve Funds
45 J	RBI to regulate or prohibit issue of prospectus or advertisement soliciting deposits of money
45 L	Power of the bank to call for information from financial institutions and to give directions
45 M	Duty of non-banking institutions to furnish statements, etc., required by RBI
45 MA	Power and Duty of Auditors
45 MC	Power of Bank to file winding up petition
45 N	Inspection

Chapter III-C - Prohibition of Acceptance of deposits by Unincorporated Bodies

Section 45S

No person, being an individual or a firm or an unincorporated association of individual shall accept any deposit if his or its business wholly or partly includes any of the activities specified in clause (c) of section 45I.

Chapter III – D - Regulation of Transactions in Derivatives, Money Market Instruments, Securities, etc.

Section 45U

- This section covers definitions of a large number of market instruments. In terms of these, A "Derivative" means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "**underlying**"), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time.

- "Securities" means securities of the Central Government or a State Government or such securities of a local authority as may be specified in this behalf by the Central Government and, for the purposes of "**repo" or "reverse repo**", include corporate bonds and debentures. This Chapter provides power to RBI to regulate derivative and money market transactions as also the power to call for information, as may be deemed fit.

Chapter III – E –

- Joint Mechanism This chapter covers those matters over which, in addition to RBI, other regulators like SEBI and IRDAI have jurisdiction.

Section 45Y

- In cases of hybrid or composite instruments, having a component of money market investment or securities market instrument or a component of insurance or any other instrument and falls within the jurisdiction of the RBI or SEBI or IRDA or PFRDA, if there is a difference of opinion, such difference of opinion shall be referred to a Joint Committee consisting of representatives from the Government, RBI, SEBI, IRDA and PFRDA.

Chapter III- F –

- Monetary Policy These comprise of sub-sections of section 45Z up to 45ZO. In this chapter, various aspects of the Monetary Policy and the Monetary Policy Committee (MPC) have been elaborated.

These include aspects such as:

- Objective of the MPC,
- Constitution of the MPC,
- Terms and conditions of appointment of the MPC members,
- Information for MPC members, and
- Periodicity of the MPC meetings and publication of the decision of the MPC and their deliberations.

Chapter IV – General Provisions

- **Section 48** – Exemption of RBI from Income Tax and Super Tax Notwithstanding anything contained in the Income-Tax Act, 1961, or any other enactment for the time being in force, relating to income-tax or super-tax, the RBI shall not be liable to pay income-tax or supertax on any of its income, profits or gains.
- **Section 49** – Publication of the Bank Rate The RBI shall make public, from time to time, the standard rate at which, it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase, under this Act.
- **Section 59** – Liquidation of RBI Nothing in the Companies Act, shall apply to the RBI, and RBI shall not be placed in liquidation except by order of the Central Government and in such manner as it may direct.

Chapter V – Penalties

This Chapter deals with various types of penalties which may be levied on any person or entity that breaches the provisions of the Act. These include providing wrong information, failure to produce the required books and records, disclosure of any confidential information, etc. Penalties for such breaches can extend from monetary fines to up to **three years in prison.**

Schedules To The RBI Act, 1934

There are two schedules to the Act, viz., Schedule one and Schedule two. Whereas Schedule one, gives details of the organisation of the country into four different territories for the purpose of RBI's operations, Schedule Two, contains the names of the different Banks, which RBI has approved to operate as Scheduled Banks.

The territories as demarcated in Schedule One are as follows:

- The Western Area shall consist of the States of Goa, Gujarat, Madhya Pradesh and Maharashtra and the Union Territories of Dadra and Nagar Haveli and Daman and Diu.
- The Eastern Area shall consist of the States of Arunachal Pradesh, Assam, Bihar, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Sikkim, Tripura and West Bengal and the Union Territories of Andaman and Nicobar Islands.
- The Northern Area shall consist of the States of Jammu & Kashmir, Punjab, Haryana, Himachal Pradesh, Rajasthan and Uttar Pradesh and Union Territories of Chandigarh, and Delhi.
- The Southern Area shall consist of the States of Andhra Pradesh, Karnataka, Tamil Nadu and Kerala and the Union Territories of Pondicherry and Lakshadweep.

Part – II Banking Regulation Act (BR Act), 1949

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Background And Structure Of The Act

The law relating to banking in India today is the outcome of gradual process of evolution before 1949. The Indian Companies Act 1913, contained special provisions relating to banking companies, which were inadequate and were subsequently incorporated in the comprehensive legislation, passed in the year 1949, under the name of Banking Companies Act. This Act was later renamed as the Banking Regulation Act, 1949, and suitably amended a number of times, to insert new provisions and to amend the existing ones, in order to suit the needs of the changing circumstances. The original Act has 56 sections contained in five parts and five schedules.

Salient features of the Act include the following:

- A comprehensive definition of banking so as to bring within the scope of the legislation all institutions which receive deposits, repayable on demand or otherwise for lending or investment.
- Prohibition of non-banking companies, from accepting deposits repayable on demand.
- Prohibition of trading to eliminate non-banking risks.

- Prescription of minimum capital standards.
- Limiting the payments of dividends.
- Inclusion the scope of legislation of banks, registered outside the provinces of India.
- Introduction of comprehensive system of licensing of banks and their branches. • Prescription of a special form of balance sheet and conferring of powers on the RBI, to call for periodical returns.
- Inspection of books and accounts of a bank, by Reserve Bank.
- Empowering the central government to take action against banks conducting their affairs in a manner detrimental to the interests of the depositors.
- Provision for bringing the Reserve Bank of India into closer touch with banking companies.
- Provision of an expeditious procedure for liquidation.
- Widening the powers of the Reserve Bank of India so as to enable it to come to the support of banking companies in times of emergencies.

Part – I (Sections 1 To 5)

Title, extent and commencement

According to Section 1, the Act is called the Banking Regulation Act, 1949. It extends to the whole of India and it came into force on 16th March, 1949. ***The Act applies to certain types of Cooperative Societies, but not the following:***

- Primary agricultural credit society, and
- Co-operative land mortgage bank

Definition of Banking

According to Section 5(b),

"banking" means the accepting of deposits of money from the public for the purpose of lending or investment, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. It may be noted that "banking" does not include other commercial activities carried on by a banking company.

Section 5(c)

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

According to explanation to Section 5, any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business, shall not be deemed to transact the business of banking, and therefore shall not be called a "**banking company**".

In terms of Section 5(cc), a "branch" or "branch office", in relation to a banking company, means any branch or branch office, whether called a pay office or sub-pay office or by any other name, at which deposits are received, cheques cashed or moneys lent.

Part – II (Sections 6 To 36AJ)

Business of Banks Section 6 provides a list of various forms of business which a banking company may do in addition to the business of banking. ***These include the following:***

(a)

- Borrowing, raising or taking up of money;
- Lending or advancing of money, either against security or without security;
- Drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scripts and other instruments and securities whether transferable or negotiable or not;
- Granting and issuing of letters of credit, travellers' cheques and currency notes;
- Buying, selling and dealing in bullion and specie (i.e., money in the form of coins, rather than notes);
- Buying and selling of foreign exchange including foreign bank notes;
- Acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds;
- Purchasing and selling of bonds, scrips and other forms of securities on behalf of constituents or others;
- Negotiating of loans and advances;
- Receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise;
- Providing of safe deposit vaults and
- Collecting and transmitting of money and securities

(b) Acting as an agent of the government, local authority or any other person and carrying on agency business

(c) Contracting for public and private loans and negotiating and issuing the same.

(d) Insure, guarantee, underwrite, participate in managing and carrying out any issue of state, municipal or other loans or of shares, stock, debentures or debenture stock of companies and lend money for the purpose of any such issue.

(e)Carry on and transact every kind of guarantee and indemnity business.

(f) Manage, sell and realise any property, which may come into its possession in satisfaction of any of its claims.

(g) Acquire, hold and deal with any property or any right, title or interest in any such property, which may form the security for any loan or advance.

(h) Undertake and execute trusts.

(i) Undertake the administration of estates as executor, trustee or otherwise.

(j) Establish, support and aid associations, institutions, funds, trusts, etc., for the benefit of its present or ex-employees; grant money for charitable purposes.

(k) Acquire, construct and maintain any building for its own purpose.

(l) Sell, improve, manage, develop, exchange, lease, mortgage, dispose of or turn into account or otherwise deal with all or any part of the business of any person or company, when such business is of a nature described in Section 6.

(m) Acquire and undertake the whole or any part of the business of any person or company, when such business is of a nature described in Section 6.

(n) Do all such things which are incidental or conducive to the promotion or advancement of the business of the company.

(o) Do any other business specified by the Central Government, as the lawful business of a banking company. The Central Government has accordingly specified leasing and factoring as permissible businesses for banks.

Note: Section 7 stipulates that every banking company, and no other company, shall use any of words “bank”, “banker”, or “banking” as part of its name. Only then, it can carry on the business of banking in India.

Prohibited functions of Banks

According to Sections 8 and 9, the banks cannot engage themselves in carrying on the following activities:

- No banking company shall directly or indirectly deal in the buying or selling or bartering of goods, or engage in any trade.
- No banking company shall buy or sell, or barter goods for others.
- No banking company shall hold any immovable property howsoever acquired for more than 7 years from the acquisition thereof. However, it can hold any immovable property required for its own use.

Management of a Bank

With regard to the management of a banking company, Section 10 provides as follows:

- A banking company cannot employ or be managed by a managing agent.
- It cannot employ “any person” who has been adjudicated insolvent, or has been convicted by a criminal Court for any act of moral turpitude; who is a director of any other company (other than subsidiary of the banking company or a company registered under **section 25 of the Companies Act, 1956 i.**e. “**Not For Profit** Company” {**section 8 company** under the Companies Act, 2013}; who is engaged in any other business or vocation; whose term of office as a person managing the company is for **more than 5 years at any one time**; whose total remuneration or its part takes the form of commission or of a share in the profits of the

company; and whose remuneration is excessive in the opinion of the Reserve Bank of India.

- The board of directors of a banking company shall include **not less than 51**% of its total number of members, persons with professional or other practical experience in the matters such as accountancy, agriculture and rural economy, banking, cooperation, economics, finance, law, small-scale industry, etc.
- Every banking company shall be managed by a whole-time chairman who shall be entrusted with the management of the whole of its affairs. The chairman shall exercise his powers subject to the superintendence, control, and direction of the board of directors. The chairman shall be one of the directors.
- **Section 16 prohibits** common directors and states that a banking company cannot have a person as director, who is a director of any other banking company.

Capital and Reserves

According to Section 11, the aggregate value of a banking company's paid-up capital and reserves shall **not be less than Rs. 5 lakhs**, if the bank has been established after 16th September, 1962. This minimum amount varies according to the number of places of business in one or more states and also with the nature of banks such as Indian banks and foreign banks whose branches are in India.

Section 12 states that the subscribed capital of a banking company **cannot be less than 50%** of the authorised capital, and the paid-up capital cannot be less than 50% of the subscribed capital. Further, the capital of the company shall consist of ordinary shares or equity shares only. A shareholder cannot exercise his/her voting rights on a poll, in excess of 10% of the total voting rights of all the shareholders of the banking company, as laid down in the Companies Act.

Restrictions concerning payment of dividend

Section 15

- No bank shall pay any dividend on its shares until all its capitalised, expenses (including preliminary expenses, organisation expenses, share-selling commission, brokerage, amounts of losses incurred or any other item of expenditure on intangible assets) have been completely written off.

Section 17:

- Every banking company shall create a Reserve Fund (known as Statutory Reserve Fund), and before declaring any dividend, transfer to it at least 20% of its profit each year.
- When the amount in the reserve fund together with the amount in the share premium account equals the paid-up capital, then (and not before that) the Central Government on the recommendation of the Reserve Bank, can allow a banking company not to transfer the **stipulated 20% of profit to the reserve fund.**

- The Reserve Fund cannot be used for any purpose until it is equal to the paid-up capital.
- Where a banking company appropriates (uses) any amount from the Reserve Fund or the share premium account, it shall report the **fact to the Reserve Bank, within 21** days of such appropriation, explaining the circumstances thereof

Section 18 (taking into accounts the amendments of 2012) states:

Every banking company, not being a scheduled bank, shall maintain a Cash reserve with itself or in a current account with the Reserve Bank equal to such percentage of the total of its DTL in India as on the last Friday of the second preceding fortnight as stipulated by the RBI.

Restriction on nature of subsidiary companies

Section 19 :

A banking company cannot form any subsidiary company. However, it may establish a subsidiary company in the following circumstances:

- To undertake any one or more forms of business permissible for a banking company under Section 6 or
- To carry on the business of banking exclusively outside India. However, before creating a subsidiary company for this purpose, previous permission in writing of the Reserve Bank is necessary; or
- To undertake such other business which the Reserve Bank may, with the prior approval of the Central Government, consider to be conducive to the spread of banking in India or to be otherwise useful or necessary in the public interest.

Restrictions on Loans and Advances

Section 20:

Deals with restrictions on banks for making certain types of loans.

According to the Section, no banking company shall:

(a)Grant any loans or advances on the security of its own shares, or-

(b)Granting any loan or advance to or on behalf of-

- Any of its directors,
- To any firm in which any of its directors is interested as a partner, manager, employee or guarantor, or
- Any company in which a director of the bank is interested as a Director, Managing Agent, Manager, employee or guarantor
- Any individual in respect of whom any of its directors is a partner or guarantor

Power of RBI to Control Advances by Banking Companies

Section 21

- RBI may direct banks with respect to the purpose of advance, the margins to be maintained, the maximum quantum that can be lent to a single entity and the rate of interest to be charged and banks would be required to adhere to such directions provided by RBI.

Licensing of banking companies

Section 22:

- Before commencing banking business in India, every banking company shall apply in writing to the RBI for a licence and RBI will grant licence

Opening of new branches and transfer of existing branches

Section 23

- Without obtaining the prior permission of the Reserve Bank, a banking company cannot open a new branch.
- It cannot change the location of an existing branch.
- The same restriction applies to opening or transferring branches outside India.
- However, a temporary branch may be opened for a, maximum period of one month for the purpose of affording banking facilities to the public on the occasion of an exhibition, a conference, or a 'mela' or any other similar occasion, if the banking company already has a branch in that city, town, or village.

Maintenance of Statutory Liquidity Reserve

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Section 24:

- Every bank shall maintain a liquid reserve in cash, gold or unencumbered approved **securities at least 25% of** the total of its demand and time liabilities in India.
- In terms of the provisions of this Section, every bank shall maintain a liquid reserve in cash, gold or unencumbered approved **securities not exceeding 40%** of the total of its demand and time liabilities in India.

Return of Unclaimed Deposits

Section 26:

- Every banking company shall, within 30 days after the close of each calendar year, submit a return to the RBI of all accounts [in India] which have not been operated upon for 10 years.

Section 26A,

- RBI shall establish a Fund to be called the **"Depositor Education and Awareness Fund"** and shall credit to the Fund the amount of such accounts which have not been operated upon for a period of **10 years or any deposit** or any amount remaining unclaimed for **more than 10 years - within a period of 3 months from the expiry of the said period of 10 years**

Inspection

- **In terms of Section 35 the RBI**, on its own or on being directed by the Central Government, can cause an inspection of any banking company and its books and accounts. It may also order a scrutiny of the affairs and books and accounts, and the officers of the said banking company shall have to fully cooperate with the order.

Power of RBI to give Directions

Section 35A:

- RBI is satisfied that in public interest or in the interest of banking policy or in order to prevent the affairs of any banking company being conducted in a manner detrimental to itself or to the interests of the depositors or to secure the proper management of any banking

Sections 35AA and Section 35AB

- Give power to the RBI to give directions to banks to initiate insolvency proceedings against specified stressed corporates under the Insolvency and Bankruptcy Code, (IBC), 2016 and also to give directions for initiation of resolution process of stressed assets.
- These Sections were invoked when the RBI commenced its Asset Quality Review (AQR) in Banks, in the year 2015

Supersession of Board of Directors of Banks in Certain Cases

Section 36ACA,

- RBI, in consultation with the Central Government is satisfied that in the public interest or for preventing the affairs of any banking company being conducted in a manner detrimental to the interest of the depositors or itself, the RBI may supersede the Board of Directors of such banking company for a period **not exceeding six months**.
- This supersession can be extended by **RBI up to a total period of 12 months**. On directing supersession as above, the RBI may appoint an Administrator who has experience in law, finance, banking, economics or accountancy to manage the affairs of the Bank.

Part – III B (Sections 45Y TO 45ZF)

Nomination

Nomination in deposit accounts, safe custody accounts and safe deposit locker accounts are covered

- Under **Sections 45ZA, 45ZC and 45ZE**, respectively. Under Section 45ZA, where a deposit is held by a banking company to the credit of one or more persons, the depositor(s) may nominate one person to whom – in the event of the death of the sole depositor(s) – the amount of deposit may be returned by the banking company and, payment by a banking company to the nominee, in accordance with the provisions of **Section 45ZA**, shall constitute a full discharge to the banking company of its liability in respect of the deposit.
- **Under Section 45ZC**, where any person leaves any article in safe custody with a banking company, such person may nominate one person to whom - in the event of the death of the person leaving the article in safe custody - such article may be returned by the banking company. Under Section 45ZE, where an individual is the sole hirer of a locker from a banking company, such individual may nominate one person to whom - in the event of the death of the such locker hirer - the banking company may give access to the locker and liberty to remove the contents of the locker.

Part – IV (Sections 46 TO 55)

- Restriction on acceptance of deposits withdrawable by cheque **According to Section 49A,** no person other than a bank shall accept deposits of money withdrawable by cheque.

Part – V (Section 56)

- Application of the Act to Cooperative Societies (Amendments of 1965 and 2020) With the introduction of Section 56 in the Banking Regulation Act, 1949, with effect from 1 March, 1966, (Act 23 of 1965) co-operative banks have come under the regulatory purview of RBI.
- While the formation and management of co-operative societies operating in one state only (including those conducting banking business) are under the control of the State Government, licensing and regulation of banking business rests with RBI. Thus, there is a dual control of State Governments and the Reserve Bank over these banks.

JAIIB IE & IFS Module C Unit 4 - Development Financial Institutions

Evolution Of Development Financial Institutions In India

- DFIs were established mainly to cater to the demand for long-term finance by the industrial sector.
- **1948:** 1st DFI - Industrial Finance Corporation of India (IFCI),

Followed by setting up of State Financial Corporations (SFCs) at the State level, after passing of the State Financial Corporations Act, 1951.

- **1955:** Industrial Credit and Investment Corporation of India (ICICI Ltd.)
- **1956:** Life Insurance Corporation of India (LIC)
- **1958**: Refinance Corporation for Industries Ltd. (later taken over by IDBI)
- **1963:** Agriculture Refinance Corporation (precursor of ARDC and NABARD)
- **1964:** UTI and IDBI
- **1969-70:** Rural Electrification Corporation Ltd. and HUDCO Ltd.
- **1971:** Industrial Reconstruction Corporation of India Ltd. (precursor of IIBI Ltd.)
- **1972: GIC**
- **2021:** National Bank for Financing Infrastructure and Development(NaBFID)

1964: Although the powers to regulate financial institutions had been made available to RBI

- **1974:** Under the newly inserted Chapter IIIB of RBI Act, the definition of term 'financial institution' was made precise and comprehensive by amendment to the RBI Act {Section 45-I (c)}

Set up after 1974.

- **1981:** NABARD
- **1982:** EXIM Bank (functions carved out of IDBI)
- **1986:** SCICI Ltd. (Shipping Credit and Investment Company of India Ltd) (set up by ICICI Ltd. in 1986 and later merged with ICICI Ltd. in 1997),
- **1986:** PFC Ltd. (Power Finance Corporation Ltd) and IRFC Ltd. (Indian Railway Finance Corporation).
- **1987:** IREDA Ltd. (Indian Renewable Energy Development Agency Ltd)
- **1988:** RCTC Ltd. (Risk Capital and Technology Finance Corporation) and TDICI Ltd. (Technology Development and Investment Corporation of India) (later known as IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Ltd.)
- **1988:** NHB
- **1989:** TFCI Ltd. (Tourism Finance Corporation of India) (set up by IFCI**)**
- **1989:** SIDBI (also carved out of IDBI)
- **1997:** IDFC Ltd.

- Apart from the fact that DFIs cater to the financial needs of different sectors, there are some significant differences among them. While most of them extend direct finance, some extend indirect finance and are mainly refinancing institutions, viz., SIDBI, NABARD and NHB - which also have a regulatory and supervisory role.

Gaps In The Post-Independence Financial System

As India launched into the road of development, post-independence, a number of gaps emerged in the then-existing banking system and capital markets, which needed to be filled up. ***These were:***

- Commercial banks had traditionally confined themselves to financing working capital requirements of trade and industry and abstained from providing long-term finance.
- Several malpractices, such as misuse of funds, excess speculation, and manipulations were unearthed. Owing to this, the investors were not interested in investing in the capital market.
- The managing agency houses, which had served as supplementary to the capital market, showed their apathy to investments, in risky ventures.
- There were a limited number of issue houses and underwriting firms that sponsored issue of bonds and other securities.

Objectives Of Development Financial Institutions

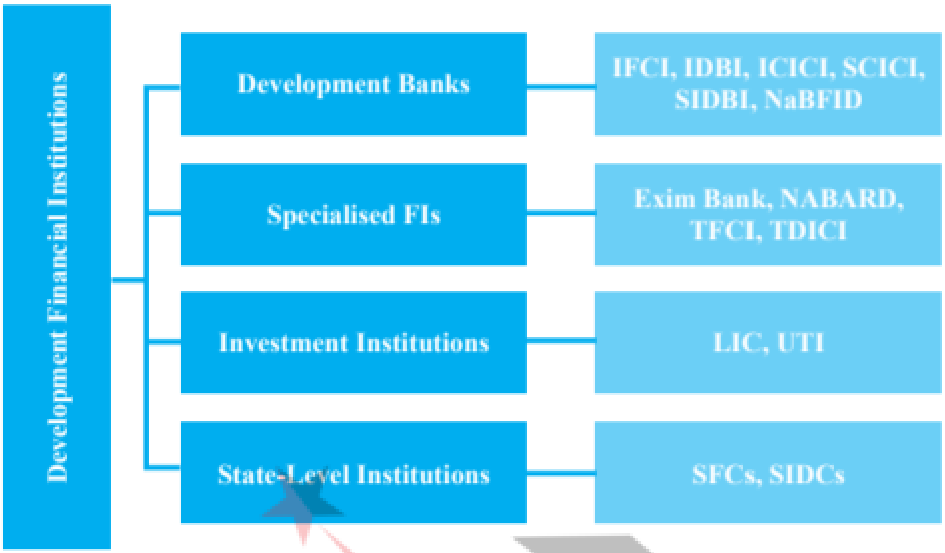
The objectives of development banks include the following:

- To serve as an agent of development in various sectors, viz., industry, agriculture, and international trade.
- To accelerate growth of the economy.
- To allocate resources to high priority areas.
- To foster rapid industrialisation, particularly in the private sector, so as to provide employment opportunities as well as higher production.
- To foster Public – Private Partnership (PPP)
- To develop entrepreneurial skills.
- To promote the development of rural areas.
- To finance housing, small-scale industries, infrastructure, and social utilities.
- Planning, promoting, and developing industries to fill the gaps in industrial sector.
- Coordinating the working of institutions engaged in financing, promoting or developing industries, agriculture, or trade.
- Rendering promotional services, such as stimulating project ideas, undertaking feasibility studies, and providing technical, financial, and managerial assistance for the implementation of projects.

Classification Of DFIS

DFIs can be classified into four categories,

- Development Banks,
- Specialised Financial Institutions,
- Investment Institutions
- State-Level Financial Institutions.



Role Of DFIS In The Indian Economy

Term Loan: The DFIs for industrial development extended term loan for setting up new units as also for expansion, modernisation, and rehabilitation of existing units.

Assistance: The DFIs could extend assistance to almost all industries, resulting in a well-diversified asset portfolio.

- **Tenor of the financial assistance was usually up to 10 years, with suitable initial moratorium periods.**
- **Mortgage charge over fixed assets of the assisted company, was provided as loan security.**

The DFIs were funded by Government provided equity capital and preferential market access for raising medium-/long-term resources.

Preferential access was in the form of channelising multilateral funding lines, fund flow from National Industrial Credit-Long-term Operations.

(NIC-LTO) of Reserve Bank of India, issuance of Statutory Liquidity Ratio (SLR) and tax-saving bonds, and suitable enablers to attract funds available through capital gains and investment allowance reserves.

There were also provisions made in the Income Tax Act, which enabled access to medium and long-term resources, which supplemented their other fund-raising avenues.

DFIs were also permitted to intermediate external commercial borrowings (ECBs) market, for on-lending.

Industrial Finance Corporation Of India (IFCI)

July 1, 1948 : The Government of India established the Industrial Finance Corporation of India (IFCI)

- Enactment of the Industrial Finance Corporation Act, 1948.
- First Development Financial Institution of India

Purpose: Propel economic growth, through development of infrastructure and industry.

Since then, IFCI has contributed significantly to the economy, through its incessant support to projects in all the three spheres of growth and development

- Manufacturing,
- Infrastructure & services
- agriculture and allied sectors**.**

The Liberalisation of the Indian Economy, in 1991, made significant changes in the Indian Capital Markets and the Financial System.

To aid raising of funds directly through capital markets, the constitution of IFCI was changed from a statutory corporation to a company, under the Indian Companies Act, 1956.

- **October 1999:** Name of the company was changed to 'IFCI Limited'**,**
- **Authorised share capital of the IFCI:** Only Rs. 10 crores at the initial stage
- Authorised capital of IFCI was increased to Rs. 250 crores [the Industrial Finance Corporation (Amendment) Act 1986]

Financial Activities of IFCI

- **Project financing is the core business of IFCI.**
- **Main objective:** To fund green-field projects.

- Financial assistance was provided, by way of medium or long-term credit, for setting up new projects, expansion/diversification schemes, modernisation/balancing schemes of existing projects.
- Provided by way of rupee loans, loans in foreign currencies, underwriting of/direct subscription to shares and debentures, providing guarantee for deferred payments and loans.

Financial services

- IFCI provided tailor-made assistance, to meet specific needs of corporates, through specifically designed schemes.
- The various fund-based products offered were equipment finance, equipment credit, equipment leasing, supplier's/buyer's credit, leasing and hire purchase concerns, working capital term loans, short-term loans, equipment procurement, instalment credit, and others. The fee-based services offered by it, were guarantees and letters of credit.

Corporate advisory services

IFCI provided advisory services in the areas of

- Projects,
- Infrastructure,
- Corporate finance,
- Investment banking, a
- Corporate restructuring.

It provided customised services, in areas of

- Investment appraisals,
- Corporatisation,
- Disinvestment,
- Business restructuring
- Bid-process management,
- Formation of joint ventures.

Corporate advisory services to foreign investors

IFCI provided a whole range of services to prospective foreign investors, namely,

- Facilitating the foreign business entities through information services;
- Necessary office infrastructure for the start-up operations of the organisation, coordination for obtaining the required approvals/clearances from the government departments/ regulators/ statutory agencies;
- Inputs on markets, materials, and manpower available in the country;
- Inputs on available manufacturing facilities;
- Syndication services for obtaining the required capital;
- Research inputs and information regarding tax incentives;

- Tariff protections, and opportunities available for acquisitions, mergers, and amalgamations.

Industrial Credit and Investment Corporation Of India (ICICI)

- **Established:** In 1955, at the initiative of the World Bank, the Government of India and representatives of Indian industry.
- **Principal objective:** To create a development financial institution, for providing medium-term and long-term project financing to Indian businesses.
- The IFCI and SFCs had confined themselves to lending activities and kept away from underwriting and investing in business, though they were authorised to subscribe for the shares and debentures of the companies and to undertake underwriting business.
- Therefore, a large number of emerging enterprises faced chronic problems, in raising funds in the capital market.
- Besides, they were not in a position to secure the desired amount of loan assistance from the financial institutions, due to their thin equity base.
- To fill these gaps, the ICICI was established.
- **Until the late 1980s, :** primarily focused on project finance, providing long-term funds to a variety of industrial projects.
- With the liberalisation of the financial sector in India, in the 1990s: transformed its business, from a development financial institution offering only project finance, to a diversified financial services provider that, along with its subsidiaries and other group companies, offered a wide variety of products and services.
- As India's economy became more market-oriented and integrated with the world economy, the ICICI capitalised on the new opportunities, to provide a wider range of financial products and services, to a broader spectrum of clients.
- **1994 : ICICI** Bank, as a part of the ICICI group.
- **1999 :** ICICI became the first Indian company and the first bank or financial institution from non-Japan Asia, to be listed on the New York Stock Exchange.
- The issue of universal banking, which in the Indian context meant conversion of long-term lending institutions such as ICICI into commercial banks, had been discussed at length, in the late 1990s.
- Conversion into a bank offered ICICI, the ability to accept low-cost demand deposits and offer a wider range of products and services, and greater opportunities for earning non-fund-based income, in the form of banking fees and commissions.
- **March 2002**: ICICI Bank, to create the first universal bank in India.

Objectives of ICICI

***To meet the needs of the industry for permanent and long-term funds in the private sector. In general, the objectives of the Corporation were*:**

- To assist in creation, growth and modernisation of business enterprises in the non-public sector.

- To stimulate private ownership of industrial entities and to promote and assist in the expansion of markets.
- To provide equipment finance.
- To provide finance for rehabilitation of industrial units.

Functions of ICICI

- Providing finance in the form of long-term and medium-term loans and equity participation.
- Sponsoring and underwriting new issues of shares and other securities
- Guaranteeing loans availed by enterprises from other lenders
- Providing project advisory services to private sector companies in the pre-investment stage on Government policies and procedures, feasibility studies and joint venture search, and to Central and State Governments on specific policy related issues.

Types of financial assistance of ICICI

- Underwriting of public issues and offer or sale of industrial bonds
- Direct subscription to such securities.
- Extending Rupee loans, repayable over periods up to 15 years.
- Providing similar loans in foreign currencies for payment of imported capital equipment and technical services.
- Guaranteeing payments for credit extended by other financial institutions
- Providing credit facilities to manufacturers for promoting sale of industrial equipment on deferred payment terms.
- Providing financial services like leasing and instalment sale.

- **1973**: ICICI started a Merchant Banking Division, for advising its clients on raising finances in suitable forms and on restructuring of financial structures, in existing companies.
- It also advised clients on amalgamation proposals.
- Assistance was provided in preparing proposals for submission to financial institutions and banks and for negotiating with them for loans, underwriting, etc.
- Played the role of Managers to issues of capital raising and assistance was also provided for completion of formalities connected with the public issues and of legal formalities for raising loans.

- **In 1982,** the ICICI gave a new dimension to its Merchant Banking Division, by offering to provide counselling for industrial investments in India, to Non-Resident Indians.

Institutions Set Up/Promoted by ICICI

- **Venture Funds Co. Ltd:** for the promotion of green field projects and risk capital investment and joined the other financial institutions, in setting up Stock Holding Corporation of India Ltd (SHCIL), Credit Rating Information Services of India Ltd (CRISIL) and OTC Exchange of India Ltd.
- **March 1995:** ICICI Brokerage Services Ltd, which is a 100% subsidiary of I-SEC. It commenced its securities brokerage activities in 1996 and is registered with the National Stock Exchange of India Limited and the Bombay Stock Exchange.
- **1997:** ICICI Credit, which later renamed as ICICI Personal Financial Services Limited in 1999, which offered a comprehensive range of products and services to retail customers.
- **ICICI Capital Services Ltd. :** Originally set up as SCICI Securities Ltd., as a wholly owned subsidiary of erstwhile SCICI Ltd., in 1994. Its objective was to provide stock broking services to institutional clients and undertaking activities such as underwriting, primary market placements and distribution, industry and company research, etc. It became a wholly owned subsidiary of ICICI in April 1996.
- ICICI promoted the Housing Development Finance Corporation (HDFC), to provide long-term finance to individuals in middle- and lower-income groups for the construction and purchase of residential homes.
- **Credit Rating Information Services of India Ltd. (CRISIL):** Set up in association with Unit Trust of India (UTI), to provide credit rating services to the corporate sector.

Industrial Development Bank Of India (IDBI)

- **Purpose:** To accelerate the industrial development in the country.
- There was a lack of co-ordination between the different institutions and it led to overlapping and duplication in their efforts. At the same time, some very large projects of national importance required financial support.
- In order to realise this objective, the IDBI was established in 1964, as a wholly owned subsidiary of Reserve Bank of India.
- Act as an apex institution, co-coordinating functions of all the financial institutions, into a single integrated movement of development banking and supplementing their resources for industrial financing and as an agency for providing financial support to all viable projects of national **importance, whose access to existing institutional sources were limited.**

- The ownership was transferred to Central Government on February 16, 1976.
- Changing its organizational structure to that of a state-owned autonomous corporation.
- The IDBI Act was amended, in the year **1994, to permit public ownership up to 49%.**
- **1995:** Raised more than Rs. 2,000 crores through its first initial public offer (IPO), reducing the stake of the government to 72%.
- **June 2000:** A part of the equity shareholding of the government was converted into preference share capital, which was redeemed in March 2001, resulting into further reduction of government stake to 58%.

Financial Resources of IDBI

- **Share Capital**: IDBI was formed with an authorised capital of Rs. 50 crores, which was increased subsequently on a number of occasions. In October, 1994, Government of India amended certain provisions of IDBI Act and under the provisions of the modified Act, the authorised capital of the bank was increased to Rs. 2,000 crores, which could further be increased to Rs. 5,000 crores.
- **Borrowings:** IDBI was authorised to raise its resources through borrowings from Government of India, Reserve Bank of India and other financial institutions.

Functions of IDBI The main functions of IDBI were as follows:

- To co-ordinate the activities of other development financial institutions providing term finance to the industrial sector and to act as an apex institution.
- To provide refinance to financial institutions, granting medium and long-term loans to industries.
- To provide refinance to scheduled banks.
- To provide technical and administrative assistance for promotion, management or growth of industries.
- To undertake market surveys and techno-economic studies, for the development of industries.
- To grant direct loans and advances to industrial concerns. IDBI was empowered to finance all types of industrial concerns, engaged or proposed to be engaged in the manufacture, preservation or processing of goods, mining, hotel industry, fishing, shipping transport, generation and distribution of power, etc.
- To render financial assistance to industrial concerns. IDBI operated various schemes of assistance viz., Direct Assistance Scheme, Soft Loans Scheme, Technical Development Fund Scheme, Refinance Industrial Loans Scheme, Bill Re-Discounting Scheme, Seed Capital Assistance Scheme, Overseas Investment Finance Scheme and Development Assistance Fund.

Operations of IDBI

Since its inception in 1964, IDBI extended its operations to various areas of industrial sector

Direct Assistance

Direct financial assistance includes project finance assistance, soft-loan assistance, assistance under technical development fund scheme and rehabilitation assistance for sick units.

Project Finance Assistance:

Under project finance scheme, IDBI extended direct assistance to industrial concerns in the form of:

- Project loans
- Subscription to and/or underwriting of issues of shares and debentures.
- Guarantee for loans and deferred payments.
- Financial assistance under this scheme was granted for setting up new projects as well as for expansion and modernisation and renovation of existing units.
- IDBI introduced special schemes for industrialisation of backward areas. In a scheme introduced in 1969, it offered concessional rates of interest and longer repayment periods.
- These concessions were made available to small and medium scale units. In collaboration with the IFCI and the ICICI, IDBI also extended concessional rupee loans up to Rs. 2 crores and underwriting assistance up to Rs.1crore.

Soft Loan Scheme

- **In 1976 :** Introduced the soft loan scheme to provide financial assistance to product units in selected industries, viz., cement, cotton, textiles, jute, sugar and certain engineering industries for modernisation.
- This scheme is implemented by IDBI with financial participation by IFCI and ICICI.

Technical Development Fund Scheme

- **March, 1976 :** The Government of India introduced the TDF Scheme for issue of import licenses for import of small value balancing equipment, technical knowhow, foreign consultancy services and drawings and designs by industrial

units, to enable them achieve fuller capacity utilisation, technological up gradation and higher exports.
- **1977:** IDBI introduced a scheme for providing matching rupee loans to industrial units, to enable them to utilise import licenses issued, under the TDF scheme.

Rehabilitation Assistance to Sick Units

- The problem of growing industrial sickness in India was a cause of worry. It adversely affected production, employment, generation of income and utilisation of productive resources.
- With a view to reducing the financial sickness amongst industries, IDBI devised the Refinance Scheme for Industrial Rehabilitation.
- Units which had been financed by State Financial Corporations or State Industrial Development Corporations and were classified as sick were eligible under this scheme, for support.

Indirect Assistance

Refinance assistance for Industrial Loans

- IDBI provided refinance facility against term loans granted by the eligible credit institutions to industrial concerns, for setting up of industrial projects as also for their expansion, modernisation and diversification.
- It provided refinance support to commercial banks, RRBs, State Cooperative Banks, State Financial Corporations, State Industrial Development Corporations and other institutions extending term loan assistance to industrial units.

Rediscounting of Bills

- **1965:** Rrediscounting facility of machinery bills was introduced.
- Purpose: to help indigenous machinery manufacturers and their purchases.
- The purchaser of machinery accepted bills of exchange or promissory notes of the seller and undertook to make the payment in instalments.
- The seller could get the bills discounted with his banker- who in turn, could rediscount the bills with IDBI. The scheme was extended for expansion and diversification of existing units also.

Seed Capital Assistance:

- With a view to supporting first generation entrepreneurs who had the skills but lacked financial resources, IDBI launched its Seed Capital Assistance Scheme, in September, 1976.

Small Industries Development Bank Of India (SIDBI)

- **Established:** In 1990, under an act of parliament, the Small Industries Development Bank of India Act, 1989.
- The charter establishing SIDBI envisaged SIDBI to be the principal financial institution, for the promotion, financing and development of industries in the

small-scale sector and to coordinate the functions of other institutions, engaged in similar activities.

- Commenced its operations on April 2, 1990, as a subsidiary of IDBI, by taking over the outstanding portfolio and activities of IDBI, pertaining to the small-scale sector.

SIDBI has been playing the following basic rules

- Financing
- Promotion
- Development and
- Coordination for orderly growth of the MSME sector.

Functions of SIDBI

- It provides direct and indirect finance to the MSME sector.
- It refinances loans that are extended by the Primary Lending Institutions (PLIs – like banks) to the MSME units.
- It discounts and rediscounts bills.
- It also helps in expanding marketing channels for the products of MSME sector, both in the domestic as well as international markets.
- It offers services like factoring, leasing, etc., to the industrial concerns in the MSME sector.
- It promotes employment-oriented industries, particularly in semi-urban areas, for creating employment opportunities and thus, checking the migration of people to urban areas.
- It initiates steps for modernisation and technological upgradation of current units.
- It enables the timely flow of credit for working capital as well as term loans to MSME units in conjunction with the commercial banks

Financing Facilities Offered by SIDBI

Direct Finance

- SIDBI offers working capital assistance, term loan assistance, foreign currency loans, finance against receivables, equity support, energy saving schemes for the MSME sector, etc., under its various direct finance loan schemes.

Indirect Finance

- SIDBI offers indirect assistance by providing refinance to PLIs, comprising of banks, State Level Financial Institutions, etc. The key objective of the refinancing schemes is to raise the resource position of the PLIs, which would, in turn, enable the flow of credit to the MSME sector.

Micro Finance

- SIDBI also offers microfinance to small businessmen and entrepreneurs for establishing their business.

Direct Finance Loan Schemes Offered by SIDBI

Loan Scheme	Loan Amount	Loan Tenure
SIDBI Make in India Soft Loan Fund for MSMEs (SMILE)	Minimum loan size – Rs.10 lakh for Equipment Finance and Minimum Loan Size for Others – Rs.25 lakhs	Up to 10 years, including 3-year moratorium
Smile Equipment Finance (SEF)	Minimum loan amount is Rs.10 lakhs	Up to 72 months
Loans under partnership with OEM (Original Equipment Manufacturer)	Up to Rs.1 crore	Up to 5 years
Working Capital (Cash Credit)	Depends upon the financial appraisal	As per the terms and conditions of the facility
SIDBI – Loan for Purchase of Equipment for Enterprise's Development (SPEED)	Up to 100% of the machinery cost subject to maximum of Rs.1 crore for New to Bank (NTB) customers and up to Rs.2 crores for existing customers of SIDBI.	Up to 2-5 years including moratorium of up to 3-6 months
SIDBI-Loan for Purchase of Equipment for Enterprise's Development Plus (SPEED PLUS)	Up to 100% of the machinery cost subject to maximum of Rs.2 crores for New to SIDBI customers and up to Rs.3 crores for existing customers of SIDBI.	Up to 2-5 years including moratorium of up to 3-6 months
Top Up Loan for Immediate Purposes (TULIP)	30% of existing exposure or 20% of net sales, subject to maximum of Rs.2 crores	Up to 5 years including 6-month moratorium
SIDBI Term-Loan Assistance for Rooftop Solar PV Plants (STAR)	Rs.10 lakhs to Rs. 2.5 crores	Up to 5 years including 3-6 months moratorium
SIDBI Assistance to Facilitate Emergency Response Against Coronavirus (SAFE)	Up to Rs.50 lakhs	Up to 5 years
SIDBI Assistance to Facilitate Emergency Response Against Coronavirus Plus (SAFE PLUS)	Up to Rs.100 lakh	Repayable over 4-months
Timely Working Capital Assistance to Revitalise Industries in Times of Corona Crisis (TWARIT)	Up to 20% of total outstanding loans with SIDBI up to Rs.25 crores	Up to 4 years including 1 month moratorium

Indirect Finance Schemes of SIDBI

Under Indirect Finance, there are schemes where financial assistance is provided to banks, NBFCs, and Small Finance Banks (SFBs). These include the following:

- **Refinance to Banks, NBFCs, and SFBs:** Refinance is provided to Banks, NBFCs and SFBs.
- **Assistance to NBFCs:** NBFCs which include the loan companies as well that are registered with RBI help in providing financial assistance to enterprises in the MSME sector.

- **Assistance to Small Finance Banks (SFBs):** In order to strengthen the equity and resource base of SFBs, this scheme was introduced. This scheme focuses on providing refinance support to SFBs.

Micro-Lending Schemes of SIDBI

There are three main schemes under Micro Lending namely, Micro Lending Development, Responsible Finance Initiatives and Beyond Microfinance.

- **Micro-Lending Development**: The objective of Micro-Lending Development is to create an institution and provide micro-financial services to the people who are economically weak.
- **Responsible Finance Initiatives**: In the light of promoting cooperation and the right lending practices in the financial sector, this loan scheme comes as a big support to banks and other financial institutions in the country.
- **Beyond Microfinance**: This loan scheme helps the entrepreneurs to graduate from microfinance to a larger ticket size loan, at affordable rates.

Export-Import Bank Of India (EXIM BANK)

- **Established:** Export-Import Bank Act, 1981, which was passed in September 1981 and it commenced its operations in March, 1982.
- **wholly owned by the Government of India**
- **Purpose:** Financing, facilitating, and promoting foreign trade in India.
- Principal financial institution in the country for coordinating working of institutions engaged in financing exports and imports.
- Exim Bank is an apex institution, which promotes foreign trade and, in addition to a number of domestic offices, it has nine overseas offices.

Functions of Exim Bank

- Financing import and export of goods and services from India.
- Financing the import and export of goods and services from countries other than India
- Financing the import or export of machines and machinery on lease or hire purchase basis
- Providing refinancing services to banks and other financial institutions for their financing of foreign trade.
- Providing financial assistance to businesses setting up joint ventures, in a foreign country.
- Providing technical and other assistance to importers and exporters.

- Undertaking functions of a merchant bank, for the importer or exporter in transactions of foreign trade.
- Underwriting shares/debentures of companies, engaged in foreign trade
- Extending short-term loans or lines of credit to foreign banks and governments
- Providing business advisory services and expert knowledge to Indian exporters, in respect of multifunded projects, in foreign countries.

Products and Services of Exim Bank

- Exim Bank has a number of products and services that it has developed for facilitating international trade for exporters and importers from India.

National Bank For Agriculture And Rural Development (NABARD)

- With the widening of the role of bank credit from "agricultural development" to rural development, the Government proposed to have a more broad-based organisation at the apex level, to extend support and give guidance to credit institutions in matters relating to the formulation and implementation of the rural development programmes.
- Recommendations of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), **headed by Shri B Sivaraman,**
- **July 1982**: National Bank for Agriculture and Rural Development (NABARD), by an Act of Parliament, to take over the functions of the Agricultural Refinance and Development Corporation (owned by RBI and refinancing the LT loans provided by various RFIs) and the refinancing functions of RBI, in relation to cooperative banks and RRBs.

Credit, promotional and development functions

- **Credit Functions**: Refinance support
- **Grant Support:** Implementing various promotional and development programmes for the growth of agriculture and rural development activities, by providing grant support from out of various funds maintained by it.
- **Institutional Development functions**: NABARD provides policy, financial as well as technical support to rural credit cooperatives, as a part of institutional development efforts.
- **Supervisory Functions:** Section 35 of the Banking Regulation Act, 1949 NABARD conducts statutory inspection of the State Cooperative Banks (StCB), District Central Cooperative Banks (DCCBs) and Regional Rural Banks

National Housing Bank

- The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) identified the non-availability of long-term finance to individual households and recommended the setting up of a national level institution.
- The Committee of Secretaries considered the recommendation and set up the High-Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI, to examine the proposal and recommended setting up of the National Housing Bank, as an autonomous housing finance institution.
- While presenting the Union Budget for 1987-88 on February 28, 1987 announced the decision to establish the National Housing Bank (NHB), as an apex level institution for housing finance.
- Following this announcement, the National Housing Bank Bill (91 of 1987) providing the legislative framework for the establishment of NHB, was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on December 23, 1987, became an Act of Parliament.
- The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing.
- Set up on July 9, 1988 under the National Housing Bank Act, 1987.
- Reserve Bank of India contributed the entire paid-up capital when the bank was initially setup.
- In the year 2019, RBI had divested its share in the bank and now the bank is fully owned by GOI.
- The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors.

Basic functions of the NHB

- As "to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto ..."

Objectives

- To promote a sound, healthy, viable and cost-effective housing finance system
- To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups
- To augment resources for the sector and channelise them for housing
- To make housing credit more affordable
- To regulate the activities of housing finance companies
- To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock

National Bank For Financing Infrastructure And Development (NaBFID) 2021

- NaBFID is regulated and supervised as an All India Financial Institution (AIFI) by the Reserve Bank under Sections 45L and 45N of the Reserve Bank of India Act, 1934.
- It is the 5th AIFI after EXIM Bank, NABARD, NHB and SIDBI.
- The NaBFID Act is meant to establish the National Bank for Financing Infrastructure and Development to support the development of long-term non-recourse infrastructure financing in India including development of the bonds and derivatives markets necessary for infrastructure financing and to carry on the business of financing infrastructure and for matters connected therewith or incidental thereto.
- The NaBFID Act 2021 is **divided into 7 Chapters consisting of 48 Sections.**
- **Section 3 and 4 of the** DFI refer to the Establishment/incorporation of Institution and Purposes and objectives of Institution.
- **Section 5 states** that the authorised share capital of the Institution shall be 100 thousand crore rupees divided into 10 thousand crores of fully paid-up shares of ten rupees each.
    - Shares of the Institution may be held by the Central Government, multilateral institutions, sovereign wealth funds, pension funds, insurers, financial institutions, banks.
    - Central Government shall hold at least 26% of the shares at all times
- **Section 6 deals** with the composition and appointment of the Board of Directors and Management which will comprise of
    - 1 Chairperson,
    - 1 Managing director,
    - not more than 3 Deputy Managing Directors, two directors, to be nominated by the Central Government- who shall be the officials of the Central Government,
    - not exceeding 3 directors elected by the Shareholders and
    - not exceeding 3 independent directors.
- **Sections 7, 8 and 9:** Deal with the general management, delegation of powers and the term of office of the Board level functionaries**.**
- **Sections 18 and 19** deal with the prohibited functions and related party transaction for NaBFID.
- **Section 41 states** that the Bankers' Books Evidence Act, 1891, shall apply in relation to the Institution as if it were a bank as defined in section 2 of that Act.

- **Section 43,** no provision of law relating to the winding up of companies shall apply to the Institution and the Institution shall not be placed in liquidation save by order of the Central Government and in such manner as it may direct.

Section 3 and 4 of the DFI refer to the Establishment/incorporation of Institution and Purposes and objectives of Institution.

Section 5 states that the authorised share capital

Section 6 deals with the composition and appointment of the Board of Directors and Management

Sections 7, 8 and 9 : deal with the general management, delegation of powers and the term of office of the Board level functionaries.

Sections 18 and 19 deal with the prohibited functions and related party transaction for NaBFID.

Section 41 states that the Bankers' Books Evidence Act, 1891

section 43 Winding up cases

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JAIIB IE & IFS Module C Unit 5 – Micro Finance Institutions

Introduction

Microfinance is a form of financial service, which provides small loans and other financial services to poor and low-income households.

It is an economic tool, designed to promote financial inclusion, which enables the poor and low-income households, to come out of poverty, increase their income levels and improve their overall living standards.

Microfinance consists of

- Micro-savings,
- Micro-credit,
- Microinsurance and
- Micro-pensions.

Evolution Of Microfinance In India

MICRO SAVINGS | MICRO CREDIT | MICRO ENTERPRISE

MICRO INSURANCE | MICRO REMITTANCE | MICRO PENSIONS

- **The microfinance sector has evolved from micro savings to micro credit and then to micro enterprises and now to micro insurance, micro remittances and micro pensions.**
- **Process has given a boost to the rural poor in India to reach reasonable economic, social, and cultural empowerment, leading to better life of participating households.**

The development of the microfinance sector in India can be divided into three phases as under:

The first phase started in the pre-independence days

- The Agriculture Credit Department was set up in the Reserve Bank of India to promote rural credit.
- In its early days, the government sought to promote rural credit, by strengthening the cooperative institutions.

The second phase started in the late 1960s

- **Dec, 1969:** The Lead Bank Scheme was introduced 1969, thereby, starting a process of district credit plans and coordination among different financial intermediaries.
- Nationalisation of 14 commercial Banks
- **1975:** RRBs were conceptualised ,to augment the delivery of financial services in rural areas. This has resulted in the creation of a wide network of banks, which is one of the largest globally.
- **1980-81:** The government initiated the Integrated Rural Development Programme (IRDP)
- **Objective:** To direct subsidised loans to poor self-employed people, through the banking sector.
- **1982:** NABARD was established
- It was around this time, the first Self Help Groups (SHGs) started emerging in the country, mostly as a result of non-government organisations' (NGO) activities.
- Commencement of the modern microfinance movement.
- The Mysore Resettlement and Development Authority (MYRADA) was one of the pioneers of the concept of SHGs.
- In 1984-85, MYRADA started linking SHGs with banks.
- SHGs, in turn, were also very responsive and flexible to the needs of their **members.**

- While MYRADA did not directly intervene in the credit market for the poor, it facilitated banking with micro institutions established and controlled by the poor.
- SHGs were a step in that direction.
- This marked the beginning of the current microfinance movement**.**

The third phase marked the modern microfinance movement

- **1992:** The SHG–Bank Linkage Programme was formally launched by NABARD, with its guidelines to banks for financing SHGs, under a pilot project that aimed at financing 500 SHGs across the country, through the banking system.
- While the banks had financed about 600 SHGs by March 1993, they continued to finance even more SHGs in the subsequent years
- This encouraged RBI to include financing SHGs as a mainstream activity of banks under their priority sector lending in 1996.
- However, as the sector grew, certain inadequacies and failures became apparent culminating in the Andhra Pradesh (AP) microfinance crisis in 2010.
- This crisis was attributed to the irrational exuberance of some MFIs who, in their eagerness to grow business, had given a go by to the conventional wisdom and good practices such as due diligence in lending and ethical recovery practices.
- Over the last decade, the landscape of the microfinance sector has changed significantly.
- One out of two entities granted approval for starting a universal bank in 2014 was a microfinance institution (MFI), while eight out of ten entities granted approval for starting small finance banks in 2016 were MFIs.

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Grameen Bank Model

- The global pioneer of microfinance was Professor Muhammad Yunus, who experimented with concept in 1976 and established the Grameen Bank in 1983, in the village of Jobra in Bangladesh.
- Professor Yunus, who was awarded the Nobel Prize in 2006, while he was on a field visit, came across a lady called Sufia, working with bamboos.
- He was surprised to know that she was not able to manage even five takas (22 US cents) to buy raw materials and Sufia explained that the local money lenders charged 10% per week and, sometimes even 10% per day and people who start borrowing with them only got poorer.
- The next day, Professor Yunus lent 856 taka to 42 people of the Jobra village and told them to repay without interest.
- This emotional support of Prof. Yunus was institutionalised by establishing Grameen Bank in Bangladesh, in the year 1983.

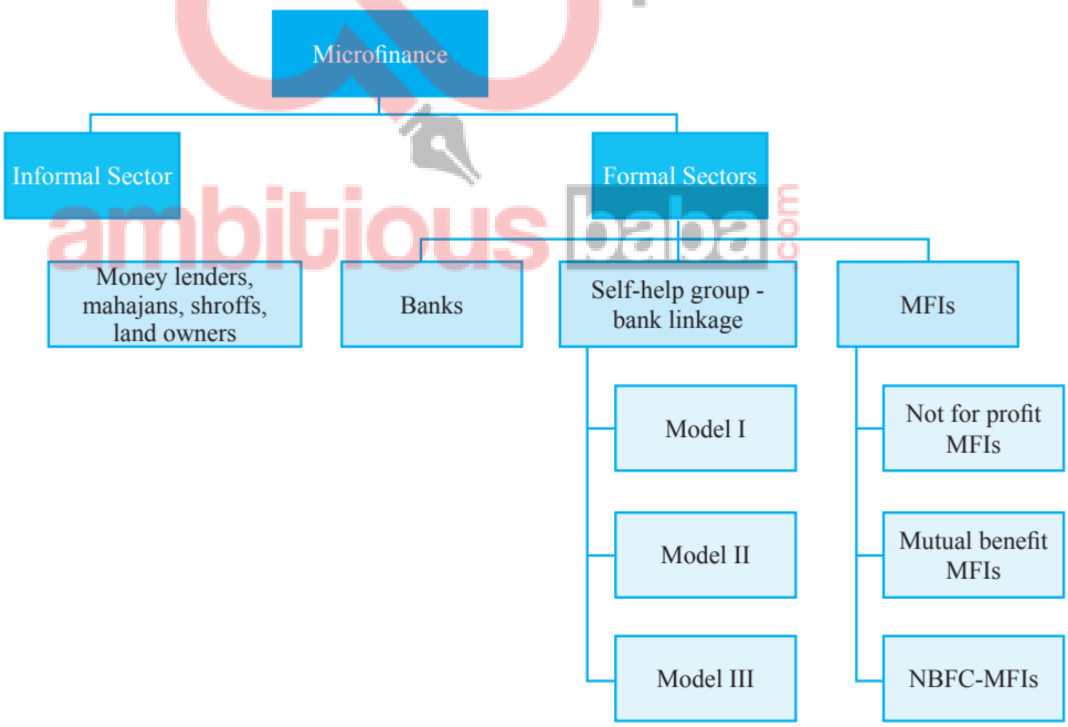
- Today, Grameen Bank has about 2,600 branches and operates in over 80,000 villages and has 9 million borrowers, with repayment rate of over 99%.
- In the Grameen Bank model, members of the group are also the owners of the bank. The group normally consists of five members and the liability to repay the loan lies with the individuals.
- The loan is given directly on the basis of trust and no agreement or document is required.
- The success of Grameen Bank proved that the poor needed access to financial services, rather than the cheap subsidised credit.

Delivery Of Microfinance

- **Today, there are two broad types of entities, which are instrumental in delivery of microfinance,**

The informal ones and the formal ones.

- **The informal entities:** Are those which are built into the social and economic fabric of the country, especially the rural areas.
- Consist of money lenders, mahajans, shroff and land owners
- **Formal sector**: Is broad and consists of entities like commercial and cooperative banks, joint liability groups and microfinance institutions (MFIs).



Banks

- The network of banks provide microfinance.

- The cooperative banks and the regional rural banks were set up specifically to cater to the needs of both rural as well as urban poor.
- The commercial banks, both in the public sector and the private sector extend finances for agricultural as well as other allied activities, as part of their priority-sector lending, which has been mandated by RBI.

Self-Help Groups (SHGs)

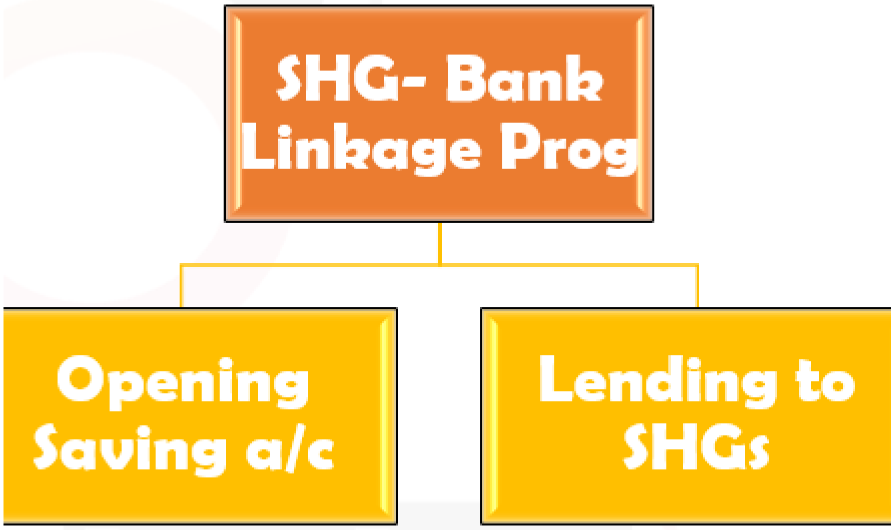
- SHGs are small informal group of 10-20 individuals, who are homogenous with respect to social and economic background and come together voluntarily, for promoting savings habit among members and for a common cause to raise and manage resources, for the benefit of group members.
- However, in hilly tracts and regions and predominantly tribal dominated areas, where communities are dispersed, economically weaker and physically challenged persons, smaller groups of minimum 5 members are also formed into SHGs.
- It is preferred that all members are from Below Poverty Line level (BPL). However, there can be up to 20%, or in exceptional cases, up to 30% of the members from Above Poverty Line (APL), provided they live contagious to the BPL members.
- The members of the SHG come together voluntarily to save small amounts regularly to a common fund and to meet their emergency needs.
- This common fund may not, often, be sufficient enough to lend to its members and hence, the SHG seeks an external funding from banks to support the income-generating activities.

Microfinance Institutions (MFIs)

As per NABARD, MFIs are defined as 'those which provide thrift, credit and other financial services and products of very small amounts, mainly to the poor in rural, semiurban or urban areas, for enabling them to raise their income level and improve living standards.

- **Not for profit MFIs** - These are societies registered under the Societies Registration Act, 1860, or similar Acts. They also include trusts set up, under the Indian Trust Act, 1882 and 'Not for Profit companies' established under Section 25 of the Companies Act, 1956 (now section 8 of the Companies Act, 2013).
- **Mutual benefit MFIs** – These include State and National Cooperatives and Mutually Aided Cooperative societies, set up under the Mutually Aided Cooperative Societies Act, which was enacted by the Government of Andhra Pradesh, in the year 1955.
- **For profit MFIs (NBFC-MFIs) –** These are non-banking financial companies (NBFCs), which are registered under the Companies Act and regulated by the RBI. Most of the microfinance in India are through MFIs that fall in this category. They form the largest category of MFIs.

SHG - Bank Linkage Programme



Linkage for Saving

- The SHGs which are engaged in promoting savings habits among their members are eligible to open savings bank accounts with banks. These SHGs need not necessarily have already availed of credit facilities from banks, before opening savings bank accounts, and the account will be opened in the name of the SHG.
- In terms of the current RBI guidelines under Simplified norms for Self Help Groups (SHGs), Customer Due Diligence (CDD) of all the members of SHG as mentioned in the above Direction are not required while opening the savings bank account of the SHG.
- CDD of all the members shall be necessary at the time of credit linking of SHGs (Amendment vide RBI MD: KYC 2016)

Linkage for Borrowing

- As per guidelines issued by NABARD, SHGs may be sanctioned savings linked loans by banks (varying from a saving to loan ratio of 1:1 to 1:4).
- However, in case of matured SHGs, loans may be given beyond the limit of four times the savings, as per the discretion of the bank.
- The loan would be in the name of the SHG and it is the SHG which is responsible for repayment of the loan. Loan may be granted by the SHG for various purposes to its members.
- The bank does not decide the purposes for which the SHG gives loans to its members.
- The purpose can be emergency needs like illness in the family, marriage, etc., or buying of assets for income generation acquisition of assets.

- Defaults by a few members of SHGs and/or their family members to the financing bank should not ordinarily come in the way of financing SHGs perse by banks, provided the SHG is not in default.
- No loan related and ad hoc service charges/inspection charges should be levied **on priority sector loans up to Rs 25,000.**
- In the case of eligible priority sector loans to SHGs/ JLGs, this limit will be applicable per member and not to the group as a whole.
- **No Collateral:** RBI/NABARD guidelines stipulate that no collateral security should be taken from SHGs, by banks.
- **Part of PSL:** Lending to SHGs constitute part of priority sector lending of banks and such advances should be included as part of their lending to the weaker sections. Financing to SHGs by banks are refinanced 100% by NABARD

The SHG–bank borrowing linkage programme operates three models, which are:

- **Model I:** NABARD–Bank–SHG. Under this model, SHGs are formed and directly financed by banks. There is no NGO intervention.
- **Model II**: NABARD–Bank–SHG (with NGO as a facilitating agency). Under this model, the NGOs will promote SHGs and link them with banks. SHGs formed by NGOs are also directly financed by banks. This is the most popular model and a majority of the SHGs were financed by banks under Model II.
- **Model III**: NABARD–Bank–NGO–SHG (with NGO as the financial intermediary). Funds flow from banks to NGOs, and the SHGs are, thereafter, financed by banks through the NGOs.

Joint Liability Groups (JLGs)

- A group of 4-10 people of same village/locality of homogenous nature and of same socio-economic background who mutually come together to form a group
- **Purpose:** Availing loan from a bank, without any collateral.
- A few members of SHGs may graduate faster to start or expand economic activities, requiring much higher levels of loans than other SHG members.
- In such cases, other members may not like to stand mutual guarantee for large sized loans for these members, and in such cases, a "Joint Liability Group (JLG)" may be created consisting of such members of one or more SHGs.
- The members of JLG will continue to remain members of the SHGs and continue to participate in the activities of SHGs as earlier

Regulatory Framework for Microfinance Institutions

- Till the beginning of the 21st century, the activities of the MFIs were largely unregulated. The rapid growth and demand for their services, unfortunately, led to a crisis in the sector in 2010, largely in Andhra Pradesh, where the activity was concentrated.

- During the said period, the lending by MFIs had escalated exponentially and this led to a very high level of borrowing, per family.
- The high level of borrowings led to increase in defaults which motivated some of the MFIs to resort to coercive recovery methods. This culminated into a spate of suicides in the State and during 2010, there were 30 suicides by women borrowers, in **the short space of 45 days.**

In order to ascertain the reasons for the crisis and in an order to bring in discipline and control in the microfinance sector, the RBI appointed a Committee to Study Issues and Concerns in the MFI Sector (Chairman: Y H Malegam). **The Committee submitted its findings in January 2011 and some of the key recommendations of the Malegam Committee are listed here:**

- Creation of a separate category of NBFC operating in the microfinance sector to be designated as NBFC-MFI
- Criteria for defining 'microfinance loans' classified as 'qualifying assets'
- Prudential norms on capital adequacy and provisioning requirements
- Prescriptions related to pricing of credit, in terms of a margin cap and interest rate ceiling on individual loans
- Transparency in interest charges as well as other terms and conditions of the loan
- Measures to address multiple lending, over-borrowing and coercive methods of recovery
- Establishment of a proper system of grievance redressal

Reserve Bank Of India (Regulatory Framework For Micro Finance Loans) Directions 2022

RBI, in exercise of the powers conferred by

- Section 21, Section 35 A and Section 56 of the Banking Regulation Act, 1949,
- Chapter IIIB of the Reserve Bank of India Act, 1934 and
- Sections 30A and Section 32 of the National Housing Bank Act, 1987,
- issued fresh directions to banks/NBFCs including micro finance institutions and housing finance companies in March, 2022

Definition of micro finance loans

- A micro finance loan is defined as a collateral-free loan given to a household, having annual household income up **to Rs. 3 lakh.**
- For this purpose, the household shall mean an individual family unit, i.e., husband, wife and their unmarried children.
- All collateral free loans, irrespective of end use and mode of applications/processing/disbursal (either through physical or digital channels), provided to low-income households.

- To ensure collateral free nature of the microfinance loans. the loan shall not be linked with a lien on the deposit account of the borrower.
- The regulated entities (REs) shall have a board-approved policy to provide the flexibility of repayment periodicity on microfinance loans as per the borrowers requirement

Assessment of household income

- Each RE shall put in place, a board-approved policy, for assessment of household income.
- Self-regulatory organisations and other associations/agencies may also develop a common framework, based on the indicative methodology.
- The REs can adopt/modify the above framework suitably, as per their requirements with approval of their boards.
- Each RE shall mandatorily submit information regarding household income to the credit information companies (CICs).
- The reasons for any divergence between the already reported household income and assessed household income shall be specifically ascertained from the borrower/s before updating the assessed household income with the CICs.

Limit on loan repayment obligation of a household

- Each RE shall have a board-approved policy regarding the limit on the outflows on account of repayment of monthly loan obligations of a household as a percentage of the monthly household income.
- This shall be subject to a **limit of a maximum 50% of** the monthly household income.
- The computation of loan repayment obligations shall take into account all outstanding loans (collateral-free microfinance loans as well as any other type of collateralized loans) of the household.
- **The outflows capped at 50% of the monthly household** income = repayments (including both principal as well as interest component) towards all existing loans as well as the loan under **consideration.**
- **Each RE shall provide timely and accurate data to the CICs and use the data available with them to ensure compliance with the level of indebtedness.**

Pricing of Loans

Each RE shall put in place a board-approved policy regarding pricing of microfinance loans which shall, inter alia, cover the following:

I)A well-documented interest rate model approach, for arriving at the all-inclusive interest rate;

II)delineation of the components of the interest rate such as cost of funds, risk premium and margin, etc., in terms of the quantum of each component based on objective parameters;

III)The range of spread of each component for a given category of borrowers;

IV)A ceiling on the interest rate and all other charges applicable to the microfinance loans

- Interest rates and other charges/ fees on microfinance loans should not be usurious.
- These shall be subjected to supervisory scrutiny by the Reserve Bank.
- Each RE shall disclose pricing related information to prospective borrower in a standardised simplified factsheet.
- The borrower shall not be charged any amount which is not explicitly mentioned in the factsheet.
- The factsheet shall also be provided for other loans (i.e., collateralised loans) extended to borrowers from low-income households.
- There shall be no pre-payment penalty on microfinance loans.
- Penalty, if any, for delayed payment shall be applied on the overdue amount and not on the entire loan amount.
- Each RE shall prominently display the **minimum, maximum and average** interest rates charged on microfinance loans in all its offices, in the literature (information booklets/ pamphlets) issued by it and details on its website.
- Any change in interest rate or any other charge shall be informed to the borrower well in advance and these changes shall be effective only prospectively.

Guidelines on Conduct towards Microfinance Borrowers:

- A Fair Practices Code (FPC) based on these directions shall be put in place by all REs with the approval of their boards.
- The FPC shall be displayed by the RE in all its offices and on its website.

Qualifying asset criteria

- Under the latest guidelines of RBI, the definition of qualifying assets of NBFC-MFI is aligned with the definition of micro finance loans.
- **The minimum requirement :** 75% of the total assets.
- Under the earlier guidelines, an NBFC that does not quality as an NBFC-MFI, cannot extend micro **finance loans exceeding 10%** of its total assets.
- The **maximum limit** on microfinance loans for such NBFCs (i.e.. finance loans for NBFC-MFIs therefore stands revised **to 75 per cent of the total assets.**

- Under the earlier guidelines, an NBFC that does not quality as an NBFC-MFI, cannot extend micro finance **loans exceeding 10 per cent of its total assets.**
- **The maximum limit on microfinance** loans for such NBFCs (i.e.. NBFCs other than NBFC-MFIs) now stands revised **to 25% of the total assets.**

RBI's Fair Practices Code For NBFC-MFIS

- A Fair Practice Code (FPC) for any industry, is a set of criteria that justifies the functioning of that industry, in compliance with the guidelines of the regulatory body and that they are not carrying out any activity, which is prohibited/barred/forbidden by the regulator.

Objective of RBI's Fair Practice Code

***The main purpose of the Fair Practices Code is to*:**

- Adopt practices which are considered best for dealing with the customer;
- Ensure customer satisfaction, by setting higher standards and achieving them;
- Follow methods of business operations that are transparent, fair, ethical and legally justifiable;
- Provide business-related information to the public, which is in their interest; and
- Avoid using unfair practices.

RBI's FPC for NBFCs details the following areas for adherence:

- Obtention of loan applications and their processing
- Loan appraisal and terms and conditions of sanction
- Disbursement of loans and change of terms and conditions of sanction
- Request for transfer of borrowal accounts
- Avoiding use of coercive measures and methods for recovery of loans
- Resolving complaints and grievances of customers
- Language to be used and mode of communication of the FPC
- Avoiding charging of unreasonably high rate of interest
- Use of various methods for re-possession of hypothecated vehicles

For NBFC-MFIs, the FPC elaborates of the following criteria:

General

- The FPC in vernacular language shall be displayed by an NBFC-MFI, in its office and branch premises,
- A statement shall be made in vernacular language and displayed by NBFC-MFIs in their premises and in loan cards, articulating their commitment to transparency and fair lending practices,
- Field staff shall be trained to make necessary enquiries with regard to existing debt of the borrowers,
- Training, if any, offered to the borrowers shall be free of cost. Field staff shall be trained to offer such training and also make the borrowers fully aware of the procedure and systems related to loan/other products.

- The effective rate of interest charged and the grievance redressal system set up by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it (in vernacular language) and on its website,
- A declaration that the MFI will be accountable for preventing inappropriate staff behaviour and timely grievance redressal shall be made in the loan agreement and also in the FPC displayed in its office/branch premises,
- The KYC Guidelines of RBI shall be complied with. Due diligence shall be carried out to ensure the repayment capacity of the borrowers,
- As specified in the RBI's directions for NBFC-MFIs, all sanctions and disbursement of loans should be done only at a central location and more than one individual should be involved in this function.
- In addition, there should be close supervision of the disbursement function,
- Adequate steps may be taken to ensure that the procedure for application of loan is not cumbersome and that loan disbursements are done, as per pre-determined time structure.

Disclosures in loan agreement/loan card

All NBFC-MFIs shall have a Board-approved, standard form of loan agreement. The loan agreement shall preferably be in vernacular language.

In the loan agreement the following shall be disclosed:

- All the terms and conditions of the loan,
- That the pricing of the loan involves only three components viz; the interest charge, the processing charge and the insurance premium (which includes the administrative charges in respect thereof), **that there will be no penalty charged on delayed payment,**
- That no Security Deposit/Margin is being collected from the borrower,
- That the borrower cannot be a member of more than one SHG/JLG.
- The moratorium period between the grant of the loan and the due date of the repayment of the first instalment would be as guided by RBI's directives for NBFC-MFIs, and
- assurance that the privacy of borrower data will be respected.

The loan card should reflect the following details:

- The effective rate of interest charged,
- All other terms and conditions attached to the loan,
- Information which adequately identifies the borrower and acknowledgements by the NBFC- MFI of all repayments including Instalments received and the final discharge,
- The loan card should prominently mention the grievance redressal system set up by the MFI and also the name and contact number of the nodal officer,
- Non-credit products issued shall be with full consent of the borrowers and fee structure shall be communicated in the loan card itself,

Non-Coercive Methods of Recovery

- As specified in RBI's directions for NBFC-MFIs, recovery should normally be made only at a central designated place.
- Field staff shall be allowed to make recovery at the place of residence or work of the borrower only if borrower fails to appear at central designated place on two or more successive occasions.
- NBFC-MFIs shall ensure that a Board approved policy is in place with regard to Code of Conduct by field staff and systems for their recruitment, training and supervision.

JAIIB IE & IFS Module C Unit 6 – Non-Banking Financial Companies (NBFCs)

Introduction

NBFC's have been an important contributor to the growth of the Banking, Financial Services and Insurance (BFS) sector of the country.

Banking side:

- They have emerged as a suitable alternative for banks, in terms of raising funds for businesses.
- They offer credit facilities in remote locations and support those individuals who are often not serviced by the banks NBFCs underpins the weaker sections of the society, thereby bringing equilibrium to the economy.

What Is A Non-Banking Financial Company (NBFC)?

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

Note: NBFCs are not a part of the payment and settlement system and as such, they cannot issue cheques drawn on itself and they cannot also borrow from the RBI.

According to the amendment of 1997 to the Reserve Bank of India Act, 1934, a Non-Banking Finance Company means:

- A Financial Institution which is a company;
- A non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner;
- Such other non-banking institution or class of such institutions as the RBI may, with the previous approval of the Central Government, specify.

In terms of Section 45-IA of the RBI Act, a non-banking financial company can commence or carry on the business of non-banking financial institution subject to:

- Obtaining a Certificate of Registration (CoR) from the Bank (RBI)
- Having net owned funds of minimum of Rs 2 crores.

Evolution of NBFC In India

- NBFCs commenced operations in a **small way, in the 1960s, as** an alternative for savers and investors, whose financial needs were not sufficiently met by the existing banking system.
- The NBFCs initially operated on a limited scale, without making much impact on the financial industry.
- They invited fixed deposits from investors and worked out leasing deals, for big industrial firms.
- In the **first stages of development, the Companies Act regulated NBFCs.**
- However, the unique and complex nature of operations and with financial companies acting as financial intermediaries, there was a call for a separate regulatory mechanism.
- **Chapter III B** was added in the Reserve Bank of India Act, which assigned the RBI, with limited authorities, to regulate deposit-taking companies.
- RBI has initiated measures to regulate the NBFC sector.
- **RBI:** Hire purchase and leasing companies could accept deposits to the extent of their Net Owned Funds, as per the key recommendations of the **James S. Raj Study Group (1975).**
- The NBFCs were also required to maintain liquid assets in the form of unencumbered approved government securities.
- The number of NBFCs rose swiftly from a mere 7,000, in 1981, to around 30,000, in 1992, which made the RBI feel the need to regulate the industry, more effectively.
- In 1992, RBI constituted a committee **headed by Mr. A. C. Shah, former Chairman** of Bank of Baroda, to suggest measures for effective regulation of the industry.

- The Shah Committee's recommendations included aspects ranging from compulsory registration to prudential norms.
- **In January 1997, major changes in the Reserve Bank of India Act, especially the Chapters Ill-B, Ill-C**, and V of the Act, seeking to put in place, a complete regulatory and supervisory structure, which would protect the interests of NBFCs' customers and also ensure the smooth functioning of NBFCs.
- During the last 20 years, NBFCs have gained prominence and added depth to the financial sector.
- **In August 2016**, the Government gave the go-ahead for foreign direct investment (FDI) **under the Automatic Route, for the regulated NBFCs**

Role Of NBDFCs In Promoting Inclusive Growth of India

- Playing an important role in catering to the lowest strata of society, resulting in growth of trade and business in rural and semi-urban areas and providing a source of livelihood, to large number of people.
- This has been possible, because of their strength of reach, proximity to customers, ability to understand the financial needs of rural and semi-urban people, particularly of concerned section and the ability to innovate products, which suit the demands of the concerned section of the people.
- NBFCs provide competition to the banks, in the field of delivery of financial services and thus, create conditions for improved consumer orientation and efficiency of the entire system.
- The Micro Finance Institutions (MFIs), which are largely the NBFCs, have been in the forefront of catering to the financial needs and creating livelihood sources of the so-called un-bankable masses, in the rural and semi-urban areas.

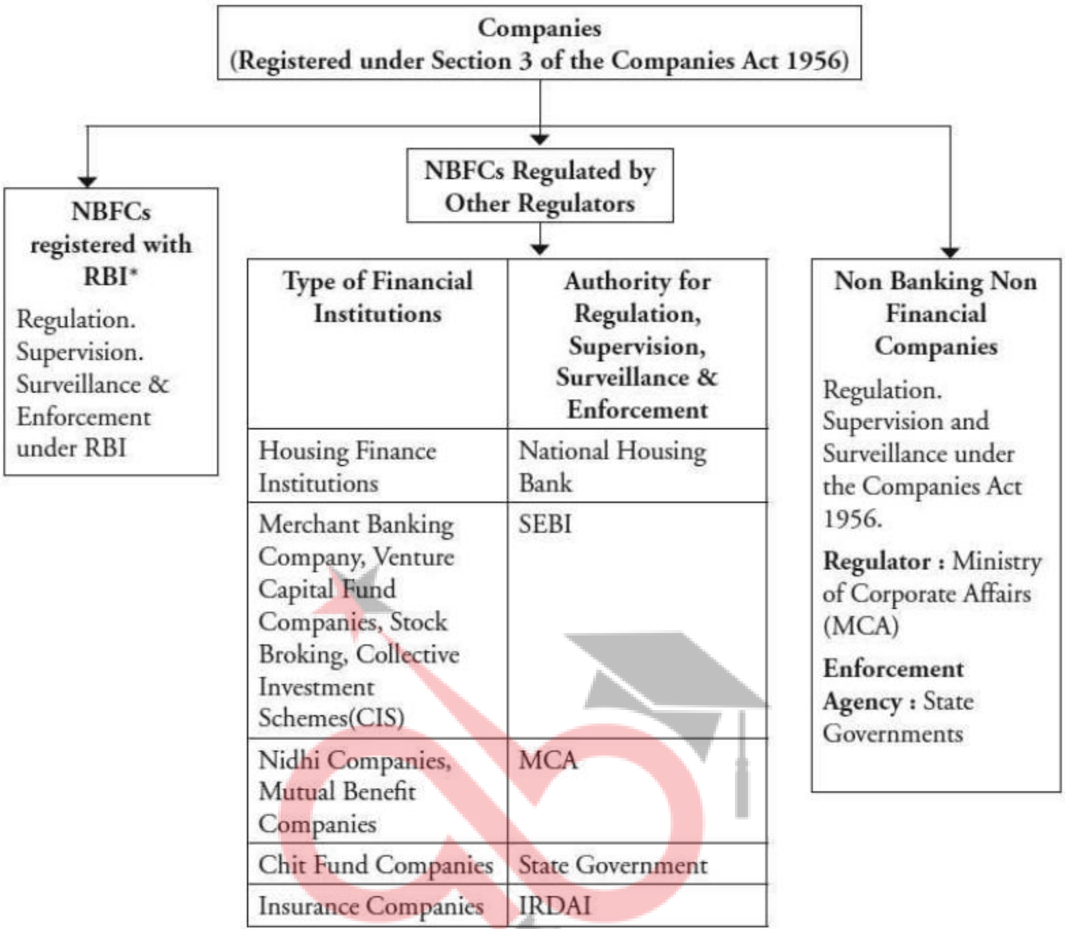
Regulators Of NBFCs

In terms of powers given to RBI, under the Reserve Bank of India Act, it regulates a section of the NBFCs. However, in order to obviate dual regulation, certain categories of NBFCs as mentioned below, which are supervised by other regulators, are exempted from the requirement of registration with RBI.

These are:

- Venture Capital Funds/Merchant Banking companies/Stock Broking companies, registered with the SEBI
- Insurance company holding a valid Certificate of Registration, issued by the IRDAI
- Nidhi companies as notified under section 620A of the Companies Act, 1956, regulated by the Ministry of Corporate Affairs
- Chit companies, as defined in section 2(b) of the Chit Funds Act, 1982, regulated by the respective State Governments

- Housing finance companies regulated by the NHB, and Stock Exchange or a Mutual Benefit Company, regulated by SEBI.



Classification Of NBFCs

NBFCs have 3 broad classifications, based on the kind of

- Liabilities they access,
- The type of activities the pursue and
- Their perceived systemic importance

Liabilities Based Classification

Liabilities Based

- Category 'A' companies, (i.e. NBFCs having public deposits, also known as 'NBFCs-D')
- Category 'B' companies, (NBFCs not having public deposits, also known as "NBFCs-ND')

▪ NBFC-Ds are now subject to requirements of capital adequacy, liquid assets maintenance, exposure norms (including restrictions on exposure to investments in land, building and unquoted shares), Assets & Liability Management (ALM) discipline, regulatory reporting requirements, etc.

Activity Based Classification

NBFCs are classified in terms of activities into following categories, viz.,

- Asset Finance Companies (AFCs),
- Loan Companies (LCs),
- Investment Companies (ICs),
- Infrastructure Finance Companies (IFCs),
- Systemically Important Core Investment Companies (CICs-ND-SI)
- Infrastructure Debt Fund Companies (IDF-NBFC)
- NBFC Microfinance Institutions (NBFC-MFI)
- Residuary NBFC (RNBFC)
- NBFC – Factors
- NBFC Non-Operating Financial Holding Companies (NOFHC)
- Mortgage Guarantee Companies (MGC) NBFC Account Aggregator (NBFC-AA), and
- NBFC Peer-to-Peer Lending Platform (NBFC-P2PL)

Size Based Classification

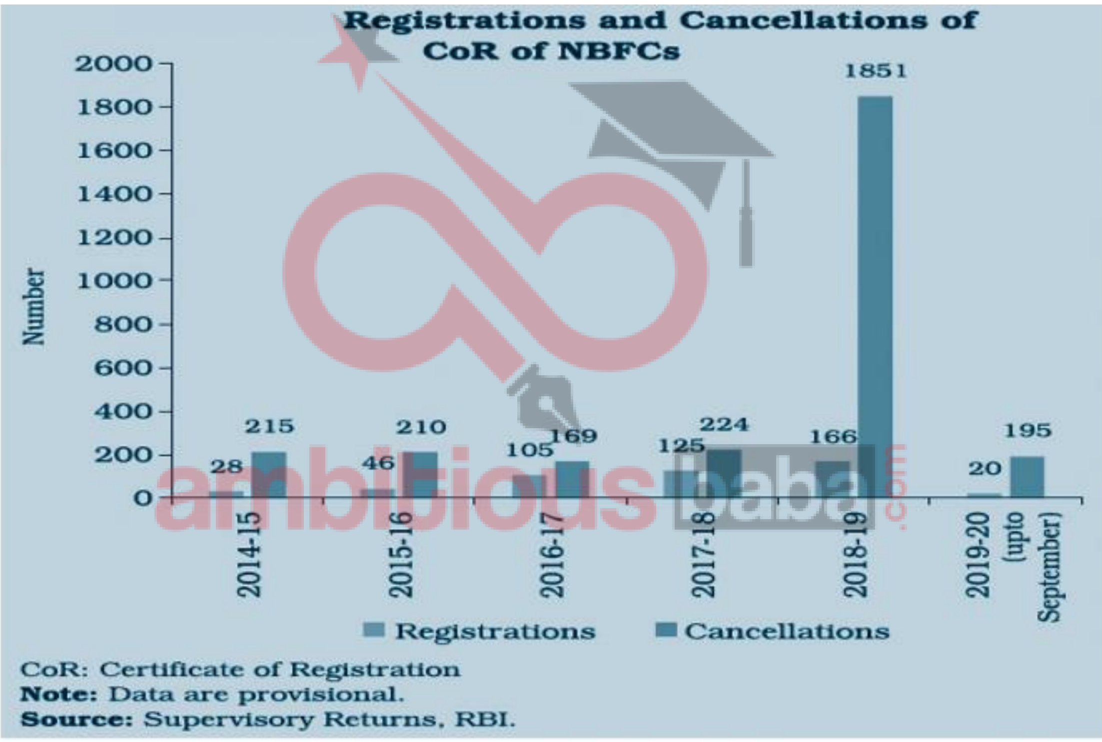
- At present, non-deposit taking NBFCs, with **assets of Rs 500 crores and** above, are termed as Systemically Important Non-Deposit taking NBFCs (NBFCs-ND-SI), and prudential regulations such as capital adequacy requirements, exposure norms along with reporting requirements are applicable to them.

Regulatory Oversight By RBI On NBFCs

Amendments to the RBI Act in 1997, bestowed comprehensive powers on RBI, to regulate and supervise NBFCs.

The salient features of the amendments made to Chapter III-B of the RBI Act in 1997 include the following:

- Making it mandatory for NBFCs, to obtain a Certificate of Registration (CoR) from RBI and to maintain a minimum level of Net-Owned Funds (NOF);
- Requiring deposit taking NBFCs, to maintain a certain percentage of assets in unencumbered approved securities;
- Requiring all NBFCs to create a reserve fund and to transfer a sum, which is not less than 20% of their profits every year;
- Empowering RBI to prescribe policies for adherence by NBFCs, with regard to income recognition, accounting standards, etc.;
- Empowering RBI to issue directions to NBFCs or their auditors, with regard to their preparation of balance sheets, profit and loss account, disclosure of liabilities, etc.;
- Empowering RBI to order a special audit of NBFCs;
- Empowering RBI to prohibit NBFCs from alienating assets, and
- Empowering RBI to file winding up petitions against NBFCs.



- A Fair Practices Code for lending was prescribed in 2006, directed towards ensuring transparency in pricing of loans and ethical behaviour towards borrowers, and
- a Corporate Governance **framework was introduced in 2007**, to ensure more professionalism in NBCs.
- Additional regulatory measures were introduced in a measured manner, to reflect the RBI's emerging focus on non-deposit taking NBFCs and systemic risk related issues.

Type of NDFCs

- Asset Finance Company
- Loan Company
- Mortgage Guarantee Company
- Investment Company
- Core Investment Company
- Infrastructure Finance Company
- Micro Finance Company
- Housing Finance Company

Guidelines prescribed by the Reserve Bank of India (RBI) that are to be followed by the Non-Banking Financial Corporations (NBFC):

The functions of the NBFCs in India are supervised by the Reserve Bank of India (RBI). Hence, the NBFCs have to abide by the guidelines put forward by the RBI in Chapter III B of the RBI Act of 1934. **The regulations prescribed by the RBI are as follows:**

- NBFCs cannot accept demand deposits from public depositors or investors as it is not authorised by law.
- The minimum time period for which the public deposits can be taken by the company is 12 months, while the maximum tenure can be 60 months.
- The Reserve Bank of India will not guarantee the repayment of any amount which is taken by the NBFCs.
- The Company cannot charge an interest rate which is more than the rate prescribed by the Reserve Bank of India.
- NBFCs can issue cheques to their customers in order to make payments or settlements.
- The company has to furnish a record of the statutory return on the deposits taken by the company in the form NBS- 1 every year.
- The company has to furnish a quarterly return on the liquid assets of the company.
- The audited balance sheet of the company has to be submitted every year.
- The company has to ascertain its credit ratings every 6 months and submit the same to the RBI.
- The companies which have a Public Deposit of Rs.20 Crore or more or have assets worth Rs.100 Crore or more will have to submit a half-yearly ALM return.
- The depositors of the NBFCs cannot avail the securing facility of the Deposit Insurance and Credit Guarantee Corporation (DICGC).
- Only the NBFCs that have been duly rated and matches the recommended Minimum Investment Grade Credit (MIGC) rating, are eligible to accept conditional deposits from public depositors.

- The RBI has restricted the NBFCs from providing additional benefits, extra incentives, or gifts to the customers or depositors, than those which are offered by the banks.
- The company has to maintain a minimum of 15% of the Public Deposits in its Liquid Assets.

Bank Finance to NBFCs (RBI MC 5th January 2022)

- In terms of **section 45-IA of the RBI Act, 1934**, all NBFCs have to mandatorily register with RBI.
- While RBI has deregulated credit related matters and bestowed greater
- Operational freedom to banks in the matter of credit dispensation to NBFCs, yet in view of the sensitivities attached to financing of certain types of activities undertaken by NBFCs, restrictions on financing such activities continue to be in force

Bank Finance to NBCs not Requiring Registration with RBI

In respect of NBFCs which do not require to be registered with RBI, viz.,

- Insurance companies registered under section 3 of the Insurance Act, 1938
- Nidhi Companies notified under section 620A of the Companies Act, 1956
- Chit fund companies carrying on Chit Fund Business as their principal business as per explanation to clause (vii) of Section 45-1 (bb) of RBI Act, 1934
- Stock Broking Companies/Merchant Banking Companies registered under section 12 of the SEBI Act,
- Housing Finance Companies regulated by NHB, which have been exempted from registration by RBI, banks may take their credit decision on merits of the case and on the basis of factors like purpose of credit, nature and quality of underlying assets, repayment capacity of borrowers as well as risk evaluation of the proposal.
- Bank finance to NBFCs by way of direct finance and subscription to their non-convertible debentures and certificates of deposits

Applicability Of Ombudsman Scheme To NBFCs

- RBI has issued guidelines on **Integrated Ombudsman Scheme, 2021** which inter alia covers the Non- Banking Finance Companies.
- The Scheme shall apply to the services provided by a Regulated Entity in India to its customers, under the provisions of the **Reserve Bank of India Act, 1934**, the **Banking Regulation Act, 1949, and the Payment and Settlement Systems Act, 2007.**

"Non-Banking Financial Company" (NBFC) means

- An NBFC as defined in Section 45-1 (f) of the Reserve Bank of India Act, 1934 and registered with the Reserve Bank, to the extent not excluded under the Scheme,
- But does not include a Core Investment Company (CIC), an Infrastructure Debt Fund-Non Banking Financial Company (IDF-NBFC), a Non-Banking Financial Company Infrastructure Finance Company (NBFC-IFC), a company in resolution or winding up/liquidation, or any other NBFC specified by the Reserve Bank;
- (Explanation: The terms CIC and IDF-NBFC shall have the same meaning assigned to them under the RBI Directions.)
- In a major change, the Executive Director of RBI has now been appointed as appellate authority in place of Deputy Governor, under the scheme.

JAIIB IE & IFS Unit 7 – Insurance Companies

Introduction

- Insurance can be defined as a contract between two parties, where one (the insurer) promises the other to indemnify or make good any financial loss suffered by the latter (the insured), in consideration for an amount received by way of ***premium'**.
- The contract of insurance is referred to as the 'insurance policy'
- Losses cannot be determined beforehand, but can be reimbursed if and when they occur, through insurance.

History And Development Of Insurance

Early History

- **It finds mention in the writings of Manu (Manusmrithi), Yagnavalkya (Dharma sastra) and Kautilya (Artha sastra).**
- The writings talk in terms of pooling of resources that could be re-distributed in times of calamities such as fire, floods, epidemics and famine.
- This was probably a precursor to modern day insurance

History of Insurance in Modern India

The tale of insurance in modern India started during the 1800 AD. The foreign insurance agencies started a marine insurance business which led to the start of the modern history of insurance in India.

- **1818**: In the year 1818, the birth of the first insurance company in India took place. The name of the insurance company was, Oriental Life Insurance with its HQ ay Calcutta.
- **1870**: In the year 1870, the history of insurance in India received a native touch with Bombay Mutual Life Insurance society becoming the first Indian insurance company to be established.
- **1912:** The year of 1912 led to the beginning of The Indian Life Insurance Companies Act. The act regulates the business of Life Insurance in the country.
- **1938:** With the aim to protect the interests of the insured people the earlier consolidated legislation was amended by the Insurance Act.
- **1956:** The business of Life Insurance was nationalized on the 1st of September of 1956. The year of 1956 also witnessed the formation of LIC Act that led to the formation of Life Insurance Corporation of India. The Government of India made a capital contribution of rupees 5 crore. During that period a total of 170 companies and seventy-five provident fund societies were doing the business of life insurance in the country. During the period between 1956 and 1999 the LIC held the solo rights of doing the business of life insurance in the country.
- **1972:** The year of 1972 led to the nationalization of the non-life insurance in the country. The enactment of General Insurance Business Nationalization, the business of non-life insurance was also nationalized. The four subsidiaries of General Insurance Corporation of India were also set up. During that period a total of 106 insurers were doing the business of non-life insurance in the country and those were amalgamated with the formation of GIC's four subsidiaries.

Commendable milestones in the history of insurance in India.

- In 1993 the establishment of the Malhotra committee took place. R.N Malhotra was the chairperson of the committee.
- The year of 1994, witnessed the publishing of recommendations by the Malhotra committee.
- The year of 1995 led to the establishment of the Mukherjee committee.
- In 1996 the setting up of the (interim) Insurance Regulatory Authority (IRA) took place.
- The Mukherjee committee was set up in the year 1997 but wasn't made public.

- In the year 1997 the Indian Government transfers greater authorities to General Insurance Corporation, Life Insurance Corporation and the subsidiaries of those. It was with the respect to the flexibility of the insurance rules that were targeted to channelize the funds to the structure of infrastructure.
- In the year of 1998, the cabinet decided to permit 40% of the foreign equity in the companies of private insurance.
- In the year of 1999 the standing committee chaired by Mr. Murali Deora decided that the equity in the sector of private insurance should be limited to a total of 26%. The year also witnessed the renaming of the bill of IRA as Insurance Regulatory and Development Authority Bill.
- The year of 1999 witnessed the clearance of the Bill of Insurance Regulatory and Development Authority.
- In the year 2000, the President of India gave assent to the Insurance Regulatory and Development Bill.

Privatisation And Foreign Direct Investment (FDI) In Insurance Sector

- **2000:** First opened to private players and FDI, when the Government permitted FDI to the extent of 26% in Indian insurance companies.
- **2015:** Increased to 49%
- **Budget 2021-22 provided for increase in the cap for FDI to 74%.**

Insurance Penetration and Density

- The measure of insurance penetration and density reflects the level of development of insurance sector in a Country
- While insurance penetration = Percentage of insurance premium to GDP,
- Insurance density is calculated = ratio of premium / population (per capita premium, expressed worldwide in US Dollars per capita).
- During the first decade of insurance sector liberalisation, the insurance sector reported increase in insurance penetration
  - **From 2.71% in 2001 to 5.20% in 2009.**
  - **Declining = 3.30% in 2014.**
  - **Increasing from 2015 and in 2019 = 3.76%.**

The level of insurance density has reported consistent increase

- From USD 11.5 in 2001 to USD 64.4 in the year 2010.
- Declining up to 2016.

- Increasing from 2017 and in the year 2019, the insurance density was USD 78.

- The insurance penetration in the life insurance sector in 2019 was 2.82%, whereas the density was USD 58.
- The penetration of non-life insurance sector in the country was 0.94% in 2019, whereas the density was USD 19.

Number Of Insurance Companies Operating In India

As at the end of March 2020, there were 68 insurers operating in India;

- 24 were life insurers
- 27 were general insurers
- 6 were standalone health insurers and
- 11 were re-insurers, including branches of foreign reinsurers and Lloyd's India.

68 insurers in operation:

- 8 were in the public sector and
- 60 were in the private sector.

In the Public Sector

- Two specialised insurers, namely ECGC and Agriculture Insurance Corporation (AIC),
- 1 life insurer namely LIC of India (LIC),
- 4 in general insurance and
- 1 in reinsurance namely GIC Re were in the public sector.

In the private sector:

- There were 23 life insurers,
- 21 general insurers,
- 6 standalone health insurers and
- 10 reinsurers including branches of foreign reinsurers and Lloyd's India.

Registered Insurers and Reinsurers

Type of Insurer	Public Sector	Private Sector	Total
Life	1	23	24
General	6	21	27
Standalone Health	-	6	6
Re-insurers	1	10	11
Total	**8**	**60**	**68**

Source: IRDA Annual Report 2019-2020

Legislations Governing Operation Of Insurance Companies

Some of the important Acts that govern the establishment and operations of Insurance Companies in India are

- The Insurance Act, 1938,
- The LIC Act, 1956 and
- General Insurance Business Nationalisation Act, 1972 (GIBNA).

- **1st :** The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate the business of insurance.
- Later, the Indian Insurance Companies Act was enacted in 1928, to enable the Government to collect statistical information about life and non-life insurance business transacted in India.

The Insurance Act, 1938

- This act, which consolidated and amended earlier legislation, was enacted in 1938
- **Objective:** To protecting the interest of the insuring public. It had comprehensive provisions for detailed and effective control over activities of insurers.
- For the administration of the above, an insurance wing was established and attached first to the Ministry of Commerce and then to the Ministry of Finance.
- The actuarial and operational matters were looked after by the Controller of Insurance.
- The act was amended in the years 1950, 1968, 1988 and 1999.
- **Specifies:** Section 35 of the General Insurance Business (Nationalisation)
- **Act:** The restrictions and limitations applicable, as specified by the Central Government

The important provisions of the Act relate to:

Registration

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

Accounts and audit:

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

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

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

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

Investments:

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

Limitation on management expenses:

- The Act prescribes the maximum limits of expenses of management including commission that may be incurred by an insurer.
- The percentages are prescribed in relation to the total gross direct business written by the insurer in India.

Prohibition of Rebates:

- The Act prohibits any person from offering any rebate of commission or a rebate of premium to any person to take **insurance.**
- Any person found guilty would be punished with **a fine up to five hundred rupees.**

Powers of Investigation:

- The Central Government may at any time direct the Controller or any other person by order, to investigate the affairs of any insurer and report to the central government.

Other Provisions:

- Other provisions of the Act deal with the licensing of agents, surveyors, advance payment of premium and Tariff Advisory Committee (TAC).

The LIC Act, 1956

- **In 1956:** The management of the life insurance business of all the insurers and provident societies, then operating in India, was taken over by the Central Government and these businesses were nationalised.

- **LIC was formed**: September, 1956

- **Capital contribution:** Rs. 5 crores from the Government of India**.**
- The Life Insurance Corporation Act, 1956 was passed by the Parliament**.**
- **Objectives: T**o conduct the business with utmost economy, in a spirit of trusteeship, to charge premium not higher than warranted by strict actuarial considerations to invest the funds for obtaining maximum yield for the policyholders consistent with safety of the capital**.**
- **Section 37 of the Act also**: provides Central Government guarantees for sums assured and bonuses declared under LIC policies.

This does not apply to ULIP policies.

- **Section 38 of this Act**: provides that LIC cannot be terminated by any law relating to the winding up of companies or corporations, unless the Central Government orders and directs it to be so.

General Insurance Business Nationalisation Act, 1972

- Came into force on 1st January, 1973.
- This Act gave effect to clause (c) of Article 39 of the constitution of India.
- **Article 39 (c) read as follows:** **"**The State shall direct its policy towards securing that the operation of the economic system does not result in concentration of wealth and means of production so as to prove harmful to the common interest of the community."
- The General Insurance Corporation of India (GIC) became the holding company with four subsidiaries,
  - United India Insurance Company with Head Office in Madras,
  - Oriental Insurance Company with Head Office in New Delhi,
  - National Insurance Company with Head Office in Calcutta
  - New India Assurance Company with Head Office in Bombay.
- The ownership of all shares on vested in the Central Government with effect from 1st Jan 1973.

Objectives of the Act The object of the Act was primarily,

- To provide for the acquisition of the shares of the existing general insurance companies
- To serve the needs of the economy by development of general insurance business
- To establish the GIC by the central government under the provisions of the Companies Act of 1956, with an initial authorised **share capital of Rs 75 crores.**
- To aid, assist, and advise the companies in the matter of setting up of standards in the conduct of general insurance business.

- To encourage healthy competition amongst the companies as far as possible
- To ensure that the operation of the economic system does not result in the concentration of wealth to the common detriment.
- To ensure that no person shall take insurance in respect of any property in India with an insurer whose principal registered office is outside India.

Reinsurance

- Reinsurance involves transferring some portion of risk by insurers to the reinsurers, enabling the insurance companies to focus on their core business.
- For the insurers, this works as a capacity enhancer, as reinsurers offer risk coverage and technical services.
- The presence of reinsurers also decreases volatility for insurers.
- The Indian experience with reinsurance can be assessed with respect to the nationalisation of the general insurance sector, as well as the liberalisation of the insurance sector.
- With the General Insurance Business (Nationalisation) Act, 1972 (GIBNA), the general insurance sector was nationalised.
- Subsequently, the General Insurance Corporation (GIC) was incorporated.
- Foreign markets, primarily British and Continental.
- **In 1956,** the Indian Reinsurance Corporation was incorporated, which consisted of general insurers and received premium cessions from the member companies.
- **In 1961,** statutory cessions were introduced that stipulated the amount that every insurer was required to cede under different categories of insurance.
- A ceding company is an insurance company that transfers the insurance portfolio to a reinsurer.
- The insurer however is liable to pay the claims in the event of default by the reinsurer.
- The purpose behind introducing mandatory cessions was to retain premiums domestically as much as possible, and the binding cessions **from direct insurers to GIC remained at 20% until 2006-07.**
- Later, this limit was lowered to **15%, in 2007-08 and then to 10%, in 2008-13**.
- The obligatory cessions, at present, are at 5%.
- In the post-liberalisation era, the Insurance Regulatory and Development Authority Act, 1999, came into effect.
- Under the Act, an amendment to GIBNA was introduced, which ended the exclusive privilege enjoyed by the GIC and its subsidiaries.

- The supervisory role of the GIC on its subsidiaries was removed, with renotification of the GIC as a national reinsurer.
- With the **General Insurance Business (Nationalisation) Amendment Act, 2002**, that came into force from March 21, 2003, the GIC ceased to be a holding company of its subsidiaries.
- The Government of India took over the ownership of the four subsidiaries and GIC, which left the insurance industry in charge of arranging its own reinsurance cover.
- GIC Re, the sole national reinsurer, provides reinsurance to insurers in India as well as abroad.
- It is the recipient of statutory cessions on every policy issued by domestic general insurers, subject to certain limits and leads almost all treaty and facultative programmes of these companies.
- From the earlier confinement of the reinsurance market to only the public sector reinsurer GIC Re, the market has in due course been opened up to private reinsurers as well, as branches of foreign reinsurers.
- At present, the reinsurance market comprises 1 national reinsurer and 10 other reinsurers, including Foreign Reinsurers' Branches (FRBs) and Lloyd's India.
- This transition from the monopoly of GIC Re to 11 reinsurers has rendered the market relatively more competitive.
- Additionally, there are several cross-border reinsurers in the market.

JAIIB IE & IFS Module C Unit 8 - Indian Financial System – Regulators and Their Roles

Introduction

Regulators in the Indian Financial System consist of

- Reserve Bank of India (RBI),
- Securities and Exchange Board of India (SEBI),
- Insurance Regulatory and Development Authority (IRDA) and
- Pension Fund Regulatory and Development Authority (PFRDA).

Reserve Bank Of India (RBI)

- Legislation to set up the **Reserve Bank of India was first introduced in January 1927**
- in March 1934, that the enactment became an accomplished fact.

- Prior to the setting up of the RBI, the central banking functions were performed by the then Imperial Bank of India and the Government of India.
- **1st April 1935:** The RBI was established in terms of the Reserve Bank of India Act, 1934.
- The RBI was conceptualised as per the guidelines, working style and outlook presented by Dr. B. R. Ambedkar in his book titled **“The Problem of the Rupee – Its origin and its solution” and**
- Recommendations of the 1926 Royal Commission on Indian Currency and Finance, also known **as the Hilton - Young Commission.**
- When set up, served as the central bank, both, for undivided India and Burma (now Myanmar).
- It served as the central bank for Burma till April, 1947.
- The Central Office was initially established in Kolkata but was permanently moved to Mumbai in 1937.
- Commencing its operations as a private statutory company, RBI was nationalised on 1st January, 1949 in terms of the Reserve Bank of India. **(Transfer to Public Ownership) Act, 1948.**
- This Act empowers the Union Government, in consultation with the Governor of the RBI, to issue such directions to RBI as considered necessary in public interest.
- The Governor and four Deputy Governors of RBI are appointed by the Union Government.

The control of the RBI vests in the Central Board of Directors, that comprises

- Governor
- 4 Deputy Governors
- 10 Directors (non-official) nominated by the Union Government from various fields,
- 2 government officials and
- 4 others – one each from local board**.**

- The RBI’s internal management is based on functional specialisation and coordination amongst about various departments**, with headquarters at Mumbai.**

Organisational Structure of RBI

Central Board of Directors

Governor
↓
Deputy Governors
↓
Executive Directors
↓
Principal Chief General Managers
↓
Chief General Managers
↓
General Managers
↓
Deputy General Managers
↓
Asstt. General Managers
↓
Managers
↓
Asstt. Managers
↓
Support Staff

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Objectives

- The main objectives of the RBI are contained in the preamble of the RBI Act, 1934, which reads as follows: 'Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

The main objectives of RBI may be stated as follows in specific terms:

- To maintain monetary stability such that the business and economic life of the country can deliver the welfare gains of a mixed economy
- To maintain financial stability and ensure sound financial institutions so that economic units can conduct their **business with confidence.**
- To maintain stable payment systems, so that financial transactions can be safely and efficiently executed.
- To ensure that credit allocation by the financial system broadly reflects the national economic priorities and social concerns.

- To regulate the overall volume of money and credit in the economy to ensure a reasonable degree of price stability.
- To promote the development of financial markets and systems to enable itself to operate/regulate.

Role and Functions

The Reserve Bank of India undertakes numerous activities, all related to the nation's financial sector, encompassing and extending beyond the functions of a typical central bank**. They are as follows:**

- Monetary Authority
- Issuer of Currency
- Banker and Debt Manager to Government
- Banker to Banks
- Regulator of the Banking System
- Manager of Foreign Exchange
- Maintaining Financial Stability
- Regulator and Supervisor of the Payment and Settlement Systems
- Developmental Role

Monetary Authority

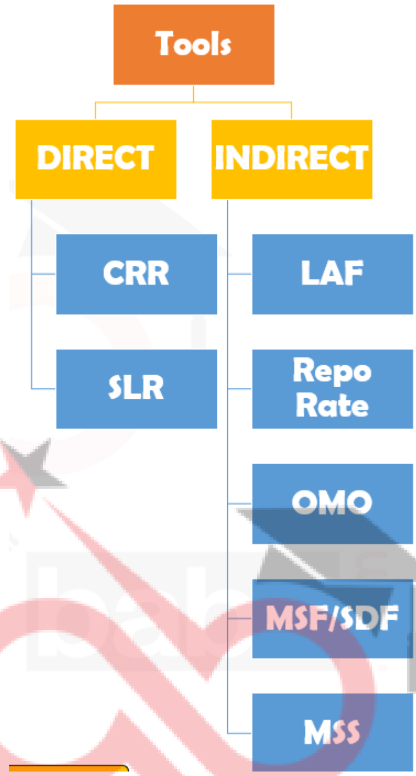
- Monetary policy refers to the use of instruments, under the control of the central bank, to regulate the availability, cost and use of money and credit.
- The goal of a monetary policy:

The main objectives of monetary policy in India are:

- ❑ Maintaining price stability
- ❑ Ensuring adequate flow of credit to the productive sectors of the economy, to support economic growth
- ❑ Maintaining financial stability

- In order to achieve these objectives, RBI has clearly laid a framework, based on a multiple indicator approach.
- This means that RBI monitors and analyses the movement of a number of indicators, including interest Interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows and fiscal position, along with trends in output, based on policy perspectives.
- RBI uses a number of direct and indirect instruments in the formulation and implementation of the monetary policy.
- In 2016, a Monetary Policy Committee (MPC) was set up, in terms of Section 45ZB of the amended RBI Act.
- The MPC consists of the

- The MPC meets at least 6 times, in a year
- The Reserve Bank's Monetary Policy Department (MPD) assists the MPC, in formulating the monetary policy.



Evolution of Currency Notes in India

- The process of issuing paper currency in India was started in the 18th century.
- Private banks such as – the Bank of Bengal, the Bank of Bombay, and the Bank of Madras – first printed paper money
- After the Paper Currency Act of 1861 that the Government of India was given the monopoly to print currency.
- The Government of India printed currency until the RBI was established in 1935, which then took up this responsibility.
- **Jan 1938:** The Rs 5 note was the first paper currency issued by RBI in
- **1938:** currency notes of Rs 10, Rs 100, Rs l,000 and Rs 10,000 were issued.
- 1946, Rs 1,000 and Rs 10,000 notes were demonetized to curb unaccounted money.
- Reintroduced in 1954 only to be withdrawn in 1978 again.
- Currency notes of Rs 500 and Rs 1,000 were again demonetized on 6th November, 2016.

- ❖ RBI has the powers to print currency notes of up to Rs 10,000 denomination.
- ❖ However, an amendment to the RBI Act, 1934 is needed if any note of higher denomination has to be printed.
- ❖ In order to determine the amount of currency to be printed, RBI factors in
  - ❖ inflation,
  - ❖ GDP growth,
  - ❖ replacement of soiled banknotes
  - ❖ reserve stock requirements.
- ❖ Minting of coins is the responsibility of the Government, and not of the RBI.
- ❖ Re 1 note had the signature of the Finance Secretary of the Government and not the Governor of RBI.
- ❖ This has been so because when the Re 1 note was reintroduced as a war time measure in 1940, it was issued by the Government with the status of a coin.
- ❖ The Government continued to issue Rupee one notes till 1994.

RBI oversees functioning of the following

- Commercial banks (including Small Finance Banks, Payment Banks, Local Area Banks)
- All- India development financial institutions (viz., Export-Import (EXIM) Bank of India,
- National Bank for Agriculture and Rural Development (NABARD),
- National Housing Bank (NHB) and
- Small Industries Development Bank of India (SIDBI)
- Urban co-operative banks
- Regional Rural Banks (RRBs),
- District Central Cooperative Banks and State Co-operative Banks (Supervisory powers for these institutions vest with NABARD without undermining the powers of RBI for exercising such powers as per the Banking Regulation Act, 1949)
- Non-Banking Financial Companies (NBFCs) (Only certain types of NBFCs are regulated by RBI.
- These are Asset Finance Companies, Investment Companies, Loan Companies, Infrastructure Finance Companies, Core Investment Companies, Infrastructure Debt Funds, Micro Finance Institutions, NBFC-Factors, Mortgage Companies, and Non-Operative Financial Holding Company.)

Manager of Foreign Exchange

- ▪ The Reserve Bank is responsible for administration of the Foreign Exchange Management Act,1999 and it regulates the market, by issuing Authorised Dealer licenses to banks and other select institutions.

- RBI has been playing an important role in the regulation and development of the foreign exchange market and assumes three broad roles relating to foreign exchange:
    - Regulating transactions related to the external sector and facilitating the development of the foreign exchange market
    - Ensuring smooth conduct and orderly conditions in the domestic foreign exchange market
    - Managing the foreign currency assets and gold reserves of the country

The **Foreign Exchange Department (FED**) is responsible for the regulation and development of the market.

The **RBI's Financial Markets Department (FMD**) participates in the foreign exchange market, by undertaking sales/purchases of foreign currency to ease volatility, in periods of excess demand for/supply of foreign currency.

The **Department of External Investments and Operations (DEIO**) invests the country's foreign exchange reserves, built up by purchase of foreign currency from the market.

In investing its foreign assets, the Reserve Bank is guided by three principles: safety, liquidity and return.

RBI also closely monitors the forex reserves of the country and discloses the reserves position to the market, through its **Weekly Statistical Supplements (WSS).**

Regulator of Payment and Settlement Systems

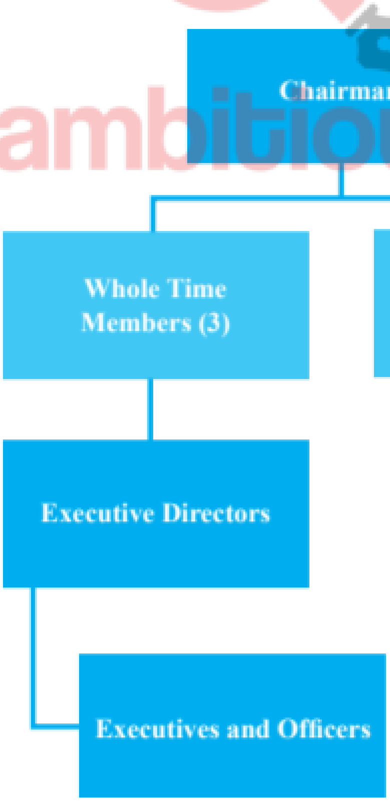
- **The Payment and Settlement Systems Act, 2007 (PSS Act)** gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country.
- RBI has constituted a Committee of its Central Board called the Board for Regulation and Supervision of Payment and Settlement Systems.
- RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.
- An efficient payment and settlement system is a pre-requisite for addressing systemic risk in banking/financial sector.
- As part of the basic framework, the Reserve Bank's network of secure systems handles various types of payment and settlement activities.
- Most operate on the security platform of the **Indian Financial Network (INFINET),** using digital signatures for further security of transactions.

Securities And Exchange Board Of India (SEBI)

- With the announcement of the reforms package in **1991, the volume of business in both the primary and secondary segments** of the Indian capital market increased.
- the Securities and Exchange Board of India (SEBI), was set up and conferred statutory powers, to regulate the capital market.
- The **Securities and Exchange Board of India Act, 1992**, provides for the establishment of the board to protect the interest of the investors in securities, promote the development of and regulate the securities market and matters connected therewith or incidental to.
- The SEBI functions under the Ministry of Finance.
- Status of an independent organisation regulating every aspect of the securities market backed by a statute and accountable to the Parliament.
- Prior to the formation of SEBI, some of the control functions were carried on by the **Controller of Capital Issues and the Company Law Board.**

Organisational Set Up

- **The SEBI is headed by a chairman,** who is supported **by 3 full time Members and 4 part time Members.**
- The part time Members are officials deputed **by the Government and RBI and**
- Full time Members are supported by Executive Directors and other line officials.



Functions

- The SEBI has powers to register and regulate all market intermediaries.
- The SEBI has powers to penalise them in case of violations of the provisions of the act, rules and regulations made thereunder.
- It can conduct enquiries, audits, and inspection of all market intermediaries and adjudicate **offences, under the SEBI Act, 1992.**
- The SEBI registers and regulates the intermediaries in the primary market. Some of the major intermediaries it regulates are merchant bankers, underwriters, bankers to an issue, registrars to an issue and share transfer agents and debenture trustees.
- The SEBI registers and regulates various intermediaries in the secondary market such **as brokers, sub-brokers, stock exchanges, foreign institutional investors (FIIs) custodians, depositories, mutual funds, and venture capital funds.**

The functions of SEBI are as under

- Protect the interests of investors in securities and to promote the development of and to regulate the securities market
- Measures to undertake inspection of any book, or register or other document or record of any listed company
- Same powers as are vested in a civil court, under the **Code of Civil Procedure, 1908 (5 of 1908).**
- Board may, by an order, for reasons to be recorded in writing, in the interests of investors or the securities market, take measures, either pending investigation or inquiry or on completion of such investigation or inquiry

Insurance Regulatory and Development Authority (IRDA)

What is the Insurance Regulatory and Development Authority (IRDA)?

- The Insurance Regulatory and Development Authority is the main organization or supervisory body that regulates the insurance sector in the country. It sets rules and regulations for the functioning of the insurance industry. Its sole purpose is to protect the interest of policyholders and to develop the industry on the whole.
- The IRDA or IRDAI regularly issues advisories to insurance companies in case of changes to the rules and regulations. The regulator guides the insurance industry in promoting the efficiency in the conduct of insurance business all the while controlling the rates and other charges related to insurance. This article dwells on the functioning of the IRDA, features and benefits as well as answers to frequently asked questions at the end of this reading.

Establishment of IRDA:

- The Government of India was the regulator for the insurance industry until 2000. However, to institute a stand-alone apex body, the IRDA was established in 2000 following the recommendation of the **Malhotra Committee report in 1999**. In August 2000, the IRDA began accepting applications for registrations through invites and allowed companies from other **countries to invest up to 26% in the market.**
- The **IRDA has outlined several rules and regulations under Section 114A of the Insurance Act, 1938**.

Objective of IRDA:

The main objective of the Insurance Regulatory and Development Authority of India is to enforce the provisions under the Insurance Act. The ***mission statement of the IRDA is***:

- To protect the interest and fair treatment of the policyholder.
- To regulate the insurance industry in fairness and ensure the financial soundness of the industry.
- To regularly frame regulations to ensure the industry operates without any ambiguity.

Important Role of IRDA in the Insurance Sector in India:

The insurance industry in India dates back to the early 1800s and has grown over the years with better transparency and focus on protecting the interest of the policyholder. The IRDA plays an integral role in emphasizing the importance of policyholders and their interest while framing rules and regulations. **Here are the important roles of the IRDA:**

- To protect the policyholder's interests.
- To help speed up the growth of the insurance industry in an orderly fashion, for the benefit of the common man.
- To provide long-term funds to speed up the nation's economy.
- To promote, set, enforce and monitor high standards of integrity, fair dealing, financial soundness and competence of the insurance providers.
- To ensure genuine claims are settled faster and efficiently.
- To prevent malpractices and fraud, the IRDA has set up a grievance redress forum to ensure the policyholder is protected.
- To promote transparency, fairness and systematic conduct of insurance in the financial markets.
- To build a dependable management system to make sure high standards of financial stability are followed by insurers.

- To take adequate action where such high standards are not maintained.
- To ensure the optimum amount of self-regulation of the industry.

Functions of IRDA:

Below are the important functions of the IRDAI in the insurance industry in India:

- Grant, renew, modify, suspend, cancel or withdraw registration certificates of the insurance company.
- Protecting the interests of the policyholder in matters concerning the grant of policies, settlement of claims, nomination by policyholders, insurable interest, surrender value of the policy and other terms and conditions of the policy.
- Specify code of conduct, qualifications and training for intermediary or insurance agents.
- Specify code of conduct for loss assessors and surveyors.
- Levying fees and charges for carrying out the provisions of the Act.
- Undertaking inspection, calling for information, and investigations including an audit of insurance companies, intermediaries, and other organizations associated with the insurance business.
- Regulate and control insurance rates, terms and conditions, advantages that may be offered by the insurance providers.

Apart from the above-mentioned core functions of the IRDA, there are several functions that the regulator performs keeping the policyholder's interest as its priority.

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How Does IRDA Work?

The apex body of the insurance industry, the IRDA, ensures it frames rules and regulations without any ambiguity towards any particular insurance company. To ensure fairness and the financial soundness of the industry, the main work of IRDA revolves around the policyholder's interests. Refer to the following roles that the IRDA is mainly involved in:

- Issues certificate of registration to new insurance companies.
- Sets rules and regulations to ensure the interests of the policyholder are taken care of.
- Monitors all claims are settled in all fairness and that no insurer will deny any claim on their own free will.
- Regulates the code of conduct of the insurance companies, insurance intermediaries, and others associated with the insurance industry.

- Provides solutions in case of disputes through the IRDA ombudsman.
- Controls and regulates the rates of insurance to prevent unwanted price hikes in the insurance premium.
- The apex body is responsible for setting the minimum percentage limit of insurance companies for General and Life Insurance, thereby developing both urban and rural sectors.

Features & Benefits of IRDA:

Following are the salient features of the apex body, the Insurance Regulatory and Development Authority of India:

- Acts as a regulator for the insurance industry.
- Protects the policyholder's interests.
- Rules and regulations are framed by the apex body under Section 114A of the Insurance Act, 1938.
- It is entrusted under the Insurance Act to grant the certificate of registration to new insurance companies to operate in India.
- Oversees the insurance industry's activities to ensure sustained development of insurers and policyholders.

Types of Insurances Regulated by the IRDAI

Insurance is mainly divided into Life and Non-Life/General Insurance. These are further classified into other types of insurance. ***Below are the types of insurance regulated by the IRDAI:***

Life Insurance

- Term Plans
- Endowment Policies
- Unit-linked Insurance Policies
- Retirement Policies
- Money-back Policies

General Insurance

- Health Insurance Policies
- Vehicle/Motor Insurance Policies
- Car insurance
- Bike Insurance
- Property Insurance Policies
- Travel Insurance Plans
- Gadget Insurance Plans

Pension Fund Regulatory and Development Authority (PFRADA)

The **Pension Fund Regulatory and Development Authority was established in the year 2003.** The body was set up with a view to promoting, regulating and developing the pension sector in the country. **The National Pension Scheme (NPS) was launched by PFRDA in the year 2003 and thereafter extended to all citizens in 2009**. PFRDA comes under the jurisdiction of the Ministry of Finance.

Functions of PFRDA

The preamble of PFRDA states that the aims of the authority is "to promote old age income security by establishing, developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental thereto**." The roles played by PFRDA are as under:**

- To promote pension scheme in the country, by fostering mandatory as well as voluntary pension schemes, in order to serve the old age income needs of retired personnel.
- National Pension System, both tier 1 and tier 2 are under the purview of PFRDA and are regulated by the same.
- PFRDA performs the function of appointing various intermediate agencies like Pension Fund Managers, Central Record Keeping Agency (CRA), Point of Presence Agencies, etc.
- Educating the general public and stakeholders about the importance of pension.
- Training of intermediaries that perform the task of popularizing and educating people about the importance of pension.
- Addressing grievances related to various pension schemes in the country.
- Addressing and resolving disputes between various intermediaries like banks and between customers and intermediaries.

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JAIIB IE & IFS Module C Unit 9-Reforms & Developments In The Banking Sector

Infrastructure Financing

Important Features of Infrastructure

Infrastructure is the backbone of any economy. It requires heavy financial investment and the benefits are, often, indirect. Thus, building of rural roads will benefit agriculture as the farmers are able to sell their products in towns where they can get remunerative prices. Besides, they can get some inputs such as fertilisers, pesticides and other industrial products, at relatively cheaper prices, as their transport costs decline due to improved transportation.

It is worthwhile to mention some distinctive features of infrastructure:

- First, the building of infrastructure requires large investment and they contribute to output, after a long period of time that is their gestation period is quite long.
- Second, due to large overhead capital and bulk investment, significant economies of scale are found in most of them.
- The third important feature of infrastructure facilities is they create externalities.

Importance of Infrastructure

- It needs to be emphasised that good quality infrastructure is important not only for faster economic growth but also to ensure inclusive growth.
- By inclusive growth, it is meant that the benefits of growth are shared by the majority of the people of a country. Inclusive growth leads to alleviation of poverty and reduction in income inequality in the country.

Components of Infrastructure

According to Government classification, infrastructure comprises of the following sectors:

- Construction
- Electricity generation, transmission and distribution
- Gas generation and distribution through pipes
- Water works and supply
- Non-conventional energy generation and distribution
- Railway tracks, signalling system and stations
- Roads and bridges, run-ways and other airport facilities
- Telephone lines and telecommunications network
- Pipelines for water, crude oil, slurry, etc.
- Waterways
- Port facilities
- Canal networks for irrigation
- Sanitation and sewerage

Channels for Financing Infrastructure in India

The channels through which the funds reach the infrastructure sector are:

- Government,
- Development Financial Institutions,
- Commercial Banks,
- Non-Banking Financial Companies,
- Insurance Companies & Pension Funds,
- External Commercial Borrowings, and
- Foreign Direct Investment (FDI) from abroad.

Characteristics of Infrastructure Financing

- **Longer Maturity**: Infrastructure finance tends to have maturities between 5 years to 40 years. This reflects both the length of the construction period and the life of the underlying asset that is created. A hydro-electric power project, for example, may take as long as 5 years to construct, but once constructed could have a life of as long as 100 years, or longer.
- **Larger Amounts**: While there could be several exceptions to this rule, a meaningful sized infrastructure project could cost a great deal of money. For example, a kilometer of road or a mega-watt of power could cost as much as US$ 1.0 million and consequently, amounts of US$ 200.0 to US$ 250.0 million (Rs.1595 crores to Rs. 1,995 crores) could be required, per project. (1 US$=INR79.75)
- **Higher Risk**: Since large amounts are typically invested for longer periods of time, it is not surprising that the underlying risks are also quite high. The risks arise from a variety of factors including demand uncertainty, environmental surprises, technological obsolescence (in some industries such as telecommunications) and very importantly, political and policy related uncertainties.
- **Fixed and Low (but positive) Real Returns**: Given the importance of these investments and the cascading effect, higher pricing here could have on the rest of the economy, annual returns here are often near zero, in real terms.

National Bank for Infrastructure and Development (NaBFID)

- A development finance institution is an agency that finances infrastructure projects that are of national importance but may or may not conform to commercial return standards.
- Since few commercial lenders are willing to take on infrastructure risk, particularly after the experience of growing NPAs in the sector, a development finance institution has become necessary.
- DFIs provide long-term credit for capital-intensive investments, spread over a long period and yielding low rates of return, such as urban infrastructure, mining and heavy industry, and irrigation systems.

DFIs in India

- After independence, the institutional framework for development banking began with the setting up of the Industrial Finance Corporation of India (IFCI) (1948), Industrial Development Bank of India (IDBI) (1964), Industrial Investment Bank of India (IIBI) (1972), National Bank for Agriculture and Rural Development (NABARD), Export-Import Bank of India (EXIM Bank) (1982), and Small Industries Development Bank of India (SIDBI) (1990).
- In the past, DFIs such as ICICI, IDBI and IDFC have transformed into universal banks, as they did not have the advantage of low-cost funding for long-term projects.
- DFIs are sector-specific, such as Rural Electrification Corporation Ltd (REC) for the power sector, National Bank for Agriculture and Rural Development

(NABARD) for the agriculture sector, and Indian Railway Finance Corporation (IRFC) to fund rail infrastructure among others.

Establishment of NaBFID

NaBFID will be set up as a corporate body with authorised share capital of Rs 1 lakh crore. Shares of NaBFID may be held by:

- Central government,
- Multilateral institutions,
- Sovereign wealth funds,
- Pension funds,
- Insurers,
- Financial institutions,
- Banks, and
- Any other institution prescribed by the central government. Initially, the central government will own 100% shares of the institution which may subsequently be reduced up to 26%.

Functions of NaBFID

- NaBFID will have both financial as well as developmental objectives. Financial objectives will be to directly or indirectly lend, invest, or attract investments for infrastructure projects located entirely or partly in India.
- Central government will prescribe the sectors to be covered under the infrastructure domain. Developmental objectives include facilitating the development of the market for bonds, loans, and derivatives for infrastructure financing.

The functions of NaBFID include:

- Extending loans and advances for infrastructure projects,
- Taking over or refinancing such existing loans,
- Attracting investment from private sector investors and institutional investors for infrastructure projects,
- Organising and facilitating foreign participation in infrastructure projects,
- Facilitating negotiations with various government authorities for dispute resolution in the field of infrastructure financing, and providing consultancy services in infrastructure financing.

Sources of fund

NaBFID may raise money in the form of loans or otherwise, both in Indian Rupees and foreign currencies, or secure money, by the issue and sale of various financial instruments including bonds and debentures.

NaBFID may also borrow money from:

- Central government,
- Reserve Bank of India (RBI),

- Scheduled commercial banks,
- Mutual funds, and
- Multilateral institutions such as World Bank and Asian Development Bank.

Management of NaBFID

NaBFID will be governed by a Board of Directors. The members of the Board include:

- The Chairperson appointed by the central government, in consultation with RBI,
- Managing Director
- Up to three Deputy Managing Directors,
- Two directors nominated by the central government,
- Up to three directors elected by shareholders, and
- A few independent directors (as specified).

Support from the central government

- **Grants worth Rs 5,000 crores to NaBFID by the end of the first FY**
- Provide guarantee, at a concessional rate of up to 0.1%, for borrowing from multilateral institutions, sovereign wealth funds, and other foreign funds.
- Costs towards insulation from fluctuations in foreign exchange (in connection with borrowing in foreign currency), may be reimbursed by the government, in part or full.
- Upon request by NaBFID, the government may guarantee the bonds, debentures, and loans issued by NaBFID.

National Asset Reconstruction Bank (NARCL – BAD BANK)

- **Indian banks have reported over Rs 8.3 lakh crore worth** of gross non-performing assets as on March 2021.
- This is **expected to go up to Rs. 10 -11 lakh crores by end March, 20**22, owing to the decline in manufacturing and production activities on account of the pandemic.
- The RBI's Financial Stability Report has also reflected that the gross NPA ratio may increase to 13.59% by September 2021.
- The Indian Bank Association (IBA) also submitted a proposal to the government for setting up a Bad Bank, with contribution from the government and banks.
- **Objective**: it would take over NPAs from banks so that it could, then focus on recovery of the said loans.
- **Benefits:** Transfer of the NPAs from the banks to the Bad Bank would also free up the balance sheets of the bank and enable them to concentrate on business development and raising capital from the market.

The concept of the Bad Bank :

- National Asset Reconstruction Company (NARCL)
- Coupled with a debt resolution company (India Debt Resolution Co. Ltd – IDRCL).

- While NARCL has been set up by banks to aggregate and consolidate stressed assets for their subsequent resolution,
- IDRCL is a service company/operational entity which will manage the asset and engage market professionals and turnaround experts**.**
- **While for NARCL, public sector banks will hold 51% of the equity capital**
- **IDRCL, public sector banks will hold 49% of the** capital, the rest will be with private sector lenders
- **7th July, 2021:** NARCL was incorporated as a Company**.**
- **While it is expected that banks will transfer NPAs to the extent of Rs 2 lakh crores (which comprises of 1.8% of total loans) to NARCL, Rs 90,000 crores will transferred in the first phase.**
- **The minimum cut off amount for transfer of loans to NARCL is Rs 500 crores.**
- While the initial tranche of Rs 90,000 crores will comprise of fully provided loans, the balance amount would comprise of loans with lower provisioning as well.
- It is expected that sale of the bad loans to NARCL will be against 15% cash and balance 85% being in the form of Security Receipts (SRs).
- Initially, the Central government is expected to guarantee the SRs, to the extent of Rs 30,600 crores.
- The Government guarantee will be **valid for 5 years.**
- The limited period of Government guarantee is expected to incentivise NARCL, to speed up resolution of the loans transferred to it.
- The NARCL will acquire assets by making an offer to the lead bank. Once NARCL's offer is accepted, then, IDRCL will be engaged for management and value addition.

The salient features of NARCL are tabulated below

Particulars	Amount (Rs crores)	%age of banking sector loans
Total assets to be transferred	200,000	1.8%
Central guarantee valid for 5 years	30,600	0.3%
Guarantee % of loans transferred	15%	
PSB ownership in NARCL	51%	
PSB and Public FIs stake in India Debt Resolution Co.	49%	
Phase – 1		
Assets to be transferred-written off loans	90,000	0.8%
Phase – 2		
Assets to be transferred	110,000	1.0%

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JAIIB IE and IFS Module D: FINANCIAL PRODUCTS AND SERVICES

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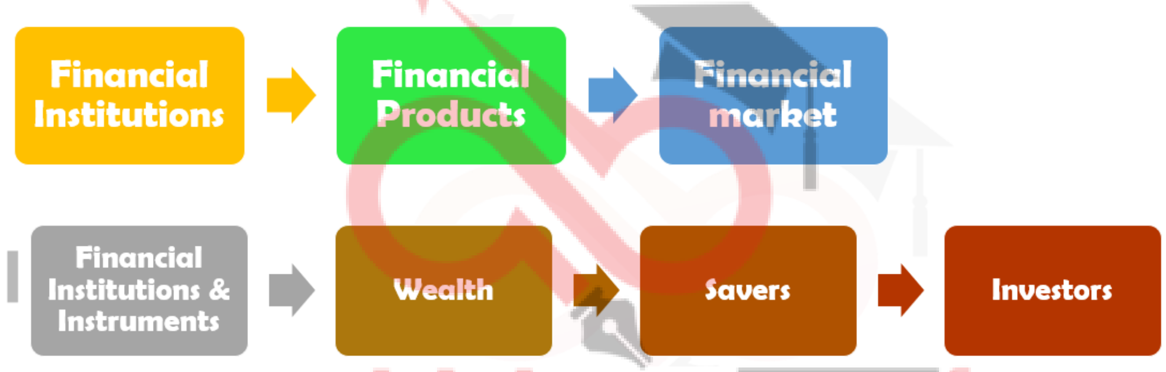
JAIIB Paper 1 IE & IFS Module D Unit 1-Financial Markets

What is a Financial Market?

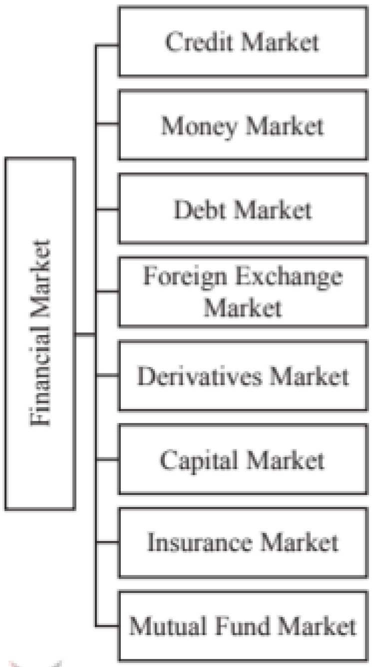
Any financial system



Financial market refers in an abstract way to the purchase and sale transactions of a commodity and the formation of its price. Used in this way, the term refers to the countless decisions made by producers of a commodity (the supply side of the market) and consumers of a commodity (the demand side of the market), which taken together, determine the price of the commodity.

Segments Of Financial Markets

The financial market has a number of different segments. While commonly, these markets are stated to consist of money market, foreign exchange market, capital market and insurance market, when studied more granularly, as stated earlier, there are additional segments like credit market and derivatives market. ***Hence, the financial markets can be understood of consisting of the following segments:***



Credit Market

The major institutional purveyors of credit in India are banks (commercial, cooperative and differentiated banks) and non-banking financial institutions, i.e., non-banking financial companies (NBFCs). The noninstitutional or unorganised sources of credit include moneylenders, indigenous bankers and sellers for trade credit.

An important aspect of the credit market is its term structure, viz.,

- Short-term credit,
- Medium-term credit, and
- Long-term credit.

While banks and NBFCs predominantly cater to short-term needs, Financial Institutions provide mostly medium and long-term funds.

Money Market

Money markets perform the crucial role of providing a conduit for equilibrating short-term demand for and supply of funds, thereby facilitating the conduct of monetary policy. The money market instruments mainly comprise:

- Call money,
- Certificates of deposit,
- Treasury bills,
- Other short-term government securities transactions, such as, repos,
- Bankers' acceptances/commercial bills,
- Commercial paper, and
- Inter-corporate funds. While inter-bank money markets and central bank lending via repo operations or discounting provide liquidity for banks, private

non-bank money market instruments, such as commercial paper provide liquidity to the corporate sector.

Debt Market

- The debt market consists, largely, of government securities and to a smaller extent, corporate bonds.
- A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or a State Government. It is a document of the Government's debt obligation. Long term securities are also issued by State Governments and these are called State Development Loans (SDLs).
- **Companies raise funds for longer period say 5 years or 10 years,** through issue of a typical long-term debt instruments, known as Corporate Bonds. A company which is engaged in infrastructure projects may issue debentures as a source of long-term funds.

Foreign Exchange Market

- The foreign exchange market consists of banks (Authorised Dealers), customers and Reserve Bank of India. The forex market in India developed, practically, only after 1978. Prior to 1978, banks were permitted to conduct only merchant transactions and their cover operations.
- They were also required to keep their positions '**square' or 'near-square**; at all times during the day. It was in the year 1978 that banks were permitted by RBI to take trading positions and they were also required to maintain a 'square' or 'near-square' position only at the end of the day, and throughout the day.

Derivatives Market

A derivative is a financial instrument:

- Whose value changes in response to the change in a **specified interest rate, security price, commodity price, foreign exchange rate, index** of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying');
- That requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- That is settled at a future date.

Capital Market

- **Capital market is a market for long-term equity and debt**. In this market, capital funds comprising of both equity and debt are issued and traded.
- This also includes private placement sources of debt and equity as well as organised markets, like stock exchanges.
- **In common parlance, capital market may be understood as the market for long-term funds**. The capital market provides long-term debt and equity finance for the government and the corporate sector.

Insurance Market

- In an increasingly competitive economy, the need for insuring against risks is well recognised. In India, the insurance industry is broadly classified into life insurance and non-life insurance business.
- In the early days, life insurance business had been undertaken by the Life Insurance Corporation of India (LIC) and the non-life insurance by the General Insurance Corporation (GIC) and its four subsidiaries. In the wake of financial liberalisation during the early 'nineties, the **Committee on Reform of the Insurance Sector (Chairman: Shri R. N. Malhotra**) recommended in 1994, the opening up of the insurance sector to private participation and the institution of a separate regulatory and development authority.
- Accordingly, the Insurance Regulatory and Development Authority (IRDA) Act was enacted in the year 1999, and a separate Insurance Regulatory and Development Authority was set up.

Mutual Fund

- **Mutual Fund is a mechanism for pooling the resources by issuing units to the investors and investing** funds in securities in accordance with objectives as disclosed in offer document.
- A fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.
- SEBI regulates Mutual Funds, though mutual funds also have formed a self-regulatory body in the form of Association of Mutual Funds of India (AMFI), which is an industry body of mutual funds.

Functions Of Financial Markets

The following are the functions of financial markets:

- Price Determination
- Funds Mobilisation
- Liquidity
- Risk sharing
- Easy Access
- Reduction in transaction costs and provision of the Information
- Capital Formation

Price Determination

- **Financial markets perform the function of price discovery for the different financial instruments** which are traded between the **buyers and the sellers on the market.**
- The prices at which the financial instruments are traded in the financial market are determined by the market forces, i.e., demand and supply in the market. Accordingly, financial markets provide the vehicle by which, the prices are set for

both financial assets which are issued newly and for the existing stock of the financial assets.

Funds Mobilisation

- Along with the determination of the prices at which the financial instruments are traded in the financial markets, the required return out of the funds invested by the investor is also determined by participants, in the market.
- The motivation for persons seeking the funds is dependent on the required rate of return, which is demanded by the investors.
- It is this function of the financial market, that determines how the funds which are available from the lenders or the investors will get allocated among the entities that are in need of the funds or raise the funds by means of issuing financial instruments in the financial market. Hence, in this manner, financial markets contribute to the mobilisation of the savings of the investors.

Liquidity

- **The liquidity function of financial markets provides an opportunity to the investors** to sell their financial instruments at their fair value prevailing in the market at any time, during the working hours of the market.
- **In case there is no liquidity in the financial market, then the investor will have to forcibly hold the financial securities** or the financial instrument, until the conditions arise in the market for selling those assets or the issuer of the security is obligated contractually to pay for the same, i.e., at the time of maturity in debt instrument.

Risk sharing

- Financial markets perform the function of the risk-sharing, as the entities which are undertaking the investments are different from the persons who have invested their savings in that entity.
- With the help of financial markets, the risk is transferred from the entity which undertakes the investments to those investors, who have provided funds for making those investments.

Accessibility

- Industries require investors for raising funds and the investors require the industries for investing their savings and earning the returns from them. Hence, financial markets bring together potential buyers and sellers, which helps them in saving their time and money, in finding the suitable investment avenues.

Reduction in Transaction Costs and Provision of the Information

- Investors requires various types of information while **buying and selling securities, and for obtaining the same, time and money is required.**

- However, financial markets help in providing all types of information, without the requirement of spending any money by individual investors. In this way, the financial markets reduce the cost of the transactions.

Capital Formation

- Financial markets provide the channel through which, the new savings flow into the economy and this aids in capital formation.

Price Discovery

- **Price discovery, also referred to as the price discovery mechanism or price discovery process**, is a very important aspect of all financial markets. It is a method for determining the price of an asset through interactions between buyers and sellers.
- **Price discovery enables buyers and sellers to set the market prices of tradable assets. T**his is because the mechanisms of price discovery set out what sellers are willing to accept, and what buyers are willing to pay. As a result, price discovery is concerned with finding the equilibrium price that facilitates the greatest liquidity for that asset.

There are a number of factors which determine the levels of price discovery. These include:

- Supply and demand
- Attitudes to risk
- Volatility
- Available information
- Market mechanisms

Supply and Demand

- Supply and demand are the two greatest factors, which determine an asset's price and which in turn, dictate how crucial price discovery mechanisms are for traders.

Attitudes to Risk

- A buyer or seller's attitude to risk can greatly affect the level, at which, a price is agreed between two market participants.
- For instance, if the buyer is willing to take on the risk of a fall in price, for the potential reward of a large rise in price, they might be willing to pay a little more, in order to secure their exposure to a market.

Volatility

- **Volatility is linked to risk, but they are not the same**. Volatility is one of the main factors which determines whether a buyer chooses to enter or not in any particular market.

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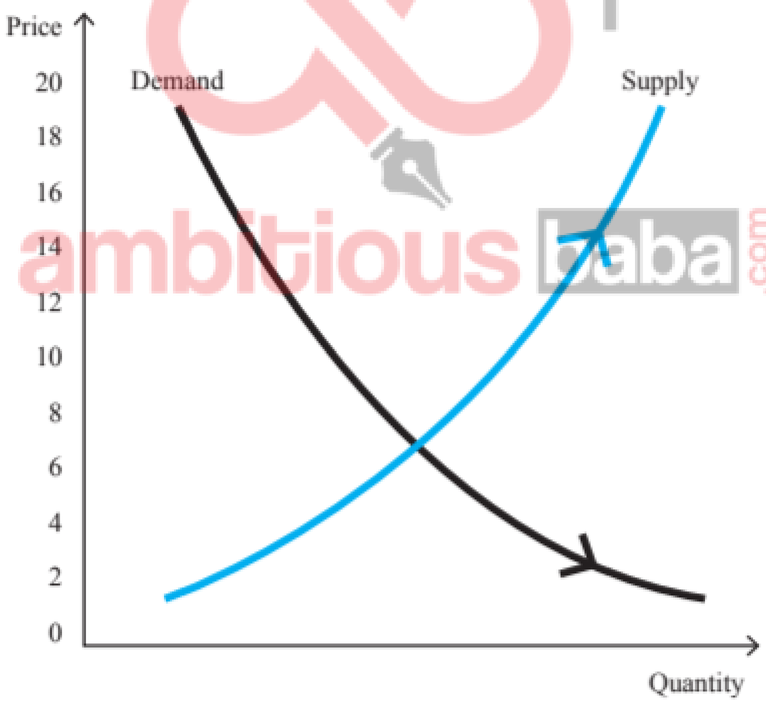
- Some traders actively seek out volatile markets as they offer the potential for larger profits. However, they could also incur larger losses.

Available Information

- **The amount of information available to both buyers and sellers can determine the levels at which, they are willing to buy or sell**. For example, buyers may wish to wait for key market announcements – such as the outcome of RBI meetings – to be made public, before determining whether they wish to buy or not.
- In turn, these meetings and their outcome could increase demand or reduce supply, which means that asset prices might change in line with any changes that are highlighted in these market announcements.

Price Discovery Example

- In the Chart below, demand is decreasing as supply is increasing. Typically, this means an asset's price will fall. As the graph shows, the two lines representing demand and supply eventually cross, representing a level at which both buyers and sellers agree is the fair market price for an asset.
- As a result, the asset will begin to trade at this level until there is a shift in the levels of supply and demand, which will require another period of price discovery.



Introduction

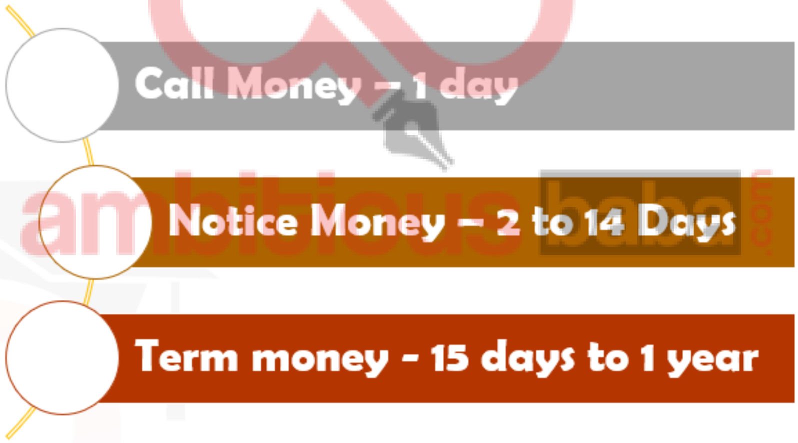
It is a market for short-term funds, with maturity ranging from overnight to one year and includes financial instruments that are deemed to be close substitutes to money.

The money market performs three broad functions.

- It provides an equilibrating mechanism for demand and supply of short-term funds.
- It enables borrowers and lenders of short-term funds to fulfill their borrowing and investment requirements, at an efficient market clearing price, and
- It provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.

Call Money, Notice Money and Term Money

- The call/notice/term money market is a market for trading **very short-term liquid financial assets** that are readily convertible into cash at low cost.
- The money market primarily facilitates lending and borrowing of funds between banks and entities like Primary Dealers.
- The interest rate on such funds depends on the surplus funds available with lenders and the demand for the same, which remains volatile.



Participants in the Market

- **Supervision:** By the Reserve Bank of India, which issues guidelines for the various participants in the call/notice money market**.**
- **Participants:** Banks, Primary Dealers, development finance institutions, insurance companies and select mutual funds.
- **Operate both as borrowers and lenders in the market: Banks and PDs**
- **operate as lenders Only:** Non-bank institutions, which have been given specific permission to operate in call/notice money markets

Prudential Lending Limits

- Prudential limits in respect of outstanding lending transactions in the Call, Notice and Term Money Markets shall be decided by the participants with the approval of their Board within the regulatory framework of the exposure norms prescribed **by the Department of Regulation of the Reserve Bank for the eligible participant concerned.**

Prudential Borrowing Limits

Sr. No.	Participant Category	Prudential Limit
1	Scheduled Commercial Banks (including Small Finance Banks)	**Call and Notice Money:** (i) 100% of capital funds, on a daily average basis in a reporting fortnight, and (ii) 125% of capital funds on any given day. **Term Money:** (i) Internal board approved limit within the prudential limits for inter-bank liabilities.
2	Payment Banks, and Regional Rural Banks	**Call, Notice and Term Money:** (i) 100% of capital funds, on a daily average basis in a reporting fortnight, and (ii) 125% of capital funds on any given day.
3	Co-operative Banks	**Call, Notice and Term Money:** (i) 2.0% of aggregate deposits as at the end of the previous financial year.
4	Primary Dealers	**Call and Notice Money:** (i) 225% of Net Owned Fund (NOF) as at the end of the previous financial year on a daily average basis in a reporting fortnight. **Term Money:** (i) 225% of Net Owned Fund (NOF) as at the end of previous financial year.

Treasury Bills

- **Treasury bills (T Bills) are money market instruments, offered for the** purpose of financing short-term debt obligation **of the Government of India.**
- **Three types of T bills are issued, through a competitive or non-competitive bidding process of auction.**

- The investment in the Bills may be made by any person resident in India, including **Non-Resident Indians, Overseas Citizens of India and Foreign Portfolio** Investors are eligible to invest, subject to the approval of the Government and provisions of **Foreign Exchange Management Act, 1999**

Non-Competitive Bidding

- State Governments, Union Territories with legislature, eligible Provident Funds in India, designated Foreign Central Banks (**Nepal Rashtra Bank, Royal Monetary Authority of Bhutan, Vnesheconom Bank (only in 91 Day T Bills), can participate on non-competitive basis, the allocation for which may be within or outside the notified amount, in consultation with the central Government.**

Certificates Of Deposit

- A negotiable money market instrument issued in dematerialised form,
- CDs are discounted instruments and are issued at a discounted price and redeemed at par value.

Tenor: from 7 days to 1 year,

- Most CDs are issued by banks **for 3, 6 and 12-months' tenors**
- NRI are also permitted to subscribe to CDs. However, they are mainly subscribed to by banks, mutual funds, provident and pension funds and insurance companies.
- **The minimum amount:** Rs. 5 lakh and are accepted in multiples of Rs. 5 lakh thereafter.
- Banks are not allowed to grant loans against CDs, unless specifically permitted by the Reserve Bank.
- Buyback of CDs at prevailing market price can be made only **7 days after the date of issue of the CD.**

Issued By :

- Scheduled commercial banks (including Regional Rural Banks (RRBs)
- Small Finance Banks (SFBs)); select all-India Financial Institutions

Issued To: **Individuals (other than minors),**

- Corporations,
- Companies,
- Trusts,
- Funds,
- Associations, etc.

Commercial Paper

- **1990:** RBI introduced Commercial Papers (to enabling highly rated corporate borrowers).

- **An unsecured money market instrument issued in the form of a promissory note.**

Subject to the condition that:

(a) Any fund-based facility availed of from bank(s) and/or financial institutions is classified as a standard asset by all financing banks/institutions at the time of issue.

(b) Net worth of Rupees 100 crore or higher.

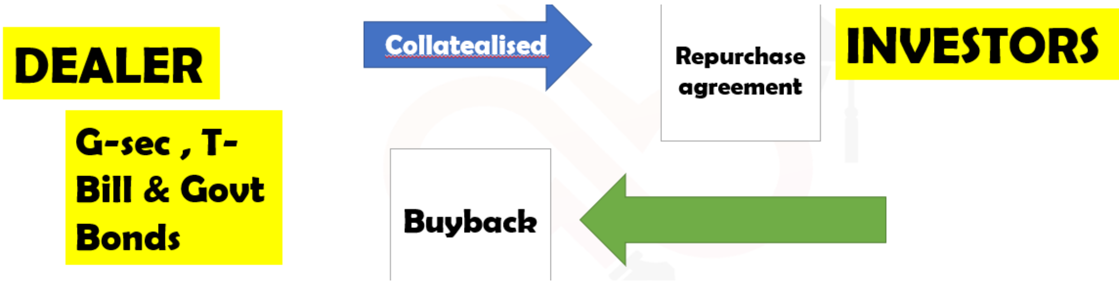
(c) Any other entity specifically permitted by **the Reserve Bank of India (RBI).**

- However, no person can invest in CPs **issued by related parties either in the primary or secondary market.**
- Eligible participants/issuers shall obtain credit rating for issuance of CP from any one **of the SEBI registered Credit Rating Agencies (CRAs).**
- **Minimum credit rating:** 'A3' as per rating symbol and definition prescribed by SEBI.
- **Total CP issuance during a calendar year is Rupees 1000 crore or more,** shall obtain credit rating from at least two CRAs registered with SEBI and should adopt the lower of the two ratings.
- Where both ratings are the same, the issuance shall be for the lower of the two amounts for which ratings are obtained.
- **Maturities**: Minimum of 7 days and maximum up to 1
- CPs can be issued **on a "stand alone" basis.**
- An FI can issue CPs, within the overall umbrella limit fixed by the RBI, i.e., the quantum for which the CPs can be issued together with other instruments, viz., term money borrowings, term deposits, certificates of deposit and inter-corporate deposits should **not exceed 100% of the Company's net owned funds, as per the latest audited balance sheet.**
- CPs may be issued to and held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, **Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs).**
- However, investment by FIIs should be within the **limits set for their investments by SEBI.**
- **Mutual Funds, Banks, Insurance companies, etc., are the dominant investors in the CP market.**
- **Secondary market trading takes** place through the inter-bank broking market between institutional participants.
- CPs are issued at a discount to their face value, as may be determined mutually by the issuer and the investor**.**

- The buyback offer can be made at the prevailing market price only not **before 30 days from the date of issue.**

Repo

- **Repo is a repurchase agreement, entered into between eligible** counterparties for borrowing and lending of funds, on a collateralised basis.



- A repo involves selling of a security, with an agreement to repurchase the same, at a future date, at a predetermined price.
- The seller of the security receives funds, while the buyer of the security receives collateral for the funds that has been lent.
- The rate at which the security will be repurchased in the 2nd leg of the repo, is derived from the rate of interest payable on the funds lent and is known as repo rate.
- Repo transactions are permitted between counterparties and in instruments permitted by **the Reserve Bank of India.**
- The rate at which the security will be repurchased in the 2nd leg of the repo, is derived from the rate of interest payable on the **funds lent and is known as repo rate.**
- **Repo transactions are permitted between counterparties and in instruments permitted by the Reserve Bank of India.**

Eligible securities:

- Government securities issued by the Central Government or a State Government,
- listed corporate bonds and debentures (subject to the condition that no participant shall borrow against the collateral of its own securities, or securities issued by a related entity),
- Commercial Papers (CPs),
- Certificate of Deposits (CDs),
- Units of Debt Exchange Traded Funds (ETFs).

Eligible participants :

- Any regulated entity,
- Any listed corporate,

- Any unlisted company, which has been issued special securities by the Government of India (using only such special securities as collateral), and
- Any All-India Financial Institution (FIs), viz., Exim Bank, NABARD, NHB and Small Industries Development Bank of India (SIDBI). Besides,
- Any other entity approved by the Reserve Bank from time to time for this purpose, can participate in repo transaction.

1st leg : The buying of securities and lending of short-term surplus in

2nd leg : selling the security at a predetermined rate

- Automatically, therefore, a repo transaction for one counterparty becomes a reverse repo transaction for the other counterparty.
- Repo transactions facilitate banks to invest their surplus cash for adjusting CRR positions and also for adjusting SLR positions.
- To facilitate equitable access to all market participants for trading, tri-party agents are **authorised by RBI/ SEBI to provide trading platform**.
- A repo contract - where a third entity (apart from the borrower and lender), known as a Tri-Party Agent, acts as an intermediary between the two parties to the repo, to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction **- is called Tri-party Repo.**

Tri-Party Repo

- **A Tri-party repo is a type of repo contract, where a third entity (apart from the borrower and lender) called a Tri-Party Agent,** acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.
- **Introduced by RBI in August 2017.**
- The job of the triparty agent is to administer the transaction **between the lender and the borrower.**
- Here, the agent does post-trade processing, such as collateral selection, payment and settlement, custody and management of the collaterals during the life of the transaction, etc.
- Once a lender or borrower notifies about transactions, the agent matches the transaction and, if successful, processes it.

BORROWER

SECURITIES

AGENT

LENDER

SURPLUS MONEY

Eligibility criteria of tri-party agents

- Prior authorisation from the Reserve Bank, to act in that capacity.
- Eligible under the Payment and Settlement Systems Act: Scheduled commercial banks, recognised stock exchanges and clearing corporations of stock exchanges or clearing corporations
- **Minimum paid-up equity share capital: Rs. 25 crores.**
- **Past experience :** at least 5 years in the financial sector, in India or abroad, preferably in custody, clearing or settlement services**.**
- **Tri-party agents should put in place, adequate system infrastructure to carry out their functions.**

Advantages of tri-party repo

- Introduced in order to provide depth and liquidity in the corporate bond market.
- To alleviate the burden of collateral management on one or both of the parties, by delegating the collateral management to the tri-party agent**.**

Bill Rediscounting Scheme (BRDS)

- **BRDS is the rediscounting of trade bills**, which have already been purchased by/discounted with the bank by the customers.
- Banks, in their normal course of business discount genuine bills of exchange. This forms part of the loans and advances or credit portfolio of the bank.
- To provide liquidity and to promote the bills culture in the economy, the RBI formulated a scheme, whereby, a bank may raise funds by issue of Derivative Usance Promissory Notes (DUPN) in convenient lots and maturities on the strength of genuine trade bills discounted by it.
- This scheme is known as the **Bills Rediscounting Scheme.**
- **Banks and permitted financial entities may invest by way of rediscounting trade bills of other eligible banks against a Derivative Usance Promissory Note issued by such bank.**
- **Tenor: M**inimum 15 days and the maximum tenor is 90 days.

- The bank borrowing under the BRDS scheme issues a Derivative Usance Promissory Note to the lender as well as a certificate that the bank holds eligible bills, equal to the amount of the transaction on its books.
- The discounting bank will hold and continue to hold such unencumbered usance bills till the date of maturity of the Derivative Usance Promissory Note.
- In case any of the bills mature during the currency of the derivative UPN, such bills should be replaced by fresh eligible bills discounted by the bank issuing such **derivative UPN.**

Long Term Repo Operations (LTRO)

Introduced by RBI in February 2020, with the following dual objectives:

- To encourage banks to undertake maturity transformation smoothly and seamlessly, so as to augment credit flows to productive sectors, and,
- To assure banks about the availability of durable liquidity, at reasonable cost, relative to prevailing market conditions.

Accordingly, it has been decided that, from the fortnight beginning on February 15, 2020, the RBI would conduct term repos of 1-year and 3-year tenors of appropriate sizes for up to a total amount of Rs 1,00,000 crores at the policy repo rate.

- The first two LTROs were conducted on February 17th and 24th, 2020 for Rs 25,000 crores each, for tenors of 3 years and 1 year, respectively. –
- The total amount of liquidity injected through these operations would be up to Rs 1,00,000 crores.
- LTROs are conducted on e-Kuber platform and the operations are conducted at a fixed rate.
- Banks are required to place their requests for the amount sought under LTRO during the window timing, at the prevailing policy repo rate.
- In case of over-subscription of the notified amount, the allotment is done, on pro-rata basis.
- The bid amount should be for a minimum of Rs 1 crore and multiples thereof.
- **Targeted Long-Term Repo Operations are Long-term repo operations (LTROs) conducted by the RBI, to ensure adequate liquidity at the longer period for specific sectors.**
- **Under LTROs, the** RBI auction funds to banks for making investments in prescribed corporate and other instruments.
- **In the initial phase, the RBI instructed banks to invest funds availed from TLTRO to invest in investment-grade corporate debt.**

- **Purpose:** To ensure that there is enough liquidity in markets like corporate bond market and their yield do not go up in the context of the COVID setback.
- **Exempted:** From regulatory requirement of the CRR for the equivalent of incremental credit disbursed by banks as loans.
- **Interest rate:** Floating rates linked to the policy repo rate.

Why TLTRO?

- Corporate were finding it difficult to mobilise funds as there were large sell offs in the corporate bonds, in the context of the COVID-19 pandemic and the accompanying economic risks.
- Therefore, providing liquidity to the corporate bond market was the **prime objective of the TLTROs.**
- On March 27, 2020, the RBI launched the first TLTRO to provide liquidity in the corporate bond market through banks.
- Four tranches were completed on April 17, 2020.
- In a similar step, the RBI also conducted a TLTRO 2.0 for supporting fund injections to NBFCs through banks.

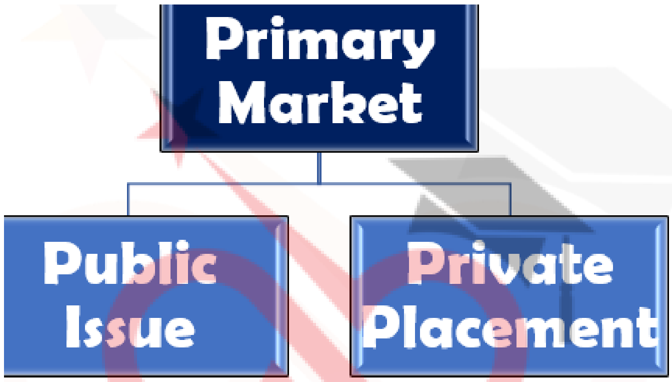
JAIIB Paper 1 IE & IFS Unit 3: Capital Markets and Stock Exchanges

Capital Market

Also includes private placement sources of debt and equity as well as organised forums like stock exchanges.

Primary Market

- In the primary market, securities (shares/bonds/debentures) are offered to the public for subscription, for the purpose of raising capital or fund.



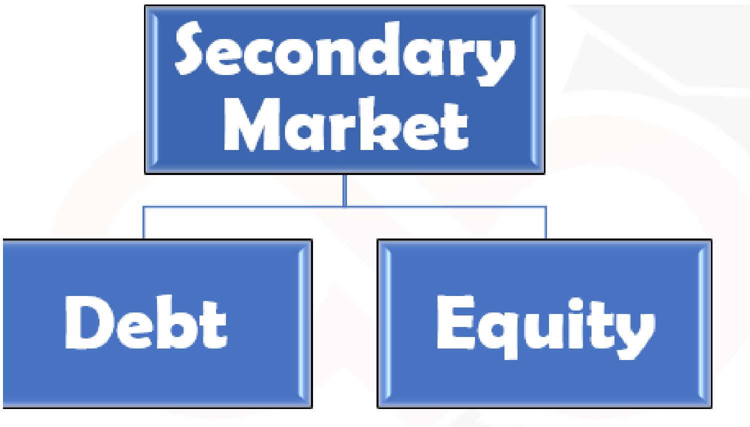
Intermediaries

- Merchant banker,
- Issue manager,
- Lead arranger, etc.

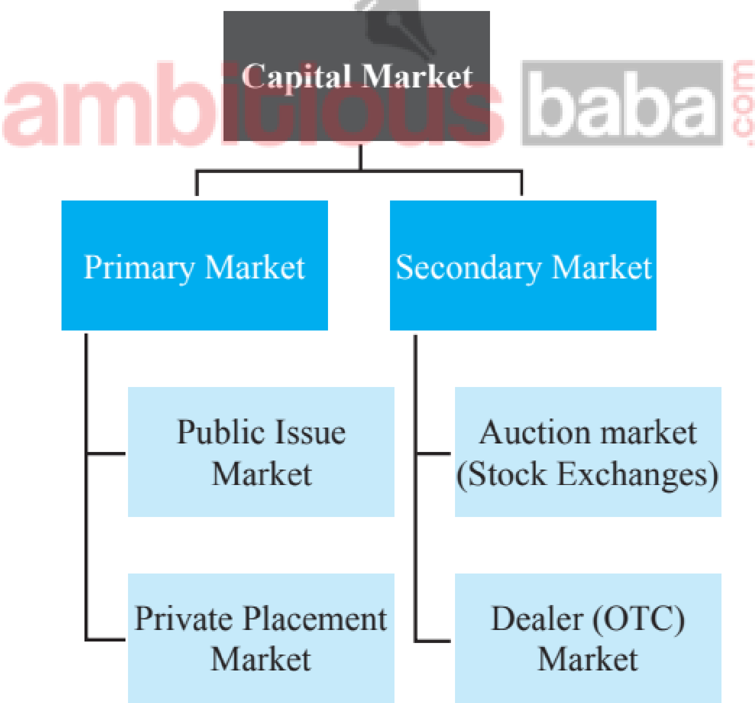
Banks participate in the capital market as bankers to the **issue, arrangers, underwriters, etc.**

Secondary Market

Secondary market refers to a market, where securities are traded, after being initially offered to the public in the primary market and/or listed on the Stock Exchange



- **Secondary market is the trading avenue**, in which, already existing/pre-issued securities are traded, amongst investors. Secondary market could be either an auction or a dealer market. While stock exchange is a part of an auction market, Over the Counter (OTC) market, is a part of the dealer market.
- For the general investors, the secondary market provides an efficient platform for trading of securities, & for price discovery.
- **For managers of the company, secondary (equity) markets** serve as a monitoring and control conduit – by facilitating value enhancing control activities, enabling implementation of incentive-based management contracts and aggregating information (via price discovery) that guides management decisions.
- **Banks facilitate secondary market transactions** by opening direct trading and demat accounts to individuals and companies. Banks also extend credit against securities. They can also function as clearing house banks.



Stock Exchanges In India

At present following are the stock exchanges in India:

BSE Ltd. (Erstwhile Bombay Stock Exchange) (BSE) –

- It is the oldest stock exchange of India
- set up in 1875
- First stock exchange to be granted permanent recognition from SEBI.
- It is one of the two major stock exchanges in the country today.

National Stock Exchange of India Ltd. (NSE) –

- **Established:** 1992 and is the other major stock exchange in the country today.
- **Permanent recognition from SEBI.**

The Calcutta Stock Exchange Ltd. (CSE) –

- One of the oldest stock exchanges of India.
- Set up as an Association in 1908.
- It has permanent recognition as stock exchange.

Metropolitan Stock Exchange of India Ltd. –

- Formed in December 2012, and commenced trading in February 2013.

India International Exchange (India INX) –

- A subsidiary of BSE and
- Set up in the International Financial Services Centre (IFSC), Gandhinagar.

NSE IFSC Ltd. –

- This stock exchange is a subsidiary of NSE and has been set up in the International Financial Services Centre (IFSC), Gift City, Gandhinagar.

Over the Counter Exchange of India Ltd. (OTCEI) –

- Set up in 1990 to aid enterprising promoters in raising finance for their projects in cost effective manner.

Demutualisation of Stock Exchanges

- **Demutualisation refers** to the transition process of an exchange from a 'mutually owned' association to **a 'shareholders-owned' company.**

Financial Products/Instruments Dealt With In The Secondary Market

The following are the main financial products/instruments dealt with in the secondary market:

- **Equity:** Equity is the ownership interest in a company of holders of its common and preferred stocks. The different types of equity shares are as follows:

- **Equity Shares**: An equity share is commonly referred to as an ordinary share. It represents the form of fractional ownership, in which, a shareholder, as a fractional owner, undertakes the entrepreneurial risk, associated with a business venture. The holders of equity shares are members of the company and have voting rights. A company may issue such shares with differential rights for voting, payment of dividend, etc.
- **Rights Issue/Rights Shares**: This refers to the issue of new securities to the existing shareholders, at a ratio to those shares already held.
- **Bonus Shares**: These shares are issued by the companies to their shareholders free of cost by capitalisation of accumulated reserves from the profits earned in the earlier years or out of the share premium account.
- **Preferred Stock/Preference Shares**: These shares do not offer voting rights. Owners of these shares are entitled to a fixed dividend or a dividend calculated at a fixed rate to be paid regularly before any dividend can be paid in respect of equity share. These shareholders also enjoy priority over the equity shareholders in the payment of surplus, during the process of liquidation of the company.
- **Cumulative Preference Shares**: This is a type of preference share on which dividend accumulates, if it remains unpaid. All arrears of preference dividend have to be paid out, before paying dividend on equity shares.
- **Cumulative Convertible Preference Shares**: This is a type of preference share where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.
- **Participating Preference Share**: This refers to the right of certain preference shareholders to participate in profits, after a specified fixed dividend, contracted for, is paid. Participation right is linked with the quantum of dividend paid on the equity shares, over and above a particular specified level. Other instruments that form part of the capital market are given below:
- **Security Receipts**: Security receipts mean receipts or other securities, issued by a securitisation company or a reconstruction company, to any qualified institutional buyer, pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial assets involved in securitisation.
- **Government Securities (G-Secs)**: These are sovereign (credit risk free) coupon-bearing instruments, which are issued by the Reserve Bank of India, on behalf of the Government of India, in lieu of the Central Government's market borrowing programme. These securities have a fixed coupon that is paid on specific dates, on a half-yearly basis.
- **Debentures**: Debentures are bonds issued by a company bearing a fixed rate of interest usually payable half-yearly, on specific dates and the principal amount repayable on a particular date, on redemption of the debentures. Debentures are normally secured/charged against the asset of the company in favour of the debenture holder.
- **Bond: A** bond is a negotiable certificate evidencing indebtedness. It is normally unsecured. A Bond (debt security) security is generally issued by a company,

municipality or a government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date.

- **Coupon Bonds**: These are normal bonds, on which, the issuer pays the investor/holder, interest at the pre-determined rate (known as coupon), at agreed intervals, normally, twice a year. The maturity of the bond is known by the period for which**, it is issued.**
- **Zero-Coupon Bond**: A bond issued at a discount and repaid at a face value is called a Zero-Coupon Bond. No periodic interest is paid in this case. The difference between the issue price and redemption price (face value) represents the return to the holder. The buyer of these bonds receives only one payment, at the maturity of the bond (known as a bullet payment).
- **Convertible Bond**: A bond giving the investor the option to convert the bond into equity, at a fixed conversion price, is referred to as a Convertible Bond.
- **Commercial Paper**: Commercial papers are borrowings of a company from the market. They take the shape of short-term promises to repay fixed amounts. They are placed on the market, either directly or through specialised intermediaries. Commercial papers are money market instruments issued, minimum of **7 days and maximum of one year**.
- **Treasury Bills**: These are short-term bearer discount security, issued by the Government (through the Reserve Bank of India), as a means of meeting its cash requirements.

Commonly Used Terms In The Capital Market

Securities Transaction Tax (STT):

- Securities Transaction Tax (STT) is a tax, being levied on all transactions done on the stock exchanges, at rates prescribed by the Central Government, from time to time.
- Pursuant to the enactment of the Finance (No. 2) Act, 2004, the Government of India notified the Securities Transaction Tax Rules, 2004 and
- came into effect from October 1, 2004.
- In order to reduce transaction costs in the capital markets, the STT was reduced to 0.1% on cash delivery transactions in the annual budget 2013-14.

Rolling Settlement:

- In a Rolling Settlement, trades executed during the day are settled, based on the net obligations for the day.
- Presently, the trades pertaining to the rolling settlement are **settled on a T+2 days basis.**
- Trades executed on a Monday, hence, are typically settled on Wednesday (considering 2 working days from the trade day).

- The funds and securities pay-in and pay-out **are carried out on T+2 day**.
- A Stock Exchange may choose to offer T+1 settlement cycle on any of the scrips with effect from January 01, 2022, after giving an advance notice of at least one month subject to applicable terms and conditions as per SEBI guidelines dated 7the September 2021.

Pay-in Day and Pay-out Day:

- **Pay-in day is the day when the brokers** make payments or delivery of securities to the exchange.
- Pay-out day is the day when the exchange makes payment or delivery of securities to the broker.
- **Settlement cycle is on a T+2 rolling** settlement basis, with effect from April 1, 2003.
- The exchanges have to ensure that the pay-out of funds and securities to the clients is done by the broker, within 24 hours of the pay-out.
- The exchanges will have to issue a press release immediately after the pay-out

Securities Lending Scheme:

- Securities Lending and Borrowing is a scheme which enables lending of idle securities by the investors to the clearing corporation and earning a return through the same.
- For securities borrowing and lending system, clearing corporations of the stock exchange would be the nodal agency and be registered as the '**Approved Intermediaries' (AIs).**
- The clearing corporation can borrow, on behalf of the members, securities for the purpose of meeting shortfalls.
- The defaulting selling broker may make the delivery within the period specified by the clearing corporation.
- In the event of the defaulted selling broker, failing to make the delivery within the specified period, the clearing corporation has to buy the **securities from the open market and return the same to the lender, within 7 trading days.**
- In case of an inability to purchase the securities from the market, the transaction shall be closed out.

Types Of Capital Issues In The Primary Market

PUBLIC ISSUE

- Classified into Initial Public Offerings (IPO) & Further/Follow on Public Offerings (FPOs).
- In a public offering, the issuer makes an offer to new investors to enter its shareholding family.
- The issuer company makes detailed disclosures, as per the Disclosure and Investor Protection (DIP) guidelines, in its offer document and offers it, for subscription.

IPO:

- An IPO is the offering that is made when an unlisted company makes either a fresh issue of securities or an offer for sale of its existing securities or both for the first time to the public.
- This paves way for listing and trading of the issuer's securities.

FPO:

- FPO is made when an 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.
- An offer for sale in such a scenario is allowed only if it is made to satisfy listing or continuous listing obligations.

RIGHT ISSUE:

- Rights Issue (RI) is when a listed company proposes to issue fresh securities to its existing shareholders, as on a recorded date.
- The rights are normally offered in a particular ratio to the number of securities held prior to the issue.
- Best suited for companies who would like to raise capital, without diluting the stake of its existing shareholders, unless they do not intend to subscribe to their entitlements.

PRIVATE PLACEMENT:

- A private placement is an issue of shares or of convertible securities by a company to a select group of persons under Section 81 of the Companies Act, 1956, which is neither a rights issue nor a public issue.
- This is a faster way for a company to raise equity capital.
- A Qualified Institutional Placement (QIP) is a private placement of equity shares or securities convertible into equity shares by a listed company to Qualified Institutional Buyers (QIB) only, in terms of provisions of Chapter XIIIA of SEBI (DIP) guidelines.

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Eligibility Norms For Making Capital Issues

- SEBI has laid down eligibility norms for entities accessing the primary market through public issues.
- There are no eligibility norms for a listed company that is making a rights issue, as it is an offer made to for a listed company making a preferential issue.
- However, for a QIP, only those companies whose shares are listed in NSE or BSE and those who are having a minimum public float, as required in terms of the listing agreement, are eligible.
- For making any public issue of securities, a draft Prospectus has to be filed by the issuer, with **the SEBI, through a Merchant Banker**.
- No listed issuer company shall make any rights issue of securities, where the aggregate value of such securities, including premium, **if any, exceeds Rs. 50 lakhs,** unless a draft letter of offer has been filed with the Board, through a

Merchant Banker, at **least 30 days prior to the filing of the** letter **of offer with the Designated Stock Exchange.**

- In QIP, the merchant banker handling the issue has to file a copy of the placement document with SEBI, post-allotment, for record purposes.
- Merchant banks are the specialised intermediaries who are required to display due diligence and ensure that all the requirements of DIP (Disclosure and Investor Protection) guidelines are complied with, while submitting the draft offer document to SEBI.
- The draft offer document filed by the merchant banker is also placed on the website for public comments.

Offer Document means

- Prospectus in case of a public issue,
- Offer for sale and Letter of Offer, in case of a rights issue, which are filed with the Registrar of Companies (ROC) and stock exchanges.
- SEBI may specify changes, if any, in the draft offer document and the issuer or the lead merchant banker (LM) shall carry out such changes **in the draft offer document, before filing the offer document with ROC/SEs.**
- The draft offer document will be available on the SEBI website, for public comments, for **a period of 21 days, from the filing of the draft offer document with SEBI.**

Red Herring Prospectus (RHP)

- **Red Herring Prospectus (RHP) is a** prospectus which does not have details of either price or number of shares being offered or the amount of issue.
- This means that in case the price is not disclosed, the number of shares and the upper and lower price bands are disclosed.
- An issuer can state the issue size and the number of shares is determined later.
- An RHP for an FPO can be filed with the ROC, without the price band. In such a case, the floor price or the price band will be notified by way of an advertisement, one day prior to the opening of the issue.
- In the case of issues for book building, it is a process of price discovery and the price cannot be determined, until the bidding process is completed.
- Such details are thus not shown in the RHP filed with ROC**, in terms of the provisions of the Companies Act.**
- Only on completion of the bidding process, the details of the final price are included in the offer document.
- The offer document filed thereafter with **ROC is called a prospectus.**

What is a Draft Red Herring Prospectus?

- A Red Herring Prospectus, or offer document, is filed by a company to SEBI (Securities and Exchange Board of India), when it intends to raise money from the public by selling shares of the company to investors.
- The document is very useful to investors because, it provides detailed information about the company's business operations, financials, promoters and the company's objective for raising funds by filing an IPOs.
- It also elaborates on how the company intends to use the money that will be raised and the possible risks for investors.

Contents of RHP:

The Red Herring Prospectus contains some of the following information

Business Description:

- This segment talks about a company's core operations and how it conducts business.
- A prospective shareholder, should pay attention to this part, as the investment will be utilised by the company, in its core business.

Financial information:

- contains the company's audit reports and financial statements.
- For an investor, the financial statement will help him to get an idea of future dividends, based on the profits disclosed.
- The investor can gauge the safety and profitability of his future investment, based on the financial information.

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Risk Factors:

- Companies lists out the potential risks that could impact their business and operations under a section titled '**Risk Factors'.**
- While many are routinely listed risks, some risks need to be scrutinised. For instance, if the investor find that the company has a number of pending legal cases, it may be a good idea to avoid the IPO.

Use of Proceeds:

- The investor should find out what the company intends to do with the capital it raises, through the IPO.
- Also, the capital structure of the company should be scrutinised in order to see if any big private investors have put money into the company.

Industry overview:

- A red herring prospectus carries information about the position of the company, relative to its competitors. The performance trends of the industry to which the company belongs to, is also included in the document.

Management:

- A company's prospects have a lot to do with the people who run it.
- The management is responsible for planning strategies on varied fronts like driving growth, pushing expansions, renovation, marketing, etc.
- This section has details such as names, qualifications, designations about directors, promoters and key management personnel.
- It may also have information about any criminal cases or that of financial delinquency or pending litigations against these people.
- It is important for an investor to check this section because all these can be a risk factor.

Pricing of the Issue

- **There is no price formula stipulated by SEBI.**
- The company and merchant banker are however required to give full disclosures of the parameters, which they had considered, while deciding on the issue price.

There are two types of issues,

- ❑ One where company and LM fix a price (called fixed price)
- ❑ Other, where the company and LM stipulate a floor price or a price band and leave it to market forces to determine the final price (price discovery through book building process).

- An issuer company is allowed to freely price the issue.
- The basis of issue price is disclosed in the offer document
- Book Building means a process by which, a demand for the securities proposed to be issued by a corporate body is elicited and built-up and the price for the securities is assessed, on the basis of the bids obtained for **the quantum of securities offered for subscription by the issuer.**

In a 100% of net offer to public through voluntary book-built issue, allotments to different ***categories of investors are required to be ensured in the following proportions:***

- **Retail Individual Investors (RIIs):** Not less than 35% of the net offer to the public
- **Non-Institutional Investors (NIIs):** Not less than 15% of the net offer to the public

- **Qualified Institutional Buyers (QIBs):** Not more than 50% of the net offer to the public (5% of which should go to Mutual funds)

In case of compulsory Book-Built Issues, the proportion of allotments shall be as under:

- **QIBs**: At least 75% of the net offer to the public (failing which full subscription monies to be refunded)
- **NIIs:** Not more than 15% of the net offer to the public
- **RIIs:** Not more than 10% of the net offer to the public

In case of Fixed Price Issues, the proportion of allotments shall be as under:

(a)A **minimum 50% of** the net offer of securities to the public shall initially be made available for allotment to RIIs.

(b)The balance net offer of securities to the public shall be made available for allotment to:

- Individual applicants other than RIIs, and
- Other investors including corporate bodies/institutions irrespective of the number of securities applied for.

Retail Individual Investor

- Means an investor who applies or bids for securities of or **for a value not more than `2,00,000.**

Qualified Institutional Buyer

- Is an institutional investor who is perceived to possess expertise and the financial strength to evaluate and invest in the capital markets.
- SEBI has specified certain categories of investors which are considered as QIB, for example mutual funds, scheduled commercial banks, etc.

Non-Institutional Investor

- Is an investor other than a QIB or a RII. Typically, this category includes High Net Worth Individuals (HNIs) and corporate bodies.
- "**Anchor investor**" means a qualified institutional buyer who makes an application for a value of at least ten crore rupees in a public issue on the main board made through the book building process in accordance with these regulations or makes an application for a value of at least two crore rupees for an issue made in accordance with Chapter IX of these regulations.
- **"Green shoe-option**" means an option of allotting equity shares in excess of the equity shares offered in the public issue as a post-listing price stabilizing mechanism.
- **"Self-certified Syndicate Bank**" means a banker to an issue registered with the Board, which offers the facility of ASBA

Intermediaries In An Issue In The Primary Market

- Merchant bankers to the issue or Book Running Lead Managers (BRLM), syndicate members, registrars to the issue, bankers to the issue, auditors of the company, underwriters to the issue, solicitors, etc., are the intermediaries to an issue, in the primary market.

Book Running Lead Managers (BRLM):

- A merchant banker possessing a valid SEBI registration, in accordance with the **SEBI (Merchant Bankers) Regulations, 1992**, is eligible to act as a BRLM to an issue.

Safety Net:

- Any safety net scheme or buy-back arrangements of the shares proposed in any public issue shall be finalised by an issuer company, with the lead merchant banker in advance and disclosed in the prospectus.
- Such a buy-back or safety net arrangement shall be made available only to original resident individual allottees**, limited to a maximum of 1,000 shares per allottee and the offer is kept open for a period of six months, from the last date of dispatch of securities.**

Cut-Off Price

- In a book-building issue, the issuer is required to indicate either the price band or a floor price in the RHP.
- The actual discovered issue price can be any price, in the price band or any price above the floor price.
- **This issue price is called the Cut- Off Price.** This is decided by the issuer and LM, after considering the **'book and investors'** appetite, for the stock.
- SEBI (DIP) guidelines permit only retail individual investors to have an option of applying at the cut off price.

Applications Supported By Blocked Amount (ASBA)

- **ASBA means "Applications Supported by Blocked Amount".** ASBA is an application containing an authorisation to block the application money in the bank account, for subscribing to an issue.
- If an investor is applying through ASBA, the application money shall be debited from the bank account, only, if his/her application is selected for allotment, after the basis of allotment is finalised, or the issue is withdrawn/failed.
- **Under ASBA facility**, investors can apply in any public/rights issues, by using their bank accounts.
- The investors submit the ASBA forms (available at the designated branches of the banks acting as SCSB), after filling the details like name of the applicant, PAN

number, dematerialised account number, bid quantity, bid price and other relevant details, to their banking branch, by giving instructions to block the amount in their account.

- In turn, the bank will upload the details of the application in the bidding platform.
- Investors shall ensure that the details that are filled in the ASBA form are correct, otherwise the form is liable to be rejected.
- In case of public issues with effect **from May 1, 2010, all the investors could apply through ASBA.**

In rights issues, all shareholders of the company as on record date were permitted to use ASBA ***for making applications provided the applicant shareholder:***

- Is holding shares in dematerialised form and has applied for entitlements or additional shares in the issue, in dematerialised form;
- Has not renounced his/her entitlements in full or in part;
- Is not a renouncee;
- Is applying through blocking of funds in a bank account with the Self Certified Syndicate Bank. (SCSB is a bank which is specialised as a bank capable of providing ASBA services to its customers. Names of such banks would appear in the list available on the website of SEBI).

Qualified Institutional Placement (QIP)

- SEBI instituted the guidelines for Qualified Institutional Placement (QIP) relatively **new Indian financing avenue on May 8, 2006.**
- QIP is a capital raising tool, whereby, a listed company can issue equity shares, fully and partly convertible debentures, or any securities other than warrants, which are convertible into equity shares, to a qualified institutional buyer (QIB).
- Apart from preferential allotment, this is the only other speedy method of private placement for companies to raise money
- To enable the listed companies, raise money from domestic markets in a short span of time, market regulator- SEBI introduced the concept of QIP.
- Prior to introduction of QIPs, the complications associated with raising capital in the domestic markets had led many companies to look at tapping overseas markets via foreign currency convertible bonds (FCCBs) and global depository receipts (GDRs). This has also helped issuing companies price their issues closer to the prevailing market price.
- The specified securities can be issued only to QIBs, who shall not be promoters or related to promoters of the issuer.
- The issue is managed by a SEBI-registered merchant banker.
- There is no pre-issue filing of the placement document with SEBI.

- The placement document is placed on the websites of the stock exchanges and the issuer, with appropriate disclaimer to the effect that the placement is meant only for QIBs on private placement basis and is not an offer to the public.

JAIIB Paper 1 IE & IFS Module D Unit 4 Fixed Income Markets Debt and Bond Markets

Introduction

- A country's financial development hinges around the existence of deep and liquid government securities market.
- Besides providing flexibility to the public debt manager to manage borrowing obligations and the maturity profile of public debt, while minimising rollover risks, this market also determines risk-free interest rates, leading to price discovery in other segments of the market spectrum, such as markets for money market instruments and corporate bonds.

Government Securities

- The Government securities market consists of securities issued by **the State and the Central governments.** Government securities include Central Government securities, Treasury bills and State Development Loans.
- They are issued in order to finance the fiscal deficit and managing the temporary cash mismatches of the Government. All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations.

Bond Valuation And Theorems

Three important parameters for any bond are its face value, maturity and coupon (interest) rate.

- The price of a bond also depends up on the prevailing market interest rate (yield). To determine the fair price of a bond, we have to understand that the market interest rate for the term to maturity (or the residual term to maturity) of a bond keeps changing in the real world.
- Although the coupon of a bond (interest payable by the bond issuer to the bond holder) is never changed, as the market interest rate changes, adjustments will have to be made in the price of bonds, in order to reflect the ongoing market interest rate.

There are four important bond theorems, based on the interplay of its price and the market interest rate. Without going deep into the details of the theorems, which may be outside the scope of this courseware, ***the theorems can be stated as follows:***

- **Theorem 1:** The price of a bond is inversely related to the change in interest rate.

- **Theorem 2**: The increase in the price of a bond when the interest rate goes down by a certain percentage, is greater than the decrease in its price when the interest rate goes up by the same percentage.
- **Theorem 3:** Longer the term to maturity of a bond, higher will be its price sensitivity.
- **Theorem 4:** Between two bonds of same maturity but different coupons, the bond with the lower coupon will experience more price sensitivity than the one with higher coupon.

Auction Of Government Securities

- As stated earlier, Government securities are issued through auctions (Multiple Price Auctions or Uniform Price Auctions), **which are conducted by the RBI.**
- Investment in the Government Securities may be made by any person resident in India, including firms, companies, corporate bodies, institutions, State Governments, Provident Funds and Trusts, Non-Resident Indians, Overseas Citizens of India **Foreign Portfolio Investors (FPIs) registered with the Securities and Exchange Board of India (SEBI)and approved by Reserve Bank of India (RBI) and other person not resident in India**, as specified by the RBI with the prior approval of the Government of India, in this regard.
- Foreign Central Banks (FCBs) will also be eligible to invest in the Government securities subject to the terms and conditions stipulated by the RBI, in consultation with the Government of India, in the Scheme for Rupee Investments by FCBs. Investment by a person resident outside India or a Company which is incorporated outside India or any branch of such Company shall be subject to the provisions of the Foreign Exchange Management Act, 1999 (FEMA) and Regulations framed there under, in addition to the other provisions of law applicable to Government Securities.

Note: Government Securities will be issued for **a minimum amount of Rs. 10,000 (Face Value) and in multiples of Rs.10,000 thereafter.**

Primary Dealers

- One of the very important players in the Government securities market are the Primary Dealers (PDs). Primary dealers are entities, registered with RBI, who have the license to purchase and sell government securities.
- They are entities who buy government securities directly from RBI, aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities. The Primary Dealers system in the government securities market was **introduced by the RBI in 1995**.
- The PDs, thus serve to promote transactions in government securities market. A facilitating arrangement is essential for selling of government securities as government is the single largest borrower in the market, which borrows through the issue of its securities, i.e., treasury bills and bonds.

- RBI guidelines stipulate that PDs should have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation, etc., in order to ensure that they are active in supporting the trade in government securities.

Eligibility Conditions for Primary Dealers

- Subsidiary of scheduled commercial bank/s and All India Financial Institutions
- Subsidiaries/ joint ventures set up in India by entities incorporated abroad.
- Company incorporated under the Companies Act, 1956 and does not fall under (a) or (b). The applicant for PD should register as an NBFC for at least one year prior to the submission of its application for PD. The decision to authorise PDs is taken by RBI, based on its perception of market needs, suitability of the applicant and the likely value addition to the system.

Role and Functions of Primary Dealers

The role of Primary Dealers is to:

- Commit participation as principals in Government of India issues through bidding in auctions,
- Provide underwriting services,
- Offer firm buy – sell/bid-ask quotes for T-Bills & dated securities, and
- Development of Secondary Debt Market

Fixed Income Money Market and Derivatives Association Of India (FIMMDA)

FIMMDA is the Self-Regulatory Organisation (SRO), associated with the fixed income and derivative markets in India. It is an association of Commercial Banks, Financial Institutions and Primary Dealers and is a voluntary self-regulating institution for the bond, money and derivatives markets.

The role of FIMMDA is as follows:

- To function as the principal interface with the regulators on various issues that impact the functioning of these markets.
- To undertake developmental activities, such as, introduction of benchmark rates and new derivatives instruments, etc.
- To provide training and development support to dealers and support personnel at member institutions.
- To adopt and develop international standard practices and a code of conduct in the above fields of activity.
- To devise standardised best market practices.
- To function as an arbitrator for disputes, if any, between member institutions.
- To develop standardised sets of documentation.
- To assume any other relevant role facilitating smooth and orderly functioning of the said markets.

RBI Retail Direct Scheme (RDS)

In order to deepen the government securities market and enable retail individual investors to participate in the process of nation building by giving them access to the G-Sec market, RBI launched its Retail Direct Scheme (RDS) on 12th November, 2021. ***The salient features of RDS are as under:***

Securities Eligible

RDS would enable retail investors to buy and sell the following types of Government securities:

- Government of India Treasury Bills;
- Government of India dated securities;
- Sovereign Gold Bonds (SGB);
- State Development Loans (SDLs).

Scope of the Scheme

'RBI Retail Direct' is a comprehensive scheme, which provides the following facilities to retail investors in ***government securities market through an online portal:***

- Open and maintain a 'Retail Direct Gilt Account' (RDG Account)
- Access to primary issuance of Government securities
- Access to NDS-OM

Eligibility of Investors

Retail investors, as defined under the scheme, can register under the Scheme and maintain a RDG Account, ***if they have the following:***

- Rupee savings bank account maintained in India;
- Permanent Account Number (PAN) issued by the Income Tax Department;
- Any OVD for KYC purpose;
- Valid email ID; and
- Registered mobile number.

Non-Resident retail investors eligible to invest **in Government Securities under Foreign Exchange Management Act, 1999, are eligible under the scheme.**

The RDG account can be opened singly or jointly with another retail investor who meets the eligibility criteria.

Corporate Bond Market

- The Corporate Debt Market in India is at a relatively early stage, in terms of an efficient price discovery mechanism as well as market participation.
- Primary corporate debt market is dominated by finance companies and relatively a small amount of funds is raised by manufacturing and other service industries through this market. Indian firms are still seeking bank finance as the path to fulfill the funding requirements.

- An efficient bond market would help corporates reduce their financing costs and allow them to structure their asset-liability profiles better. A well-developed corporate bond market is also necessary for long-term financing of corporates.

Objectives of development of a robust corporate bond market are as follows:

- To diffuse stress on banks, by diversifying credit risk across the various investors.
- To supply long-term investment products, for long-term investors.
- To reduce funding cost for corporate and others, by eliminating agency and disintermediation cost.
- To ensure that capital is allocated more efficiently among various enterprises.

Inter-Corporate Deposits

- An Inter-Corporate Deposit (ICD), is an unsecured borrowing by corporates and FIs from other corporate entities, registered **under the Companies Act, 1956 or the Companies Act, 2013.**
- The corporate having surplus funds would lend to another corporate, in need of funds. This lending would be on uncollateralised basis and hence, a higher rate of interest would be demanded by the lender.
- The short-term credit rating of the corporate would determine the rate at which, the corporate would be able to borrow funds. Further, the credit spreads demanded even for the top-rated corporates would be higher than similar rated banks and the rates on ICDs would be higher than those in the Certificate of Deposit (CD) market.
- The tenor of ICD may range from one day to one year, but the **most common tenor of borrowing is for 90 days.** Primary Dealers are only permitted to borrow in the ICD market. The borrowing **under ICD is restricted to 150% of the Net Owned Funds and the minimum tenor of borrowing is for 7 days.**

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JAIIB Paper 1 IE & IFS Module D Unit 5 - Foreign Exchange Market

Profile Of Foreign Exchange (Forex) Market

In terms **of Section 2(n) of FEMA, 1999**, the definition of **'foreign exchange'** is as follows. ***"Foreign exchange" means foreign currency and includes:***

- Deposits, credits and balances payable in any foreign currency,
- Drafts, travellers' cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,
- Drafts, travellers' cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency".

The forex market has developed as a consequence of the international trade and foreign exchange requirement of nations. It is primarily an over-the-counter (OTC) market, although there are exchange traded transactions, as well, in the segments of futures.

Evolution Of The Forex Market In India

- **1978**: RBI allow banks to undertake intra-day trading in foreign exchange**.**
- As a consequence, the stipulation of maintaining **"square" or "near square"** position was to be complied with only at the close of business each day.
- During the period 1975- 1992, the exchange rate of rupee was officially determined by the RBI, in terms of a weighted basket of currencies of India's major trading partners and there were significant restrictions on the current account transactions.
- **July 1991**: Significant two-step downward adjustment in the exchange rate of the rupee on July 1 and July 3, 1991, with a view to placing it at an appropriate level in line with the inflation differential to maintain the competitiveness of exports.
- Following the recommendations of the High-Level Committee on Balance of **Payments (Chairman: Dr C. Rangarajan):**
- **Mar 1992:** The Liberalised Exchange Rate Management System (LERMS), involving dual exchange rate mechanism was instituted, which was followed by the ultimate convergence of the dual rates.
- **Effective from March 1, 1993 (known also as modified LERMS).**
- The unification of the exchange rate of the rupee marks the beginning of the era of market determined exchange rate regime of rupee, based on demand and supply in the forex market.
- It is also an important step in the progress towards current account convertibility, which was finally achieved in August 1994, by accepting **Article VIII of the Articles of Agreement** of the International Monetary Fund**.**
- **November 1994:** The appointment of an Expert Group on Foreign Exchange **(popularly known as Sodhani Committee),** was a landmark in the design of foreign exchange market in India.
- **Recommendations:** To develop, widen and deepen the forex market. Banks have been accorded significant initiative and freedom to operate in the market.
- This led to increasing turnovers in the forex market which rose from approximately USD 6 billion daily in the year 2000 to USD 70 billion daily, at present.

Characteristics Of The Forex Market

- **Liquidity:** The market operates the enormous money supply and gives absolute freedom in opening or closing a position in the current market quotation. High liquidity is a powerful magnet for any investor, because it gives the freedom to open or to close a position of any size whatever.
- **Promptness:** With a 24-hour work schedule, participants in the forex market need not wait to respond to any given event, as is the case in many markets.
- **Availability:** A possibility to trade round-the-clock; a market participant need not wait to respond to any given event.
- **Flexible regulation of the trade arrangement system:** A position may be opened for a pre-determined period of time in the forex market, at the investor's discretion, which enables to plan the timing of one's future activity in advance.
- **Value:** The forex market has traditionally no service charges, except for the natural bid/ask market spread between the supply and the demand price.
- **One-Valued quotations:** With high market liquidity, most sales may be carried out at the uniform market price, thus enabling to avoid the instability problem existing with futures and other forex investments where, limited quantities of currency only can be sold concurrently and at a specified price.
- **Market trend:** Currency moves in a quite specific direction that can be tracked for rather a long period of time. Each particular currency demonstrates its own typical temporary changes, which presents investment managers with the opportunities to manipulate in the forex market.
- **Margin:** The credit "leverage" (margin) in the forex market is only determined by an agreement between a customer and the bank or the brokerage house that pushes it to the market and is normally equal to 1:100.

Market Participants

- **Commercial banks and investment banks:** They generally act on their own behalf or based on the needs and interests of their clients.
- **Brokers:** They act as intermediaries between financial institutions or as links with private individuals, in exchange market, for a fee.
- **Central banks:** Central banks like RBI are responsible for issuing their respective country's currency and managing and controlling the money supply. Central Banks therefore intervene in currency markets – individually or in a coordinated way – to keep the value of their currencies within the limits defined by their monetary policies.
- **Sovereign funds:** These are public investment funds that invest proceeds from business privatisations, natural resources (oil, gas), etc., in foreign currency assets.

- **Hedge funds and investment entities:** These entities intervene in foreign exchange markets, with speculative purposes or to obtain returns. Multinationals, large corporations and SMEs and institutional investors (such as insurance companies and asset managers):
- These engage in exchange markets for commercial or investment purposes.
- **Individuals:** They operate in the foreign exchange market, for transactional hedging or speculative purposes.

Libor And Alternate Reference Rates (ARRs)

- London Inter Bank Offered Rate or LIBOR was a very popular benchmark and was issued for US Dollar, British Pound, Euro, Swiss Franc, Canadian Dollar and the Japanese Yen.
- The rate was being calculated and published each day by the ICE Benchmark Administration (IBA).
- The LIBOR had come into a great amount of criticism and irregularities, as a result of which, steps were taken to replace it as a financial benchmark rate.
- The events of **'LIBOR rigging'** created shock waves in the financial system and the credibility of a financial reference used to price and determine payoffs for trillions of dollars of loans/bonds/derivatives came under a cloud.
- In response to these developments, the UK commissioned a review of the **structure and governance of LIBOR.**
- The review concluded that LIBOR should be retained as a benchmark but that it should be comprehensively reformed.
- It also recommended that the publication of LIBOR in certain currencies and maturities in which the volumes of trades were particularly low should be discontinued.
- However, since these steps did not generate the required confidence for a universally acceptable benchmark rate,
- it was decided to phase out the LIBOR and replace it with the Alternate Reference Rates (ARRs) by 31st December, 2021.

Foreign Exchange Dealers' Association Of India (FEDAI)

- FEDAI is one of the very important institutions connected with the forex market and foreign exchange transactions in India.
- The **Foreign Exchange Dealers'** Association of India (FEDAI) is an association of banks that are authorised to deal in foreign exchange markets in India. Established in the year 1958, the body regulates the rules that determine various aspects of operations and charges that are attached to the foreign exchange business.

- In addition to rule setting, FEDAI assists member banks, by acting as an advisor and assists with the training of banks' personnel and accrediting foreign exchange brokers.

FEDAI has a number of functions, which are as follows:

- Issuing of guidelines and rules for handling of foreign exchange business,
- Training of bank personnel in the areas of foreign exchange,
- Accreditation of forex brokers,
- Advising/assisting member banks in settling issues/matters in their dealings,
- Representing member banks on Government/Reserve Bank of India/Other Bodies, and
- Announcement of daily and periodical rates to member banks.

Foreign Exchange Management Act (FEMA), 1999

- First time introduced through a series of rules**, under the Defense of India Act, 1939, on temporary basis.**
- **An** Act was promulgated in the statute under the title **"Foreign Exchange Regulation Act, 1947".**
- Subsequently, this Act was replaced by the **Foreign Exchange Regulation Act, 1973 (FERA) which came into force**
- With effect from January 1, 1974 and regulated **foreign exchange for more than 26 years under this Act.**
- Economic liberalisation in the year **1991, foreign investment in many sectors were permitted in India.**
- **In 1997: Tarapore Committee** on Capital Account Convertibility, constituted by the Reserve Bank of India.
- **Recommendation:** Changes in the legislative framework, governing foreign exchange transactions
- Accordingly, the **Foreign Exchange Regulation Act, 1973 was repealed and replaced by the new Foreign Exchange Management Act, 1999 (FEMA), with effect from June 01, 2000.**
- **Under FEMA, the** emphasis was on management, rather than on regulation, of foreign exchange.

Applicability of FEMA

- **FEMA, 1999,** was enacted to consolidate and amend the law relating to foreign exchange,
- **Objective:** Facilitating external trade and promoting the orderly development and maintenance of foreign exchange market in India**.**

- **Applies:** To all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention committed thereunder outside India, by any person to whom this Act applies.

Overall Structure

- **The overall structure of FEMA, 1999, is** covered by legislations, rules and regulations.
- **Contains 7 chapters divided into 49 sections.**

Authorities and Enforcement Machinery

FEMA in itself is not an independent and isolated law. The provisions of FEMA are spread at different places and so there are several regulatory bodies. Reserve Bank of India makes Regulations under FEMA and the Rules are made by ***the Central Government. Authorities governing the enforcement of FEMA are:***

- Foreign Exchange Department, Reserve Bank of India.
- Directorate of Enforcement, Department of Revenue, Ministry of Finance.
- Capital Market Division, Department of Economic Affairs, Ministry of Finance.
- Foreign Trade Division, Department of Economic Affairs, Ministry of Finance.

Machinery responsible for various aspects of FEMA

- Enforcement Directorate
- Adjudicating Authorities
- Special Director (Appeals)
- Appellate Tribunal

Important Provisions of the Act

Section 3 – It prohibits dealings in foreign exchange except through an authorised person. This Section states that no person can, without general or special permission of the RBI:

- Deal in or transfer any foreign exchange or foreign securities to any person not being an authorised person.
- Make any payment to or for the credit of any person resident outside India, in any manner.
- Receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India, in any manner.
- Enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire any asset outside India by any person.

Section 4 – It restrains any person resident in India from acquiring, holding, owning, possessing or transferring any foreign exchange, foreign security or any immovable property situated outside India except as specifically provided in the Act. The terms "foreign exchange" and "foreign security" are defined in sections 2(n) and 2(o)

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respectively of the Act. The Central Government has made Foreign Exchange Management (Current Account Transactions) Rules, 2000.

Section 6 – It deals with capital account transactions. This section allows a person to draw or sell foreign exchange from or to an authorised person for a capital account transaction. RBI in consultation with Central Government has issued various regulations on capital account transactions, in terms of sub-section (2) and (3) of section 6.

Section 7 – It deals with export of goods and services. Every exporter is required to furnish to the RBI or any other authority, a declaration, etc., regarding full export value.

Section 8 – It casts the responsibility on the persons resident in India who have any amount of foreign exchange due or accrued in their favour to get the same realised and repatriated to India, within the specific period and the manner specified by RBI.

Sections 10 and 12 – These provisions deal with duties and liabilities of the authorised persons. Authorised person has been defined in Section2(c) of the Act, which means an authorised dealer, money changer, offshore banking unit or any other person for the time being authorised to deal in foreign exchange or foreign securities.

Sections 13 and 15 – Provisions of these sections deal with penalties and enforcement of the orders of Adjudicating Authority as well power to compound contraventions under the Act.

Sections 36 and 37 – These pertain to the establishment of Directorate of Enforcement and the powers to investigate the violation of any provisions of Act, rule, regulation, notifications, directions or order issued

Fx-Retail Platform

- **The Reserve Bank of India, in its "Statement on Developmental and Regulatory Policies"** dated October 04, 2017, had stated
- Mechanism should be in place, for improving the pricing outcome for the **"Retail User"** under which, client pricing is directly determined in the market by providing customers with access to an inter-bank electronic trading platform, where bid/offers from Retail clients and Authorised Dealer banks can be matched anonymously and automatically.
- **According to RBI, a mechanism in the form of a trading platform**: Provide the much-needed transparency and at the same time, enhance competition and lead to better pricing for the customers.
- Further, direct execution of orders by the customer would also bring down the risk that banks face in warehousing transactions, until they can be aggregated to a market- lot.
- In this mechanism, the banks may charge their customers a pre-agreed flat fee, towards administrative expenses [should be disclosed to the customer by the bank]

- Overall, a trading platform shall bring down the total cost faced by the retail customer, in the foreign exchange market.
- RBI in its **"Statement on Developmental and Regulatory Policies"** dated June 06, 2019 announced the introduction of a Foreign Exchange Trading platform for buying and selling foreign exchange for the customers of Banks.

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JAIIB Paper 1 IE & IFS Module D Unit 6 - Interconnectedness Of Markets And Market Dynamics

Process Of Interconnectedness of Financial Markets

- With the development of the economy and with the forces of globalisation setting in, the different financial markets in India are interconnected with each other and integrated with markets in other parts of the world, as well.
- Similarly, other countries in the world are connected to one another and the ups and downs in one part of the globe can have a resonating effect, on other parts of the globe.
- **"Coupling"** of economies and disturbances when they spread, which can be calle**d as "contagion effect".**
- Integration of financial markets is a process of unifying markets and enabling convergence of risk-adjusted returns on the assets of similar maturity, across the markets.
- The process of integration is facilitated by an unimpeded access of participants to various market segments. Financial markets all over the world have witnessed growing integration within as well as across boundaries, spurred by deregulation, globalisation and advances in information technology.

Reasons For Interconnectedness

The implications of integration of the financial markets are as under:

- Capital has become more mobile across national boundaries, as nations are increasingly relying on savings of other nations, to supplement the domestic savings.
- Technological developments in electronic payment and communication systems have substantially reduced the arbitrage opportunities across financial centres, thereby aiding the cross-border mobility of funds.
- Changes in the operating framework of monetary policy, with a shift in emphasis from quantitative controls to price-based instruments such as the short-term policy interest rate, brought about changes in the term structure of interest rates.
- Harmonisation of prudential regulations, in line with international best practices, by enabling competitive pricing of products, has also strengthened the market integration process.

Importance Of Interconnectedness Of Financial Markets

If markets functioned on stand-alone basis and were not interconnected, there would be ample scope of arbitrage between the different segments, which in turn, would make the markets imperfect.

Other points which bring out the importance of market integration are listed below:

- Serve as a conduit for authorities to transmit important price signals.

- Efficient and integrated financial markets constitute an important vehicle for promoting domestic savings, investment and consequently economic growth.
- Fosters the necessary condition for a country's financial sector, to emerge as an international or a regional financial centre.
- Enhances competition and efficiency of intermediaries in their operations and allocation of resources, contributes to financial stability.
- lead to innovations and cost-effective intermediation, thereby, improving access to financial services for members of the public, institutions and companies alike.
- Induce market discipline and informational efficiency.
- Promotes the adoption of modern technology and payment systems to achieve cost effective financial intermediation services.

Different Levels Of Market Integration

Financial markets can be observed to be integrated at three different levels, viz., domestic, global and regional.

- **Domestic financial integration:** Domestic markets may be closely integrated because some of the intermediaries operate simultaneously in various market segments; for instance, commercial banks operate in both the saving (deposit) and loan markets.
- **Global financial integration:** Refers to the opening up of domestic markets and institutions to the free cross-border flow of capital and financial services, by removing barriers such as capital controls and withholding taxes.
- **Regional financial integration**: Occurs due to ties between a given region and the major financial centre serving that region. Economic integration might be easier to achieve at a regional level, due to network externalities and the tendency of market makers to concentrate in certain geographical centres.

Asian Clearing Union

- Asian Clearing Union (ACU) is a payment arrangement, whereby the participants settle payments for intra-regional transactions among the participating central banks, on a net multilateral basis.

- **Objectives:** To facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade and banking relations, among the participating countries.

- The need for the formation was felt as early as in the 1930s, due to foreign exchange shortages, the breakdown of the gold standard, and the collapse of the international capital markets, forcing the Governments to introduce controls on foreign exchange and foreign trade on the one hand and to sign bilateral trade and payments agreements on the other.

- Established at the initiative of the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP),

- **Established:** December 1974, when the countries in the region were facing settlement difficulties, mainly due to resource constraints.
- A clearing union can be defined as a multilateral payments arrangement that periodically offsets the debits and credits accumulated by each member against the other members in the process of trade and other transactions.
- Multilateral clearing or payments arrangements facilitate the use of national currencies, and thus, serve to relax the foreign exchange constraints of the members.
- **Members:** Bangladesh, Bhutan. India, Iran, Maldives, Myanmar, Nepal, Pakistan and Sri Lanka.

The important reasons for the formation of a clearing union are:

- ✓ Exports and imports among members can expand relatively faster because of conservation of foreign exchange in intra-group transactions, at least until the settlement date.
- ✓ Trade liberalisation can be promoted initially among the members.
- ✓ Exploitation of scale economies would be made possible by enlarged trade.
- ✓ An adjustment process can be promoted that would raise the international competitiveness of the members which have similar distortions in trade and production.
- ✓ Measures and surveillance by the union can help to secure a more balanced current account which in turn, contributes to the creation of conditions for the future convertibility of each of the currencies of member countries.
- ✓ Ground can be prepared for regional economic co-operation in general and for monetary and financial co-operation in particular.

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JAIIB Paper 1 IE & IFS Module D Unit 7- Merchant Banking Services

Definition Of Merchant Banking

- **Merchant Banking primarily involves providing financial advice and services** to large corporates and wealthy individuals. Merchant Banks do not provide regular banking services to the general public.
- **The notification of the Ministry of Finance defines Merchant Banker** as – "Any person who is engaged in business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management."

Merchant Banking Vs Commercial Banking

There are key differences in approach, attitude and areas of services between Merchant Banks and Commercial Banks. Some of them are listed below:

- Merchant Banks are regulated by SEBI, whereas Commercial Banks are governed by RBI regulations;
- Merchant Banks primarily assist in raising equity and equity related finance, whereas Commercial Banks primarily deal with debt and debt related finance;
- Merchant Banks are management oriented, whereas Commercial Banks are assets oriented;
- Activities of Merchant Banks are project counseling, capital structuring, amalgamations and takeovers, whereas Commercial Banks are mainly financiers;
- Merchant Bankers mainly undertake fee-based business, whereas Commercial Banks mainly undertake funding business.

Licensing Requirements

Prospective Merchant Banks have to obtain the following Licenses from SEBI for initiating Merchant Banking activities:

- **Merchant Banker**: Certificate of Registration from SEBI is to be obtained for Category I/II/III/IV Merchant Banker, for rendering Issue Management Services (Public/Rights/Private Placement Issues related to Equity/Debt), Underwriting, Consultancy and Corporate Advisory Services, etc., as Capital Market Intermediary.
- **Banker to the Issue**: Certificate of Registration from SEBI is to be obtained to handle "Bankers to the Issue" assignments with network of exclusive Capital Market Branches and Designated Branches to handle ASBA applications, collecting (Escrow)/refund/paying banker assignments.
- **Debenture Trustee** : In terms of SEBI guidelines, all debenture issues (public rights) of the companies with the maturity period exceeding 18 months are required to have 'Debenture Trustee' and its name must be stated in the Prospectus to the issue. A Merchant Bank cannot, directly, be the Trustee, but the Trust can be a subsidiary of the Merchant Bank.
- **Portfolio Management**: In terms of SEBI guidelines, the Merchant Bank can carry on the activity as Portfolio Manager only if, separate Certificate of Registration under the provisions of the SEBI (Portfolio Manager) Regulations, 1993 is obtained.

Sebi Regulations On Merchant Banking

Certification under SEBI Regulations

Certificate from SEBI is mandatory to commence Merchant Banking activities. Certification of Merchant Bankers is of four types, viz.,

Category I Merchant Bank: can act as Issue managers—

- ✓ To carry on any activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of the subscriptions; and
- ✓ To act as advisor, consultant, manager, underwriter, portfolio manager;

Category II Merchant Bank: Can act only as advisor, consultant, co-manager, underwriter, portfolio manager.

Category III Merchant Bank: can act as underwriter, advisor, consultant to an issue.
Category IV Merchant Bank: can merely act as advisor or consultant to an issue.

Capital Adequacy Norms as per SEBI Regulations

As per SEBI Regulations, the applicant for a Merchant Banking License should have net worth of not less than:

- ✓ **Rs. 5 crores for Category I Merchant** Bank Where "net worth" means the sum of paid-up capital and free reserves of the applicant. The certificate of registration granted under sub-regulation (1) shall be valid unless it is suspended or cancelled by the Board.

Key SEBI Guidelines for Merchant Banks

SEBI's authorisation criteria to allow the applicant to act as Merchant Bank include:

- ✓ Professional qualification in finance, law or business management
- ✓ Infrastructure like office space, equipment and man power
- ✓ Capital Adequacy
- ✓ Past track of record, experience, general reputation and fairness in all transactions.

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Activities Of Merchant Banks

- Issue Management
- Pre-issue Functions
- Post-issue Functions
- Bankers to the Issue (Collecting Banker)
- Mobilising Payment of Dividend Warrants/Interest Warrants/Refund Orders (Paying Banker)
- Debenture Trustee
- Monitoring Agency

Key Policy Requirements As Per Sebi Regulations

- Every merchant bank should maintain copies of balance sheet, profit and loss account, statement of financial position
- Half-yearly unaudited result should be submitted to SEBI

- Merchant Banks (including their directors and employees) are prohibited from buying/selling securities, based on the unpublished price sensitive information of their clients, during the tenor of the assignment
- Merchant Bank should not associate with any business other than that of the securities market. The exception is granted to Banks and Financial Institutions.
- Lead Merchant Bank should not associate with a merchant banker, without registration
- Merchant Bank should not act as such for an associate.
- Every merchant bank shall appoint a Compliance Officer to monitor compliance with prevailing Regulations
- SEBI has the right to send inspecting authority to inspect books of accounts, records, etc., of merchant banks
- Inspections will be conducted by SEBI to ensure that the provisions of the regulations are properly complied with
- An initial authorisation fee, an annual fee and renewal fee shall be collected by SEBI.

Key Codes Of Conduct As Per Sebi Regulations

According to the **Regulation 13 of the SEBI (Merchant Bankers) Regulations of 1992**, every Merchant Bank should comply with codes of conduct, as per Schedule III of the Regulations. Some of the key Codes of Conduct as per SEBI Regulations are listed below.

A Merchant Bank

- Should make all efforts to protect the interest of investors
- Should maintain high standards of integrity, dignity and fairness in conduct of business
- Should fulfill all obligations in a professional and ethical manner
- Should not discriminate among the clients
- Should ensure that prospectus, letter of offer, etc., is available to investors at the time of issue
- Should render best possible advice to its clients
- Should inform its clients of any penal action taken against it, by SEBI
- Should inform the board about any legal proceedings initiated against it
- Should abide by the rules of "Securities and Exchange Board of India Regulations, 2003"
- Shall develop its own internal code of conduct, for governing its internal operations
- Should ensure that any person it employs should have the capacity to be a merchant banker
- Would be responsible for the act of its employees and agents

JAIIB Paper 1 IE & IFS Module D Unit 8- Derivatives Market

Introduction

- **Derivatives are financial instruments, whose values are based on the value of an underlying asset.**
- Derivatives are important tools for hedging risks as well as for speculation.
- Derivatives can be Over the Counter products, as well as exchange traded instruments.
- **Types:** Forwards, futures, options and swaps

What Is A Derivative?

In terms of guidelines issued by RBI, A derivative is a financial instrument:

- ✓ Whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (called the 'underlying');
- ✓ That requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- ✓ That is settled at a future date.
- A derivative security is a financial contract whose value is derived from the value of something else, such as a stock price, a commodity price, an exchange rate, an interest rate, or even an index of prices.
- A simple commonplace example of derivative is butter, which Is derivative of milk. The price of butter depends upon price of milk, which in turn, depends upon the demand and supply of milk.

- The asset underlying a derivative may be commodity or a financial asset. For example, the price of gold or a currency, say, like US Dollars to be delivered after two months will depend, amongst other things, on the present and expected price of this commodity/currency.

Derivatives are also defined under Section 2(ac) of Securities Contract Regulation Act (SCRA), 1956. In terms of the said Act, a Derivative is:

- ✓ "A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security";
- ✓ "A contract which derives its value from the prices, or index of prices, of underlying securities".

Underlying Assets

As we have seen, the value of a derivative instrument depends upon the value of an underlying asset. ***The underlying asset may assume many forms:***

- Commodities including grains, coffee, pulses, etc.;
- Precious metals like gold and silver;
- Natural resources like oil and gas;
- Foreign exchange rates or currencies;
- Bonds of different types, including medium to long-term negotiable debt securities issued by governments, corporates, etc.;
- Shares and share warrants of companies, traded on recognised stock exchanges;
- Stock Indexes;
- Short term securities such as T-bills; and
- Over-the-Counter (OTC) money market products, such as loans or deposits.

Exchange Traded and Over-The-Counter Markets

Derivatives can trade on organised exchanges like the New York Stock Exchange, Chicago Board of Trade and National Stock Exchange or be traded/issued over-the-counter (OTC).

Exchange-Traded Markets

- **Standardisation of the contracts:** Terms and conditions are precisely specified by the exchange.
- This specification applies to features like the schedule of expiry dates and contract amounts**.**
- **Participants:** Market-makers (dealers) and speculators who are typically exchange members.
- The interplay between market makers and speculators creates a more liquid and more orderly market.
- The standardisation also ensures that clearing (verification of transaction and identities) and settlement (transfer of money) of derivatives contracts happens efficiently and allows for the provision of a credit guarantee by the clearinghouse.
- The clearing house can provide this guarantee through the requirement of a cash deposit called a margin.

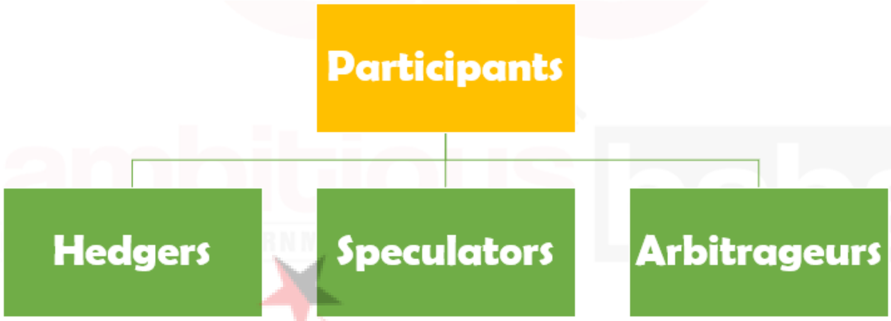
Over-the-Counter (OTC) Markets

- OTC markets provide a substitute for firms wishing to trade non-standardised products.
- Risk management activities become more complicated.
- Example of OTC derivative is the forward foreign exchange contract. It can be difficult for a dealer to find an OTC contract that is a perfect match to hedge a

position, and they usually have to rely on similar transactions in which, they can lay off their risk.

- The ability to customize OTC contracts does not necessarily make the market less liquid than the standardised exchange-traded contracts.
- OTC markets have a lower level of regulation than exchange-traded markets. However, post the 2008 Global Financial Crisis, regulatory oversight has increased.

Participants In The Derivatives Market

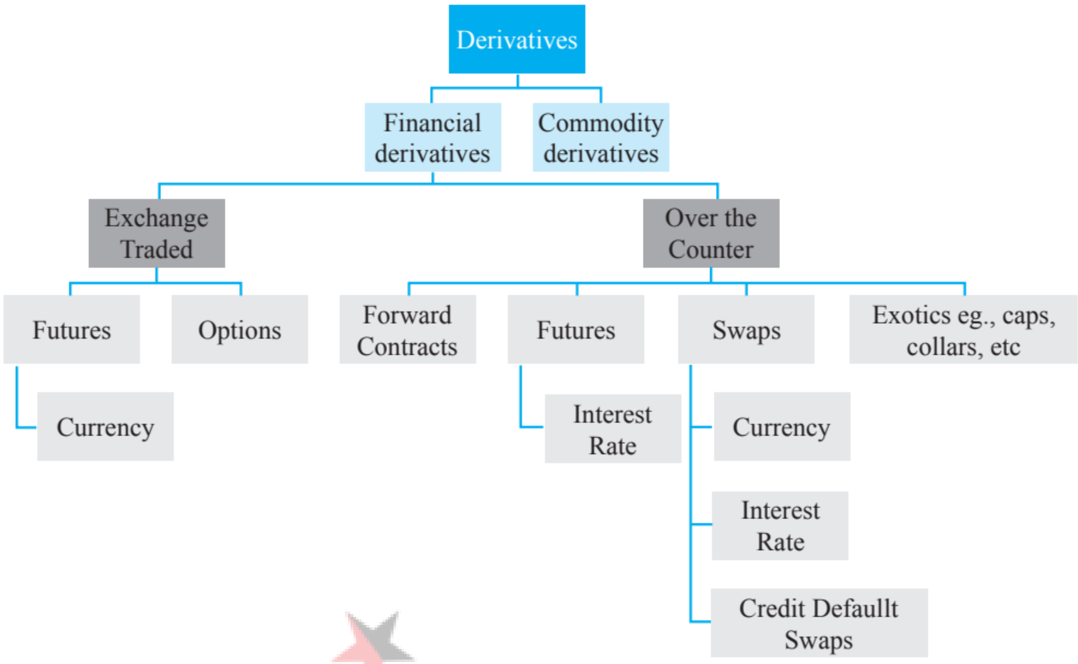


- **Hedgers**: They use derivatives markets to reduce or eliminate the risk associated with price of an asset. Majority of the participants in derivatives market belongs to this category.
- **Speculators:** They transact futures and options contracts to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and potential losses by usage of derivatives, in a speculative venture.
- **Arbitrageurs:** Their behaviour is guided by the desire to take advantage of a discrepancy between prices of more or less the same assets or competing assets in different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Functions Of Derivatives

- Price Discovery
- Transfer of Risk
- Hedging Price Risk
- Lower Transaction Cost
- Provide Access to Unavailable Assets and Markets
- Higher Leverage

Types Of Derivatives



Futures

A futures contract is a standardised forward contract, a legal agreement to buy or sell some asset at a predetermined price, at a specified time in the future, between parties not known to each other. The asset transacted is usually a financial instrument or commodity.

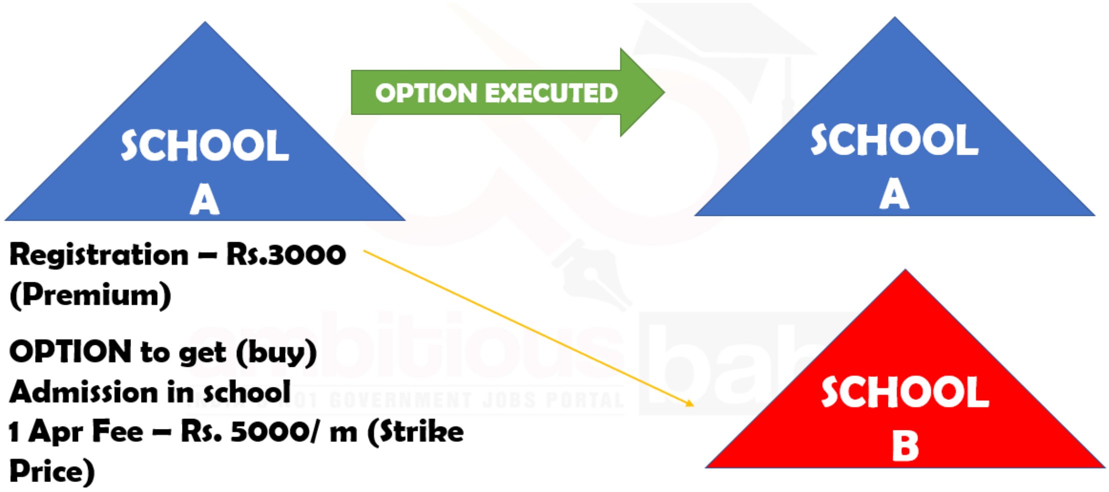
Currency Futures

Currency futures are exchange-traded contracts that specify the price in one currency at which, another currency can be bought or sold at a future date. Currency futures contracts are legally binding and counterparties that are still holding the contracts on the expiration date must deliver the currency amount, at the specified price, on the specified delivery date.

Futures	Forward Contracts
Standardised amounts	Non-standard amounts
Fixed maturities	Flexible maturities
Traded on exchanges	Traded OTC
Initial margin required, which is marked to market	No margin requirement
Traded during exchange hours	Can be traded 24x7
Counterparty unknown	Counterparty in direct contact

Options

An option is a contract which gives the buyer (holder) the **right, but not the obligation**, to **buy or sell** specified quantity of the underlying assets, at a specific (strike) price, on or before, a specified time (expiration date).



- The underlying assets may be physical commodities, like wheat/rice/cotton/gold/ oil or financial instruments like equity stocks/stock index/bonds, etc.
- Option buyer gets the privilege to legally back out, from a contract.

Some terminologies associated with options transactions are as follows:

- **Underlying**: The specific security/asset/index on which, an options contract is based (e.g., a foreign currency).
- Option Premium: Premium is the price paid by the buyer to the seller, to acquire the right to buy or sell the option.
- **Strike Price or Exercise Price**: The strike or exercise price of an option is the specified/pre-determined price of the underlying asset, at which, the same can be bought or sold, if the option buyer exercises his right to buy/sell on or before the expiration day. The buyer of the Option can choose the Strike Price he wants, according to which, the premium will change.
- **Expiry date**: The date on which, the option expires is known as expiry date. On the expiry date, either the option is exercised, or it expires unutilised.
- **Call option:** It is an option that gives the buyer of the option the right to BUY the underlying asset, at the strike price, on or before the expiry date.
- **Put option**: It is an option that gives the buyer of the option the right to SELL the underlying asset, at the strike price, on or before the expiry date. Open Interest: The total number of options contracts outstanding in the market at any given point of time.
- **Option Holder**: is the one who buys an option which can be a call or a put option. He/she enjoys the right to buy or sell the underlying asset, at a specified price, on or before specified time.

- **Option seller/writer**: is the one who is obligated to buy from the option holder (in case of put option) or to sell to the option holder (in case of call option), the underlying asset in case the buyer of the option decides to exercise his option.
- **American Option: It** is the one, which can be exercised by the buyer on or before the expiration date, i.e., anytime between the day of purchase of the option and the day of its expiry.
- **European Option: It** is the one, which can be exercised by the buyer on the expiration day only, and not any time before that.
- **Call Options**: A call option gives the holder (buyer) the right to BUY specified quantity of the underlying asset at the strike price, on or before expiration date. The seller or writer of the option, however, has the obligation to sell the underlying asset, if the buyer of the call option decides to exercise his option to buy.
- **Put Options**: A Put option gives the holder (buyer), the right to SELL specified quantity of the underlying asset, at the strike price, on or before expiry date. The seller of the put option, however, has the obligation to buy the underlying asset at the strike price, if the buyer of the option decides to exercise his option to sell.

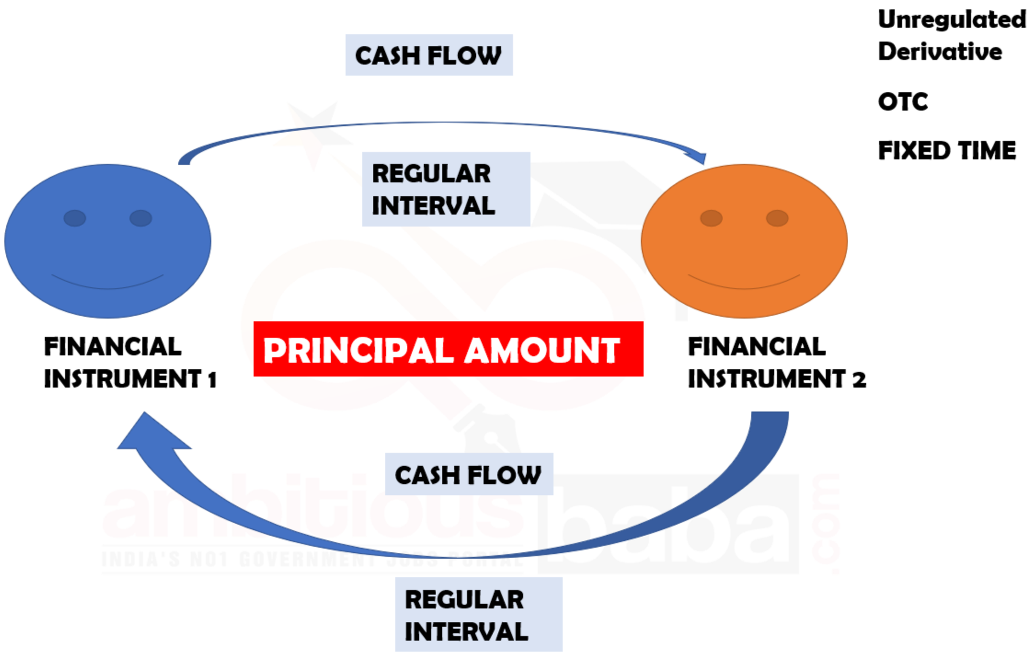
	Call Options	Put Options
Option buyer or option holder	Buys the right to buy the underlying asset at the specified price.	Buys the right to sell the underlying asset at the specified price.
Option seller or option writer	Has the obligation to sell the underlying asset (to the option holder) at the specified price.	Has the obligation to buy the underlying asset (from the option holder) at the specified price.

Swaps

- A swap refers to an exchange of one financial instrument for another between the parties concerned.
- This exchange takes place at a predetermined time, as specified in the contract.
- In financial markets, the two parties to swap a transaction contract, exchange cash flows.
- An interest rate swap is a customised bilateral agreement, in which, the cash flows are determined by applying a pre-arranged formula, on a notional principal,
- whereas in a currency swap, physical exchange of one currency against another takes place at pre-determined prices.

3 types of Swaps:

- Currency swaps,
- Interest rate swaps and
- Credit default swaps.



Currency Swaps

- A currency swap is an agreement in which, two parties exchange the principal amount of a loan and the interest in one currency for the principal and interest in another currency.
- At the inception of the swap, the equivalent principal amounts are exchanged at the spot rate.
- Companies requiring foreign currency borrowings can use their natural advantage to borrow in their home currencies and thereafter, swap the same into foreign currency.

Interest Rate Swaps

- An interest rate swap (IRS) is an agreement in which, one stream of future interest payments is exchanged for another, based on a specified principal amount.
- Interest rate swaps usually involve the exchange of a fixed interest rate for a floating rate, or vice versa.
- IRSs can be, either floating to fixed or from fixed to floating and are used by entities to reduce their costs, as well as to protects themselves from adverse movements in interest rate.

Credit Default Swaps (CDS)

- A credit default swap (CDS) is a financial derivative or contract that allows an investor to "**swap" or offset his or her credit risk,** with that of another investor.

- For example, if a lender is worried that a borrower is going to default on a loan, the lender could use a CDS, to offset or swap that risk.
- To swap the risk of default, the investor/lender buys a CDS from a CDS seller, who agrees to reimburse the investor in the case the borrower defaults.
- Most CDS contracts are maintained via an ongoing premium payment,
- similar to the regular premiums paid on an insurance policy. A credit default swap is emerging rapidly in India and are mainly directed to cover default risks associated with corporate bonds.
- RBI has, also, recently issued guidelines governing CDS in India.

Rbi Guidelines On Credit Default Swaps

- **RBI issued draft guidelines for Credit Default Swaps in February 2021**. Under the said guidelines, RBI has proposed to allow retail users undertake transactions in permitted credit derivatives for hedging their underlying credit risk.
- Non-retail users shall be allowed to undertake transactions in credit derivatives for both hedging and other purposes.
- The RBI guidelines have been issued as a measure for development of a market for corporate bonds, especially for the bonds of lower rated issuers.
- According to the draft guidelines, exchanges may offer standardised single-name CDS contracts with guaranteed cash settlement.
- Retail users shall undertake transactions in exchange-traded CDS only for hedging their underlying credit risk.

User classification

- Any user who is not eligible to be classified as a non-retail user will be classified as a retail user.
- Non-retail users will include insurance companies, pension funds, mutual funds, alternate investment funds, foreign portfolio investors.
- These entities will also be eligible to act as protection seller in CDS**.**
- Standalone primary dealers (SPDs) and non-banking finance companies (NBFCs), including housing finance companie**s (with minimum net owned funds of Rs 500 crores) and resident companies (with minimum net worth of Rs 500 crores),** too, will be classified as non-retail users.

Eligible debt instruments

- Commercial Papers,
- Certificates of Deposit and

- Non-Convertible Debentures of original maturity, up to one year**,**
- Rated Indian Rupee (INR) denominated corporate bonds (listed and unlisted) and
- Unrated INR bonds issued by the Special Purpose Vehicles set up by infrastructure companies.
- Shall be in dematerialised form only.
- Asset-backed securities/mortgage-backed securities and structured obligations such as credit enhanced/guaranteed bonds, convertible bonds, bonds with call/put options, etc., shall not be permitted as reference and deliverable obligations.
- Market-makers, who are entities that can buy and sell protection from/to users and other market-makers, in order to provide liquidity to the market – will include Scheduled Commercial Banks (except Small Finance Banks, Payment Banks, Local Area Banks and Regional Rural Banks) and NBFCs, including HFCs, and SPDs **with minimum net owned funds of Rs 500 crores.**

Restrictions

- The RBI said market-makers and users shall not enter into CDS transactions if the counterparty is a related party or where the reference entity is a related party to either of the contracting parties.
- Further, marketmakers and users shall not buy/sell protection on reference entities, if there are regulatory restrictions on assuming similar exposures in the cash market or in violation of any other regulatory restriction, as may be applicable.

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JAIIB Paper 1 Module D Unit 9: Factoring, Forfaiting and Trade Receivables Discounting System (TReDS)

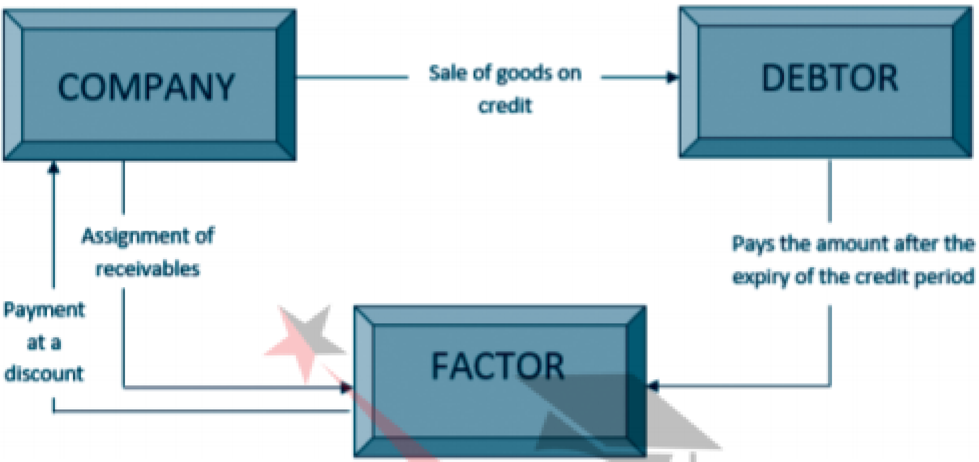
What Is Factoring?

Factoring is an arrangement for financing a company's business against invoices raised on its buyers and in which, the factor is responsible for credit control, sales ledger administration, and collection activities. In full-service factoring, the factor bears the losses, if the buyer fails to pay.

The business of factoring in India is regulated by the **Factoring Regulation Act, 2011, and Section 2(j) of the Factoring Regulation Act, 2011,** defines factoring business as follows:

"**Factoring business**" means the business of acquisition of receivables of assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or otherwise, against the security interest over any receivables but does not include:

- Credit facilities provided by a bank in its ordinary course of business against security of receivables;
- Any activity as commission agent or otherwise for sale of agricultural produce or goods of any kind whatsoever or any activity relating to the production, storage, supply, distribution, acquisition or control of such produce or goods or provision of any services.



Types Of Factoring

Two types of factoring services,

Recourse factoring (with recourse):

- In this case of non-payment of invoices by buyers, the factor will recover the amount advanced from the client (seller).

Non-recourse factoring (without recourse).

- Factor provides both finance and credit protection.
- In case of non-payment of invoices by customers, the factor will bear the risk of bad debts and cannot recover the amount from the client/supplier.
- The factor operates by buying, from the seller's company, their invoiced debts. These are purchased usually with credit protection by the factor, who will then be responsible for all credit control, collection and sales accounting work.
- The management of the seller company can, thus, concentrate on production and sales and need not concern itself, with unremunerative work, like control and sales accounting matters.

Factoring can also be classified as domestic or international, depending upon whether the sellers and buyers are in the same country (domestic) or in different countries (international). **International factoring is also called cross-border factoring.**

Domestic Factoring

- Under domestic factoring, receivables arising only out of domestic (inland) trade are considered for factoring.
- The supplier/borrower draws bills of exchange for goods supplied and the purchaser accepts them.
- Factor makes an upfront payment of about 80% of invoice value after deducting its discount charges, at normal interest rates for the period of bill of exchange to the supplier.
- The balance of payment (20% of the invoice value) is made, after collecting the payment from the purchaser.
- If the purchaser fails to pay the due amount on due dates, the supplier has to make good the payment.
- The borrower/supplier submits the bill of exchange along with the invoice and LR/ RR receipts, while requesting for factoring the transaction.
- **Maximum credit period normally permitted under factoring is 150 days - inclusive of a maximum grace period of 60 days.**
- Various Management Information System (MIS) reports such as Debtors Ageing Analysis, Weekly Statement of Accounts, Sales Analysis and Statement of Outstanding Invoices are provided to the seller by the factor.
- Sub-limit of each purchaser is fixed and sum of these sub-limits is the overall limit of the supplier.

International Factoring

In international factoring, there are usually two factors

Export factor

- looks at financing the exporter
- Sales administration (presenting invoices at the right time and collecting payments being the key tasks).

Import factor

- Interested in evaluating the buyer,
- collecting the money on time
- Ensuring that the buyer is protected against default.

International factoring encompasses all the four services,

- Pre-payments,
- Sales ledger administration.

- Credit protection
- Collections

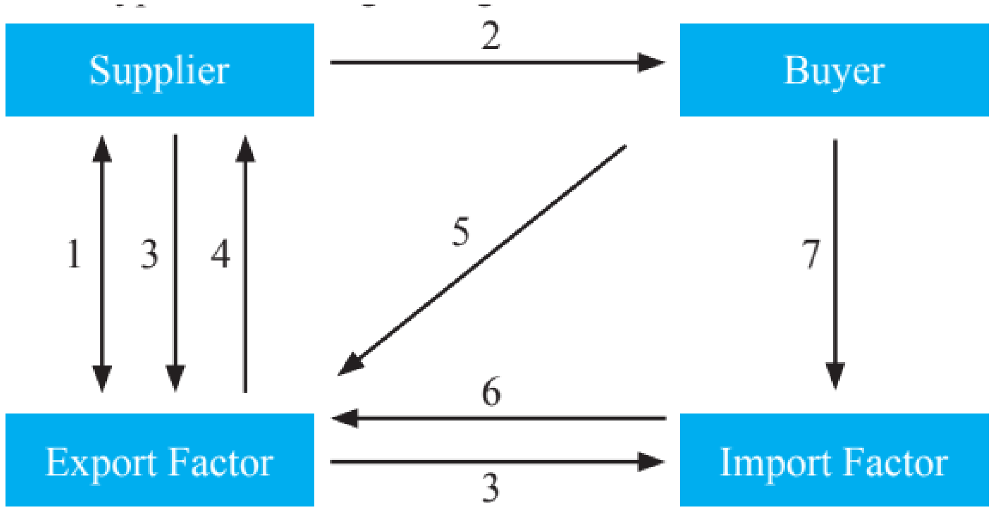
The various steps involved in international factoring are listed here.

- The importer places the order for purchase of goods with the exporter.
- The exporter requests the export factor for limit approval on the importer.
- The export factor, in turn, forwards this request to an import factor in the Importer's country.
- The import factor evaluates the importer and conveys its approval to the export factor, who in turn conveys commencement of the factoring arrangement to the exporter.
- The exporter delivers the goods to the importer.
- The exporter produces the documents to the export factor.
- The export factor disburses funds to the exporter up to the prepayment amount decided and at the same time forwards the documents to the import factor.
- The importer, on the due date of the invoice, pays the import factor, who in turn, remits this payment to the export factor.
- The export factor applies the received funds to the outstanding amount of the advance against the invoice.
- The exporter receives the balance payment. The above arrangement is also called the Two-factor system.

- **In addition to the above, there are three other types of international factoring.**

Single factor system –

- In this type of factoring, the import factor comes into focus only if the buyer defaults in making the payment.
- In such case, the export factor recovers the amount from the import factor, and it is then left to the import factor to recover the factored amount from the buyer.

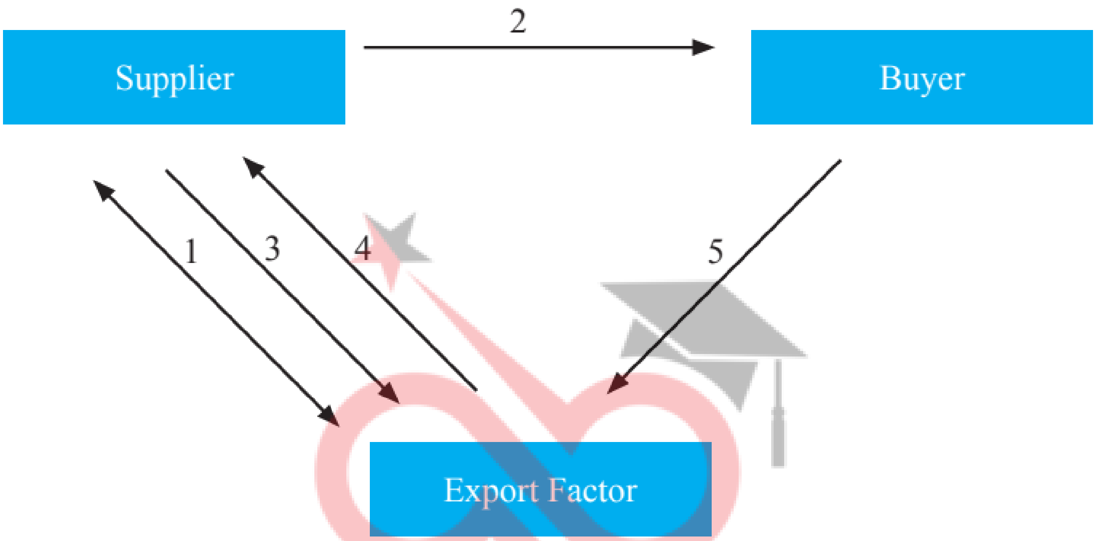


- Factoring Agreement

- Delivery of goods
- Assignment of accounts receivable
- Funding to supplier by export factor
- Payment by buyer to export factor
- **In case buyer does not pay in 90 days**, import factor pays to export factor
- If point (6) materialises, import factor recovers amount from buyer

Direct Export Factoring System –

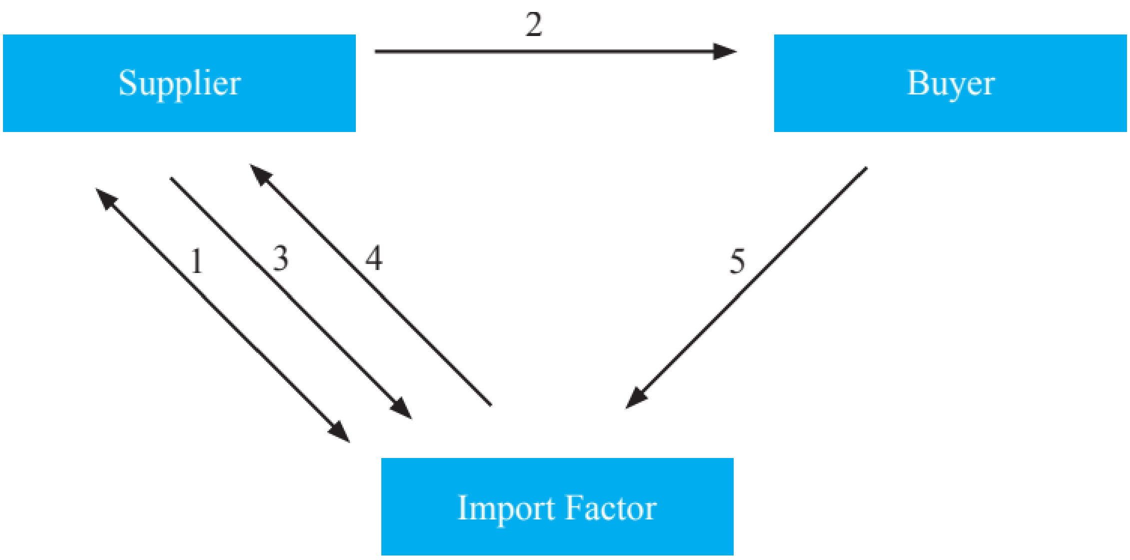
- In this system, there in only one factor, viz., the Export Factor.
- This factor manages all aspects of the factoring transaction



- Factoring Agreement
- Delivery of goods
- Assignment of accounts receivable
- Funding to supplier by export factor
- Payment by buyer to export factor

Direct Import Factoring System –

- In this type of factoring, there is only one factor, viz., the import factor and the sellers directly deal with the import factor for all aspects of the transaction.



- Factoring Agreement
- Delivery of goods
- Assignment of accounts receivable
- Funding to supplier by import factor
- Payment by buyer to import factor

Bills Discounting Vs Factoring

- Although, both bills discounting and factoring involve financing of receivables (often exports receivables), there are differences between them.

BILLS DISCOUNTING	FACTORING
Requires strong balance sheet and collaterals	Can be done with weak balance sheet, no collateral provided the receivables are of good quality
Always with recourse	Can be without recourse
Collection is job of exporter	Collection is job of factor
Financing is transaction based	Financing is based on accounts-receivable ledger
It is only a mode of financing	It consists of complete receivables management, including MIS, collection, and even credit insurance
There is no assignment of debt	It involves assignment of debt

Fees Involved In Factoring

Finance Charge

- Finance charge is computed on the pre-payment outstanding in exporter's account, at monthly intervals.

Service Fee

- Service charge is a nominal charge levied, at monthly intervals in order to cover the cost of services, viz., collection, sales ledger management and periodical MIS reports.
- It ranges from 0.1% to 0.3% on the total value of invoices factored/collected by the Banks.

Advantages Of Factoring

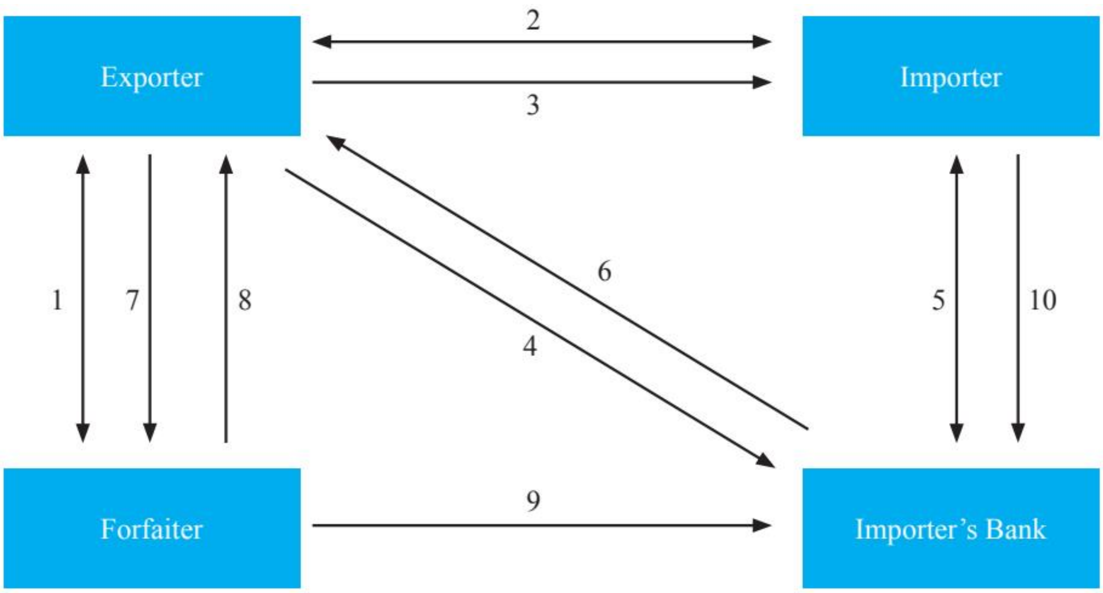
- Factoring replaces high-cost market credit and enables purchases on cash basis, for availing cash discounts.
- The customer gets instant finance against each invoice.
- Low margin (up to 20%), thereby improving cash flow.
- The customer gets large credit/grace period.
- Each invoice is followed up for payment by the factor, on the due date and thereafter.
- MIS reports and sales ledger administration is totally taken care of by the factor.
- Factoring accelerates receivables turnover and improves operating cycle, resulting in more production, larger sales, higher profits and increased ROI.

FORFAITING

What Is Forfaiting?

- Forfaiting can be defined as financing exports by discounting export receivables, evidenced by bills of exchange or promissory notes, carrying medium to long-term maturities, on fixed rate basis (known as discount) up to 100% of the invoice value.
- When an exporter transfers his right to receive payment in favour of the forfaiter, the transaction is called forfaiting.
- Thus, forfaiting is a method of discounting of international trade receivables **on a 'without recourse' basis.**
- Forfaiting is used for international trade transactions.
- In fact, it is the discounting of trade receivables such as drafts drawn under letters of credit, bills of exchange, promissory notes, or other freely negotiable instruments on a 'no recourse' basis
- **Forfait'** is derived from the French word 'forfeit', which means surrendering of rights.
- All forfaiting transactions have a minimum transaction size, normally in the range of **US$ 250,000.**
- In terms of RBI guidelines, Exim Bank and AD Category – I Banks (on Non-recourse basis only) are permitted to handle forfaiting transactions.

Mechanism Of A Forfaiting Transaction



- Forfaiter gives commitment to forfeit to exporter
- Commercial contract made between exporter and importer
- Shipment of goods to importer
- Exporter submits shipping documents to importer's bank thru his banker
- Importer's bank obtains acceptance of importer an bill of exchange
- Importer's bank co-accepts (avalises) the bill of exchange and sends to exporter thru his banker
- Exporter tenders avalised bill of exchange to forfaiter
- Forfaiter makes payment to exporter, less charges
- Forfaiter presents bill of exchange to importer's bank on maturity
- Importer makes payment on maturity

Fees Involved In Forfaiting

Discount fees

- Discount is the interest cost payable by the exporter for the entire period of credit involved and is deducted by the forfaiter from the amount paid to the exporter, against the avalised (accepted) promissory notes or bills of exchange.
- The discount is normally linked to an international benchmark interest rate like LIBOR.

Commitment fees

- Commitment fees is payable to the forfaiting agency for its commitment to execute a specific forfaiting transaction at a firm discount rate, within a specified time.

- Ranges between 0.5% and 1.5% per annum of the unutilised amount to be forfaited and is charged for the period between the date the commitment is given by the forfaiter and the date the discounting takes
- Place or until the validity of the forfaiting contract, whichever is earlier.

Advantages Of Forfaiting

The following are the advantages of forfaiting to the exporters:

- **100% Financing:** Forfaiting provides 100% financing – without recourse
- **Improves cash flow of the exporter:** By converting receivables into current cash inflow and it is beneficial to the exporter to improve his liquidity and his ability to improve further the fund-raising capability.
- **Saves administration cost:** By using forfaiting, the exporter will be freed from the management of the receivables.
  Increases trade opportunity: With forfaiting, the exporter is able to grant credit to his buyer freely and thus, be more competitive in the market**.**
- **Helps to realise price transfer:** The exporter can also transfer the corresponding financing cost, which is known in advance, into the sale price.
- Enables the exporter to avoid various risks, i.e., forfaiting business enables the exporter to transfer various risks, resulting from deferred payment, such as interest-rate risk, currency risk, credit risk and political risk.

Differences Between Factoring and Forfaiting

FACTORING	FORFAITING
Suitable for on-going open account sales, not backed by LCs or accepted bills of exchange.	Suitable for one-off transactions backed by LCs or accepted (avalised) bills of exchange.
Short term in nature.	Medium to long term in nature (1 to 5 years).
Factoring can be 'with recourse' or 'without recourse'.	Forfaiting is generally 'without recourse'.
Requires continuous arrangement between factor and client, whereby all sales are routed through the factor.	Seller need not route other business through the forfaiter. Deals are concluded transaction-wise.
Factor assumes responsibility for collection and helps client reduce overheads for the same.	Forfaiter's responsibility extends to collection of forfaited debt only.
Charges include those for financing, collection, administration, credit protection and MIS.	Charges include discount and commitment charges.
Factoring is commonly for domestic and international transactions.	Forfaiting is commonly for international transactions only.

TRADE RECEIVABLES DISCOUNTING SYSTEM (TReDS)

What is TReDS?

- TReDS is a scheme for setting up and operating the institutional mechanism, for facilitating financing of trade receivables of MSMEs from corporate and other buyers, including Government Departments and Public Sector Undertakings (PSUs), through multiple financiers.

- It is a form of factoring.
- MSMEs, despite their important role in contributing to the Indian economy, continue to face constraints in obtaining adequate finance.
- One big factor which affects the ability of MSMEs to convert trade receivables into liquid funds are their difficulty to realise the payments, in the absence of any well established system for doing so.
- RBI in the year 2014, introduced the concept of TReDS, a mechanism of trade receivables financing for MSMEs on a secure digital platform.
- It may be stated that the TReDS facilitates the discounting of both invoices as well as bills of exchange.
- Further, as the underlying entities are the same (MSMEs and corporate and other buyers, including Government Departments and PSUs), TReDS could deal with both receivables factoring as well as reverse factoring, so that, higher transaction volumes come into the system and facilitate better pricing.
- "Without recourse" to the MSMEs.

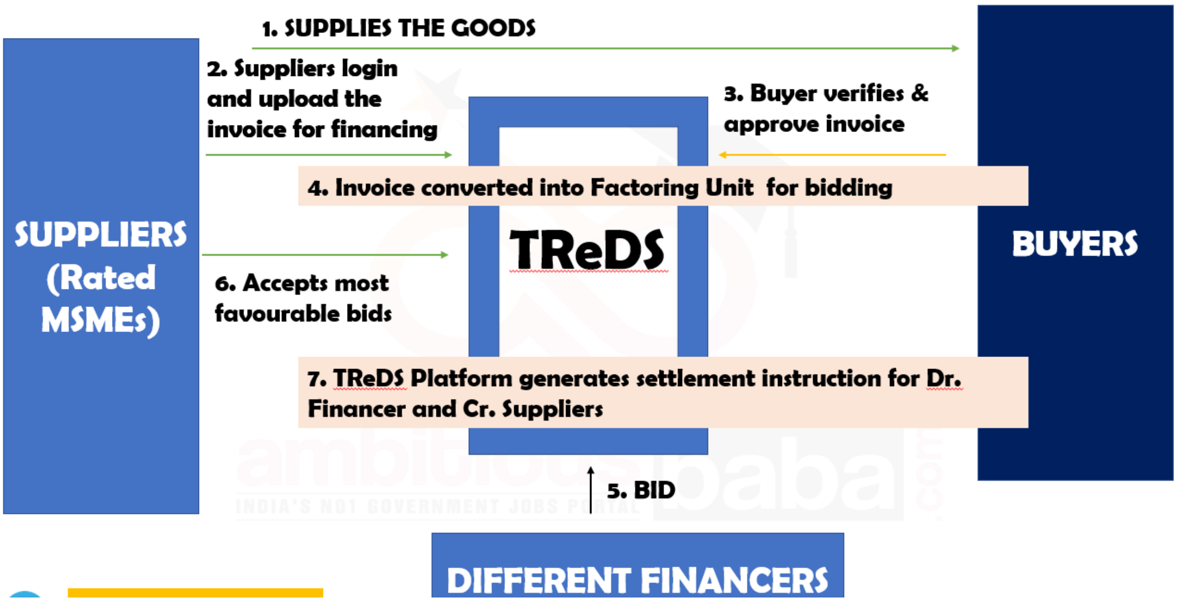
Participants Under TReDS

Direct Participants:

- ✓ MSME sellers,
- ✓ Corporate and other buyers, including the Government Departments and PSUs, and
- ✓ Financiers (both banks and NBFC factors)

- The TReDS will provide the platform to bring these participants together for facilitating uploading, accepting, discounting, trading and settlement of the invoices/bills of MSMEs.
- The bankers of sellers and buyers may be provided access to the system, where necessary, for obtaining information on the portfolio of discounted invoices/bills of respective clients.
- TReDS may tie up with necessary technology providers, system integrators and entities providing dematerialisation services for providing its services

Process Flow Under TReDS



JAIIB Paper 1 IE & IFS Module D Unit 10: Venture Capital

Introduction

- Venture Capital is a private institutional investment made to start-up companies, at early stage.
- Venture capital funds are the investments made by the investors, who seek private equity stakes, in small to medium business, which have potential to grow.
- These investments are generally high-risk/high-return opportunities.
- The ventures involve risk in the expectation of sizable gain.
- The people who invest this money become the financial partners are called venture capitalists (VCs).
- Venture capital is the most suitable option for funding capital for companies, which are start-ups, with little or no track record of performance.

Concept Of Venture Capital

- When an entrepreneur is a new and unknown technocrat, who possesses innovative ideas to develop a new product, but lacks his own capital, which is essential to turn his ideas into a successful commercial venture.
- Risk involved as the innovative ideas of the entrepreneur have not been tried on a commercial scale.
- On the other hand, if the venture proves successful, it has potential for high returns.
- Usual sources of finance cannot be tapped by the entrepreneurs, for lack of availability of funds from his own sources.

- In such circumstances, the Venture Capitalist comes to his rescue by providing risk bearing capital, which is widely known as Venture Capital.
- Venture Capital may be broadly defined as long-term investment in business, which has potential for significant growth and financial returns.
- In the form of equity, apart from conditional loans and conventional loans.
- **Venture Capitalists:** Financiers + Risk bearer .
- Their return from the enterprise depends upon the extent of the success achieved by them.
- **The most distinguishing feature:** That it meets the needs of a business wherein the probability of loss is quite high, because of the uncertainties associated with the business, but the returns expected are also higher than normal.
- Venture Capital is therefore termed as high risk, high return capital.

Evolution Of Venture Capital In India

- **1972:** Bhatt Committee (Committee on Development of Small and Medium Entrepreneurs) ,
- **Recommendation:** Creation of venture capital in India.
- The committee urged the need for providing such capital to help new entrepreneurs and technologists in settings up industries.

A brief description of some of the venture capital funds which have been established are as follows:

- **Risk Capital Foundation**: The Industrial Finance Corporation of India (IFCI) launched the first venture capital fund, in the year 1975. The fund, 'Risk Capital Foundation' (RCF) aimed at supplementing promoters' equity, with a view to encouraging technologies and professionals to promote new industries.
- **Seed Capital Scheme**: This venture capital fund was launched by IDBI in 1976, with the same objective in mind.
- **Venture capital schemes**: Venture capital funding obtained official patronage, with the announcement by the Central Government of the "Technology Policy Statement" in 1983. It prescribed guidelines for achieving technological self-reliance, through commercialisation and exploitation of technologies. ICICI Ltd set up a Venture Capital Scheme in 1986, to encourage new technocrats in the private sector, to enter new fields of high technology, with inherent high risk. The scheme aimed at allocating funds for providing assistance in the form of venture capital to economic activities having risk, but also high profit potential.
- **PACT:** ICICI undertook the administration of Programme for Application of Commercial Technology (PACT) aided by USAID, with an initial grant of USD 10 million. The programme aims at financing specific needs of the corporate sector industrial units along the lines of venture capital funding.

- **Government fund**: IDBI, as nodal agency, administers the venture capital fund created by the Central Government, with effect from April 1, 1986. The government started imposing a Research and Development (R & D) levy on all payments made for the purchase of technology from abroad, including royalty payments, lump sum payments for foreign collaboration and payment for designs and drawings under the R & D Cess Act, 1986. The levy was used as a source of funding the venture capital fund.
- **TDICI:** In 1988, an ICICI sponsored company, viz., Technology Development and Information Company of India Ltd. (TDICI) was founded, and venture capital operations of ICICI were taken over by it, with effect from July 1, 1988.
- **RCTFC: The** Risk Capital Foundation (RCF) sponsored by IFCI was converted into Risk Capital and Technology Finance Corporation Ltd. (RCTFC) in the year 1988. It took over the activities of RCF, in addition to the management of other financing technology development schemes and venture capital fund.

Characteristics Of Venture Capital Finance

Largely in the form of equity

The most distinguishing feature of Venture Capital is that it is provided largely in the form of equity, when the investee company is unable to float its equity shares independently in the market, or from other sources, in the initial stage. Thus, risk capital is provided, which is not available otherwise, due to the high degree of risk involved in the venture.

Not act as owner:

- The venture capitalist, though participating in the equity, does not intend to act as the owner of the enterprise. The venture capitalist does not participate in the day-to-day management, but aids and guides the management, by providing the benefit of the skill, experience and expertise.
- The venture capitalist nurtures the new enterprise, till it enters the profit-earning stage.

Exit at the time of profit-earning

- The Venture Capitalist does not intend to retain the investment in the investee company for ever.
- He/she intends to divest his/her shares, as soon as the company becomes a profitable business and the returns from the business are high, as per expectations.
- At this stage, he/she withdraws himself from the venture and in turn, provides finance for another venture.

Earning from capital gain

- A Venture Capitalist intends to earn largely by way of capital gains arising out of sale of the equity holdings, rather than through regular returns, in the form of interest on loans.

Conditional Loan

- A Venture Capitalist also provides conditional loans, which entitles him/her to earn royalties on sales, depending upon the expected profitability of the business. (Such loan is partly or fully waived, if the business enterprise does not prove to be a success).

Venture capital investments have the following features:

- High risk investments made with an intention of making high profits;
- Based on long-term goals;
- Made in start-ups, which have potential to grow;
- Money is invested, generally, by buying equity shares, in the start-up company;
- Generally done in innovative projects in the fields of technology and biotechnology;
- The provider of venture capital can participate in the management of the company.

Stages Of Venture Capital Financing

A venture capital fund provides finance to the venture capital undertaking at different stages of its life cycle, according to the requirements.

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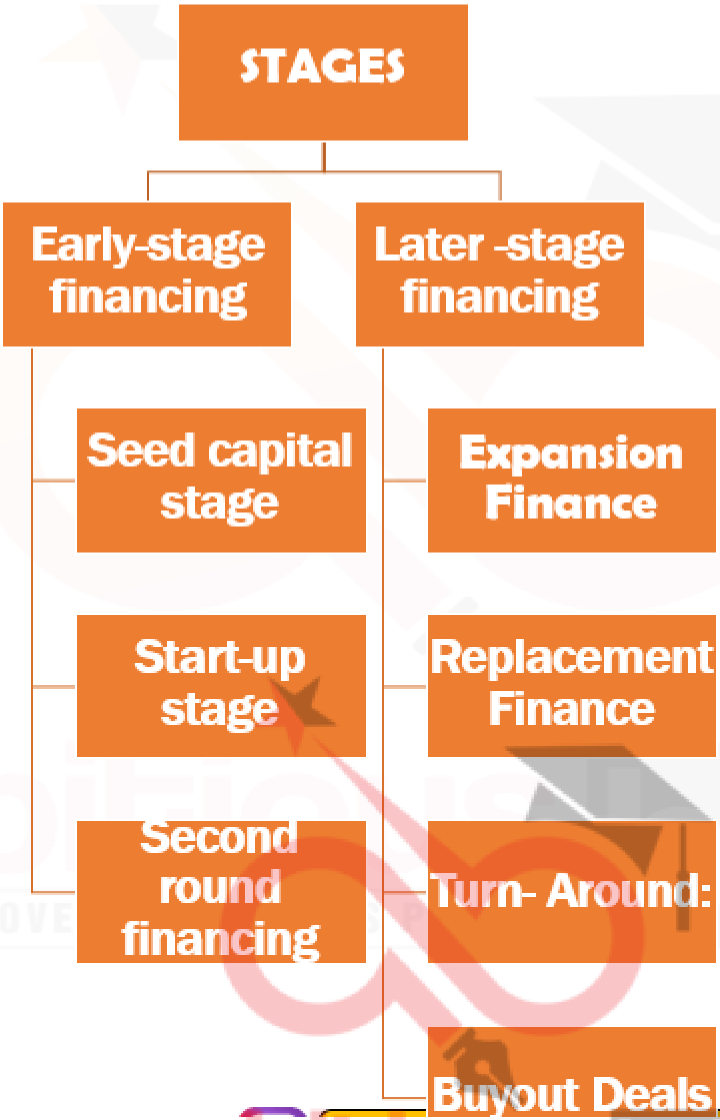


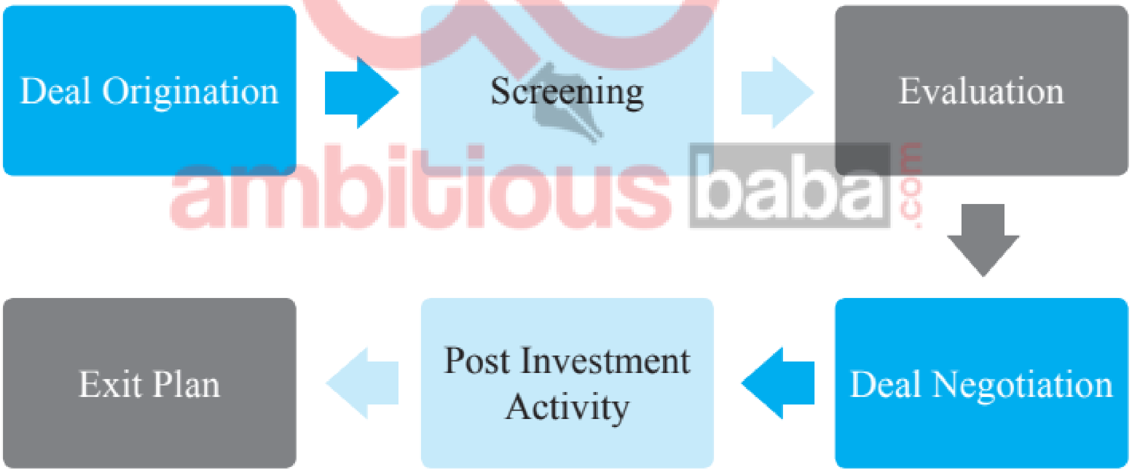
Process Of Venture Capital Financing

Venture capital financing consists of the following six steps:

- **Deal origination**: Origination of a deal is the primary step, in venture capital financing. One of the most common sources of such origination is referral system. In referral system, deals are referred to the venture capitalist by their business partners, parent organisations, friends, etc.
- **Screening:** Screening is the process by which, the venture capitalist scrutinises all the different projects which are available for investing in ventures. The projects are categorised under certain criterion, such as market scope, technology or product, size of investment, geographical location, stage of financing, etc. For the process of screening the entrepreneurs have to either provide a brief profile of their venture or they are invited for face-to-face discussions, for seeking certain clarifications.
- **Evaluation:** The short-listed proposal is evaluated, after the screening and carrying out a detailed study. Some of the documents which are studied in detail are projected profile, track record of the entrepreneur, future prospects, etc. The

process of evaluation is thorough, which not only evaluates the project capacity, but also the capacity of the entrepreneurs to meet such projections. Certain qualities in the promoters, such as entrepreneurial skills, technical competence, manufacturing and marketing abilities and experience are considered, during such evaluation. After considering all the factors, a thorough risk management study is done, which is then followed by deal negotiation.

- **Deal negotiation**: Deal negotiation is a process by which, the terms and conditions of the deal are formulated so as to make it mutually beneficial. Both the parties put forward their demands and a mutually acceptable solution is sought, in order to meet the requirements. Some of the factors which are negotiated are, the amount of investment, the percentage of profit for both the parties, the rights of the venture capitalist and entrepreneur, etc.
- **Post investment activity**: Once the deal is finalised, the venture capitalist becomes a part of the venture and takes up certain duties and responsibilities. The capitalist however does not take part in the daily activities of the firm, but becomes involved only during the situation of financial risk. The venture capitalists participate in the enterprise by a representation in the Board of Directors and ensures that the enterprise is operating, as per the plan.
- Exit plan: The last stage of venture capital investment is to make an exit plan, based on the nature of investment, extent and type of financial stake, etc. The exit plan is made in order to minimise losses and maximise profits. The venture capitalist may exit through IPOs, acquisition by another company, purchase of the venture capitalist's share by the promoter or an outsider.



Regulatory Aspects Of Venture Capital Funds

- Regulated by the guidelines issued **by the Controller of Capital Issues, Government of India, in 1988.**
- **In 1995:** Securities and Exchange Board of India Act was amended, which empowered SEBI to register and regulate the Venture Capital Funds in India.
- **December, 1996:** SEBI issued its regulations in this regard**.**
- These regulations replaced the Government Guidelines issued earlier.

The SEBI guidelines, as amended in 2000, are as follows:

Definitions

- ✓ A Venture Capital Fund has been defined to mean a fund established in the form of a trust or a company including a body corporate and registered with SEBI which –
- ➢ has a dedicated pool of capital, raised in the specified manner; and
- ➢ **invests in venture capital undertakings, in accordance with these regulations.**

A Venture Capital Fund may be set up either as a trust or as a company.

The purpose of raising funds should be to invest in Venture Capital Undertakings, in the specified manner.

A Venture Capital Undertaking means a domestic company –

- ✓ Whose shares are not listed on a recognised stock exchange in India, and
- ✓ Which is engaged in the business for providing services, production or manufacture of articles or things and does not include such activities or sectors, which have been included in the negative list by the Board.

The negative list of activities : Real estate, non-banking financial services, gold financing, activities not permitted under Government's Industrial Policy and any other activity specified by the Board.

As per SEBI definition "venture capital fund" means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early-stage venture capital undertakings, mainly involved in new products, new services, technology or intellectual property-right based activities or a new business model and shall include an angel fund.

Registration of Venture Capital Funds

- ✓ A venture capital fund may be set up either by a company or by a trust. SEBI is empowered to grant a certification of registration to the fund on an application made to it.

***The applicant company or trust must fulfil the following conditions*:**

- ✓ MoA of the company must specify, as its main objective, the details of business activity of the venture capital fund.
- ✓ It is prohibited by its memorandum of association and Articles of Association from making an invitation to the public to subscribe to its securities.
- ✓ Its director, or principal officer or employee is not involved in any litigation connected with the securities market.
- ✓ Its director, principal officer or employee has not been, at any time, convicted of an offence involving moral turpitude or any economic offence.
- ✓ The applicant is a 'fit and proper' person.

Resources for Venture Capital Fund

- ✓ **A** Venture Capital Fund may raise moneys from any investor – India, foreign or Non-Resident Indian – by way of issue of units, provided, the minimum amount accepted from an investor **is Rs. 5 lakhs.**
- ✓ This restriction does not apply to the employees, principal officer or directors of the venture capital fund, or non-Resident Indians or persons or institutions of Indian Origin.
- ✓ It is essential that the venture capital fund shall not issue any document or advertisement inviting offers from the public for subscription to its securities/units.
- ✓ Moreover, each scheme launched or fund set up by a venture capital fund shall have firm commitment from the investors to contribute **at least Rs. 5 crores, before the start of its operations.**

Modes Of Venture Capital Financing

Venture capital funds provide finance to venture capital undertakings through different modes/instruments, which are traditionally divided into:

(i)Equity

(ii)Debt instruments.

Equity Instruments

Equity instruments are ownership instruments and bestow the rights of the owner to the investor/VCFs. They are:

- Ordinary Shares on which no dividend is assured. Non-voting equity shares may also be issued, which carry a little higher dividend, but no voting rights are enjoyed by the investors.
- Preference Shares carry an assured dividend at a specified rate. Preference shares may be cumulative/non-cumulative, participating preference shares which provide for an additional dividend, after payment of dividend to equity shareholders. Convertible preference shares are exchangeable into equity shares, after a specified period of time.

Debt Instruments

VCFs may prefer debt instruments, in order to ensure a fixed return in the earlier years of financing, when the equity shares do not give any return**. *The debt instruments are of various types, as follows:***

Conditional Loans

- 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 VC funds recover their investments along with the return thereon, by way of a stake in the sale of the undertaking, after a specified period of time.

- The recovery by the VCFs depends upon the success of the business enterprise. Hence, such loans are termed as '**conditional' l**oans.

Convertible Loans:

- Sometimes loans are provided with the stipulation that they may be converted into equity at a later stage, at the option of the lender or as agreed upon between the two parties.

Conventional Loans:

- These loans are the usual term loans carrying a specified rate of interest and are repayable in instalments, over a number of years.

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JAIIB Paper 1 IE & IFS Module D Unit 11 -Lease Finance & Hire Purchase

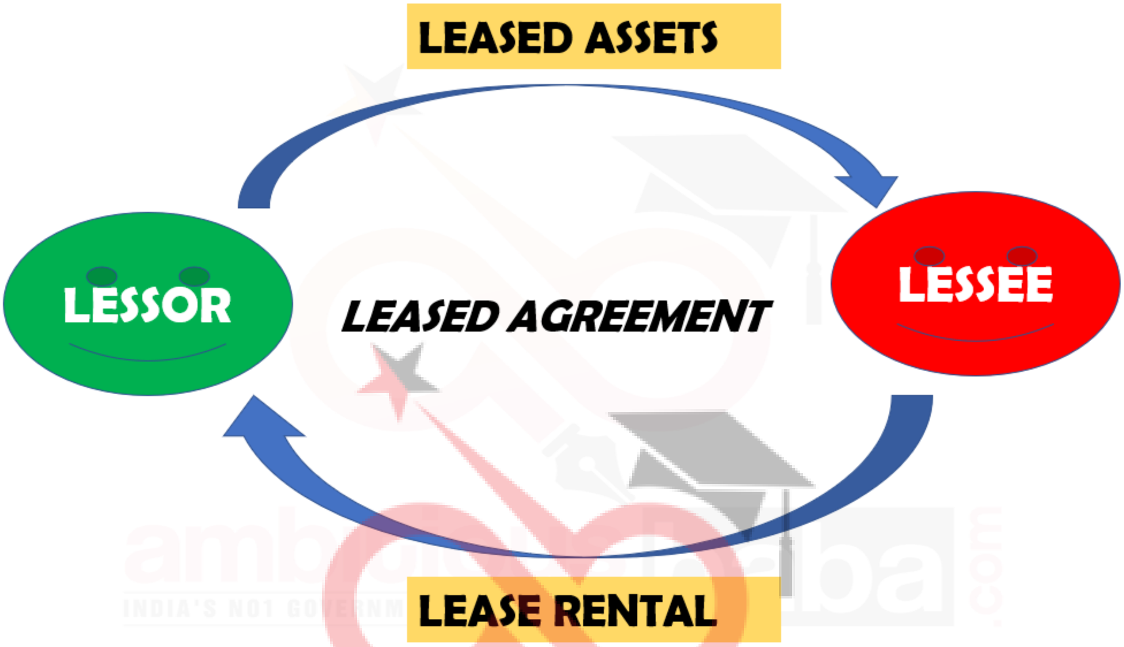
Lease Finance

- Business enterprises need capital assets like plant, machinery, building, land, transportation equipment, etc., in order to produce goods and services.
- These can be acquired either using capital funds (equity) or borrowings from various sources (debt).
- Funding could also be a **mixture of both equity and debt.**
- There are two other methods of acquiring capital assets – **lease financing and hire purchase.**
- These are two important sources of finance, whereby, the entrepreneur resorts to, neither equity nor borrowings to acquire the assets.

Leasing

Is a method of acquiring right to use an equipment or asset for a consideration, resulting in an entrepreneur getting the right to use the asset.

- A lease is a contract whereby, the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset, for an agreed period of time, in return, for the payment of a rent **(called lease rental).**
- Capital assets like land, buildings, equipment, machinery, vehicles are usually the assets, which are generally acquired on lease basis.
- The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee.



Evolution Of Leasing In India

- **1973:** Leasing activity was initiated in India
- **The first leasing Company**: First Leasing Company of India Ltd.
- **By Farouk Irani, with industrialist Shri A C Muthiah.**
- **By 1981:** Shetty Investment and Finance, Jaybharat Credit and Investment, Motor and General Finance, and Sundaram Finance, etc., joined the leasing game.
- These firms, already involved with hire-purchase of commercial vehicles, were looking for a tax break and leasing seemed to be their ideal choice.
- **Third Stage of Growth**: In late 1982, when numerous financial institutions and commercial banks either started leasing or announced plans to do so.
- **1983:** ICICI, entered the industry, giving a boost to the concept of leasing.
- International Finance Corporation (IFC) announced its decision to open 4 leasing joint ventures in India.

- To add to the leasing boom, the Finance Ministry announced strict measures for enlistment of investment companies on stock exchanges, which made many investment companies to turn overnight, into leasing companies.
- Another significant phase in the development of Indian leasing was **the G S Dahotre Committee's recommendations,** based on which, the RBI formed guidelines for commercial banks funding leasing companies.
- The growth of leasing in India has distinctively been assisted by funding from banks and financial institutions.
- Banks themselves were allowed to offer **leasing facilities later in the year 1994, with banks like State Bank of India and Bank of India opening** specialised branches for handling Lease Financing.

Types Of Leasing

Finance Lease: Also called a capital lease

- Usually covers the full useful economic life of the assets or a period that is close to the economic life.
- The lessor receives lease rentals during the lease period so as to recover fully, not only the cost of the assets but also the interest cost.
- Usually a non-cancellable and the lessee provides for the maintenance of the assets.

Operating Lease

- Period of lease is short, when compared to the useful life of the asset or the equipment being leased.
- For instance, an aircraft which has an **economic life of 25 years may be leased to an airline for 5 year**s, on an operating lease.
- Lessor will recover the cost of the asset from multiple lessees.
- They are typically for assets like computers, windmills and so on.
- In operating lease, the lessor is responsible for all kinds of maintenance, insurance and all other expenses related to the leased asset.

	Finance Lease	Operating Lease
Duration	Finance Lease is generally for the whole useful life of the asset.	Operating Lease is generally for a shorter duration.
Revocation	Finance lease contract cannot be revoked.	Operating-lease contract is revocable.
Maintenance	In Finance Lease, all the cost relating to maintenance, taxes and insurance are to be borne by the lessee.	In Operating Lease, all such expenses are borne by the lessor.
Obsolescence risk	The Lessee has to bear the risk of obsolescence.	The Lessor has to bear the risk of obsolescence.
Option of purchase	A Finance Lease contract provides for the option to purchase the asset at the end of the contract.	No such option is available in an Operating-lease contract.

Other types of lease finance arrangements that are prevalent are:

- **Close- and Open-ended Lease** - In a close-ended lease, the asset gets transferred to the lessor, at the end of the lease-contract period, whereas in an open-ended lease, the lessee has the option of purchasing the asset.
- **Up-front and Back-end Lease** - In an upfront lease, higher lease rentals are charged in the initial years and lower rentals in the later years of contract. Whereas, in the back-end lease, in the initial years, the lease rentals are less with increase in the later years.
- **Percentage Lease** - In the percentage lease, the lessor needs to pay fix-lease rentals plus some percentage of the previous year's gross revenue.
- **Cross-border Lease** - In the cross-border or international lease, the lessee and the lessor are situated in two different countries.

Lease Financing can be of three different types, depending upon how the lessee acquires the asset. These are as follows:

Direct Lease

- The lessor firm itself purchases the asset and hands it over to the lessee.
- A manufacturer can also act as a lessor and can deliver the assets to the lessee, under the lease agreement (instead of delivering under the sale agreement).
- In other words, the lessee will normally specify the manufacturer, the model number and other relevant characteristics of the asset it wishes to lease and the lessor will procure for the lessee.

Leveraged Lease

- A leveraged lease is an arrangement, where the lessor borrows a portion of the purchase price, from some lender/financial institutions.
- This loan is secured by the assets and the lease rentals.
- The loan is repaid out of the lease rentals either directly by the lessee or the lessor.
- The surplus (i.e., the under the leveraged lease, the lessor acts as an equity participant, supplying only a part of the cost of the assets and the lender supplies

the balance. The lease rentals are distributed first to the lender to satisfy the scheduled debt service payments; any surplus then going to the lessor.

- If lease payments < the debt service, the lessor or the lessee (as the contract may provide for) will have to make up the difference.

Sale and Lease Back

- The lessee is already the owner of the assets. The to-be lessee, under the lease agreement, sells the assets to the lessor who, in turn, leases the assets back to the owner (now the lessee).
- Under the sale and lease back, the lessee not only retains the use of the assets but also gets funds from the **'sale'** of the assets to the lessor.
- The **'sale and lease back arrangement'** is usually preferred by firms requiring fixed assets but are short of funds.

Advantages And Disadvantages Of Lease Finance

The Lease Finance offers following advantages:

- **Regular income**: Lessor gets assured rental income during the period of lease, without transferring the ownership of the asset to the lessee.
- **High profitability**: Leasing is highly profitable since the rate of return is the lease rental is higher than the interest payable on financing the asset.
- **Growth and expansion**: An entrepreneur will not have to spend a lot of money acquiring the asset. He/she can utilise the funds for further growth of the business.
- **Tax benefit**: Lease rental is deductible from the taxable income of the lessee. The lessor has the benefit of depreciation in respect of leased assets.
- E**conomica**l: Leasing as a source of financing is cheaper than many other sources of finance. The lessee can use the asset and earn profits, without investing money in the asset.

Impact Of Leasing On Financial Ratios

- When an asset is acquired on lease basis, lease rentals are shown as an expense in the firm's profit and Loss account.
- Neither the leased asset nor the liability under the lease agreement are shown in the Balance Sheet.
- Hence, the debt-equity ratio remains unaffected, as compared to a firm which buys the asset with borrowed funds.

Example:

There are two firms in an industry with identical balance sheets as shown below:

Balance Sheet

Equity Capital	**100**	**Fixed Assets**	**100**
Debt	**100**	**Current Assets**	**100**

Total	**200**	**Total**	**200**

- **Debt Equity Ratio = 1: 1**
- **Firm A:** borrows Rs. 100 to buy a fixed asset, while
- **firm B :** Takes it on lease. The respective balance sheets of the two firms will appear as follows:

Firm A

Equity Capital	100	Fixed Assets	200
Debts	200	Current Assets	100
Total	**300**	**Total**	**300**

Debt Equity Ratio = 2 : 1

Firm B

Equity Capital	100	Fixed Assets	100
Debts	100	Current Assets	100
Total	**200**	**Total**	**200**

- **Debt Equity Ratio = 1:1**
- The debt-equity ratio of firm A increases from 1:1 to 2:1,
- while that of firm B remains unaffected.
- In its balance sheet, the leased asset is shown as an off-balance sheet item.
- Higher debt-equity ratio of Firm A will adversely affect its further debt taking capacity, while firm B can take further debt easily to acquire other assets or to meet its working capital needs.

Legal Aspects Of Leasing

- **The Transfer of Property Act :** Defines a lease as a transaction in which, a party owning the asset provides the asset for use, over a certain period of time, to another for consideration, in the form of periodic rent.
- **Indian Accounting Standard 19 :** Defines a lease as an agreement, whereby, the lessor conveys to the lessee in return for a payment or a series of payments the right to use an asset, for an agreed period of time.
- **Sale of Goods Act:** A 'sale' means a transfer of property in goods. A lease, on the other hand, is merely a transfer of the right to use the goods and is therefore not a sale.

- A lease transaction is a deemed sale under the law and Goods and Services Tax (GST) is levied on the lease rentals.

- As there is no separate statute in India to govern the contracts of leasing, which is akin to a contract of bailment, the provisions of the Indian Contract Act apply to it.
- **According to Section 146 of the Indian Contract Act, 1872:** Bailment is "the delivery of goods by one person to another person for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of, according to the directions of the person delivering them."
- **Bailor:** The person delivering the goods
- **Bailee:** Person to whom they are delivered**.**
- Since equipment lease transactions fall in the category of a bailment contract, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (unless expressly specified otherwise in the lease agreement), as giv**en in the Indian Contract Act.**

Briefly, these may be stated as follows:

- ✓ The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset and to leave the asset in peaceful possession of the lessee during the lease period.
- ✓ The lessor has the obligation to pay the lease rentals, as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset, at the expiry of the lease period.

Regulatory Aspects Of Leasing Activities

Banks are permitted by RBI to undertake leasing activities, either through subsidiaries or through their departments.

Equipment Leasing Services through Subsidiaries

With the prior approval of the Reserve Bank of India

BANKS → SUBSIDIARY

- The subsidiaries formed should primarily be engaged in leasing activities and such other activities as are incidental to equipment leasing services.
- In other words, they should not engage themselves in direct lending or carrying on the activities which are not approved by the Reserve Bank and financing of other companies or concerns engaged in equipment leasing services.

Equipment Leasing Services as Departmental Activities

- Banks can also undertake equipment leasing services departmentally.
- Prior approval of the RBI is not necessary

- However, report to the RBI about the nature of these activities together with the names of the branches from where these activities are taken up.

The banks should comply with the following prudential guidelines when they undertake these activities departmentally:

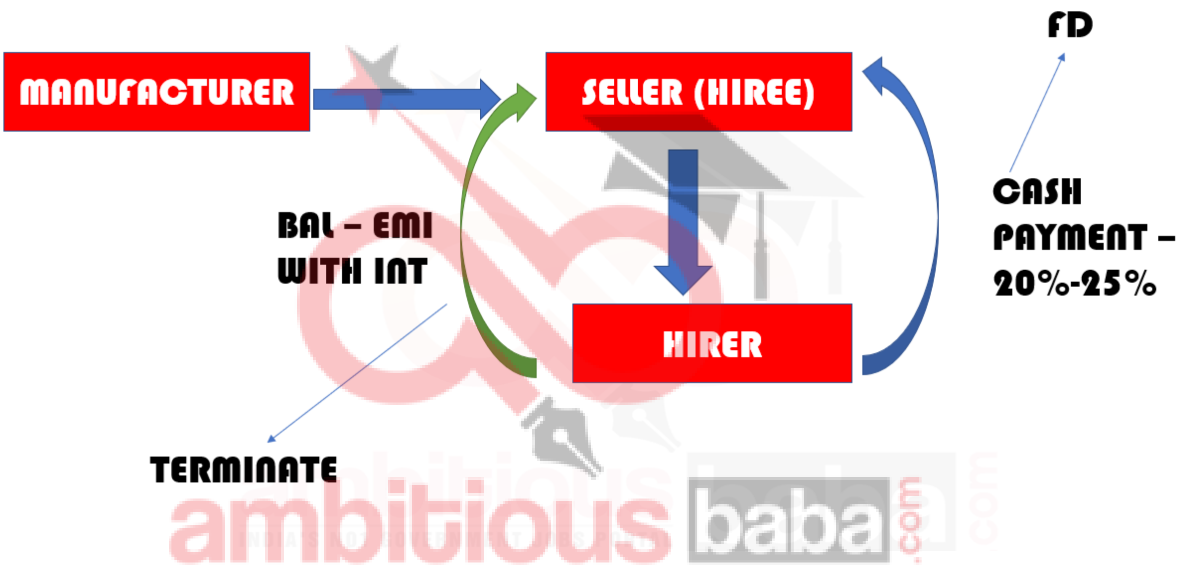
- Require skilled personnel and adequate infrastructural facilities, they should be undertaken only by certain select branches of banks.
- These activities should be treated on par with loans and advances and should accordingly be given **risk weight of 100%, for calculation** of capital to risk asset ratio. Further, the extant guidelines on income recognition, asset classification and provisioning would also be applicable to them.
- The facilities extended by way of equipment leasing services would be covered within the exposure ceilings with regard to
- ✓ **Single borrower (15% of the bank's capital funds; 20% provided the** additional credit exposure is on account of extension of credit to infrastructure projects)
- ✓ **Borrower group (40% of the bank's capital funds; 50% provided the** additional credit exposure is on account of extension of credit to infrastructure projects).
- Their exposure to each of these activities should **not exceed 10% of total advances.**
- Banks are required to frame an appropriate policy on leasing business with the approval of their Boards and evolve safeguards to avoid possible asset liability mismatch.

Hire Purchase

- Hire purchase is another method of acquiring a capital asset for use, without paying its price immediately.
- Under hire purchase arrangement, goods are let on hire, the hirer (user) is allowed to pay the purchase price in instalments and enjoys an option to purchase the goods, after all the instalments have been paid.
- Thus, the ownership in the asset is passed on to the hirer only on payment of the last instalment.
- The amount and number of instalments is fixed at the time of delivering the asset to the hirer.
- If the hirer makes default in making payment of any instalment, the seller is entitled to recover the asset from the hirer.
- The hirer may, on his own also, return the asset to the hiree, without any commitment to pay the remaining instalments.
- The instalments for this purpose are treated as hire charges.
- Thus, the property in the asset remains vested in the seller (hiree) till, the right of. purchase is exercised by the hirer, after making payment of all the instalments

The hire purchase transaction takes place in the following manner:

- ✓ The seller (hiree) purchases the asset from the supplier/manufacturer and hires it to the hirer who is required to make a cash down payment of, **say 20-25% of the cost of the asset.**
- ✓ The balance of the cost price of the asset with interest thereon is payable in equated monthly instalments, over a pre-determined period**, which ranges between 36 months and 48 months.**
- ✓ Sometimes, in place of cash down payment, a fixed deposit is required to be made with the seller and the entire amount of the cost is recovered through EMIs.
- ✓ The amount of FDR plus interest is returned to the hirer on payment of the last instalment.
- ✓ The hirer is entitled to terminate the hire purchase contract by giving due notice to the seller (hiree).



<u>Evolution Of Hire Purchase In India</u>

- 1ST hire-purchase company is believed to be Commercial Credit Corporation, successor to Auto Supply Company.
- **Based in Madras (presently Chennai),**

North India:

- ✓ **1920s-** Motor and General Finance
- ✓ **1930s-** Instalment Supply Company

Development of Hire-purchase took two forms:

- ✓ **Consumer durables**
- ✓ **Automobiles.**

Consumer durables hire-purchase was promoted by the dealers in their respective equipment.

- Thus, Singer Sewing Machine company, or Murphy radio dealers would provide instalment facilities on hire-purchase basis to the customers of their products The other side that developed very fast was the hire-purchase of **commercial vehicles.**
- The dealers in commercial vehicles, as well as pure financing companies, were set up.
- The value of the asset being good and repossession being comparatively easy, this branch of financing activity flourished fast.

Legal Aspects Of Hire Purchase

- Hire purchase agreement is not a contract of sale but a contract of bailment as, although the hirer has the right of using the goods, he is not the legal owner while the term of the agreement is operational.
- In India, all the hire purchase finance organisations are **controlled by the Hire Purchase Act, 1972.**
- However, a Bill was initiated in the year 1989, for making certain amendments which could never come into force**.**
- Such a transaction has two basic elements which are governed by the
- **Indian Contract Act, 1872**

Sale of Goods Act, 1930:

- **Bailment:** This aspect of the hire purchase agreement is governed by Chapter IX of the Indian Contract Act, which covers finance agreements like the purchase of consumer durables such as motor vehicles, computers, household appliances like televisions, refrigerator.
- **Sale:** This aspect of the hire purchase agreement is a part of the Sale of Goods Act. The law commission had recommended in its eighth report of Sale of Goods Act that there should be a separate enactment, regulating hire-purchase transaction.
- As there were no proper laws to regulate such transactions of hire purchase, hence provisions were made by a separate act **called the Hire Purchase Act, 1972.**

	Lease Finance	Hire Purchase
Meaning	A lease transaction is a commercial arrangement, whereby, an equipment owner or a manufacturer conveys to the equipment user, the right to use the equipment in return for a rental.	Hire purchase is a type of instalment credit under which, the hire purchaser agrees to take the goods on hire, at a stated rental, which is inclusive of the repayment of the principal, as well as interest, with an option to purchase.
Option to user	Except the financial Lease, no option is provided to the lessee (user) to purchase the goods.	The hire purchaser becomes the owner of the asset after paying the last instalment.
Nature of payment	Lease rentals paid by the lessee are entirely the revenue expenditure of the lessee.	Only the interest element included in the hire-purchase instalments are in the nature of revenue expenditure.
Who can claim depreciation	Lessor can claim for depreciation.	Hire purchaser can claim for depreciation.
Tax benefit	In a Lease agreement, the Lessor can claim depreciation and the lessee can claim maintenance and rentals from taxable income as expense.	A hire purchaser can claim depreciation and interest payment from the taxable income, whereas the seller can claim for the interest on the borrowed fund for purchasing the assets.

JAIIB Paper 1 IE & IFS Module D Unit 12-Credit Rating and Credit Scoring

What Is Credit Rating

- Credit rating is an analysis of the credit risks associated with a financial instrument or a business entity.
- It is a risk grade given to a particular entity, based on its credentials and the extent to which, the financial statements of the entity are sound, in terms of borrowing and lending that has been done in the past.

Usually, a credit rating is in the form of

- ✓ An alpha/numeric grade,
- ✓ Accompanied by a detailed report, based on the financial history of borrowing or lending and
- ✓ Credit worthiness of the entity or the person obtained from the statements of its assets and liabilities,

- With a view to determining their ability to meet the debt obligations
- It helps in assessment of the solvency of the particular entity.
- In other words, a credit rating may be defined as an opinion of a Credit Rating Agency (CRA) as to the issuer's (i.e., borrower of money) capacity to meet its financial obligations to the depositor or bondholder (i.e., lender of money), on a

particular issue or type of instrument (e.g., a domestic or foreign currency - short-term or medium or long-term, etc.), in a timely manner.

- HIGH credit rating indicates a high possibility of paying back the loan in its entirety, without any issues;
- POOR credit rating suggests that the borrower has had trouble paying back loans in the past and might follow the same pattern, in the future.

Credit Rating Agencies (CRAs)

- A private company
- Looks at the credit worthiness of a large-scale borrower, such as a company or country.
- Effectively ranks the borrower on their ability, to pay off their loan.
- It assigns credit ratings, which assess a debtor's ability to pay back debt, by making timely payments of interest and repayments of principal and the likelihood of default.
- An agency may rate the creditworthiness of issuers of debt obligations, of debt instruments, and in some cases, of the servicers of the underlying debt, but not of individual consumers.
- The debt instruments rated by CRAs may include, corporate bonds, Certificate of Deposits (CDs), Commercial Paper, Municipal Bonds, Preferred Stock, Debentures, and collateralised securities, such as mortgage-backed securities, collateralised debt obligations, etc.

History Of Credit Rating

- **1909:** John Moody started rating US railroad bonds.
    - Currently, three rating agencies dominate the international scene.
    - Moody's Investors Service,
    - Standard & Poor's Global Ratings
    - Fitch.
- While normally CRAs assign a rating on the request of an issuer, there are occasions, when unsolicited ratings are assigned.
- While the rating of corporate bonds started in early 20th century, sovereign ratings represent a relatively new line of business for the agencies.
- **1959:** 1st industrial country to be rated was **France, by S&P**
- The Credit Rating Information Services of India Limited (CRISIL) initiated the concept of credit rating in India.
- **1987:** CRISIL was established

- **Jan 1988:** Started its operations
- Currently, 7 rating agencies are in operation in India, for rating bonds, time deposits, CPs and structured obligations.

Some of these Indian rating agencies have tie-ups/alliances with international rating agencies, such as

- **CRISIL with S&P,**
- **ICRA with Moody's**
- **CARE with Fitch.**

Characteristics Of Credit Rating

- **Assessment of issuer's capacity to repay:** It assesses issuer's capacity to meet its financial obligations, i.e., its capacity to pay interest and repay the principal amount borrowed, as per the decided repayment schedule.
- **Based on data:** A credit rating agency assesses financial strength of the borrower, on the basis of its financial data.
- **Expressed in symbols:** Ratings are expressed in symbols, e.g., AAA, BBB, etc., which can be understood by non-experts, as well.
- **Carried out by experts:** Credit rating is done by experts of reputed, accredited institutions.
- **Guidance about investment not recommendation:** Credit rating is only a guidance to investors. It is not a recommendation to invest in any particular instrument.

Benefits Of Credit Rating

There are 2 main stakeholders in the credit rating by CRAs, viz.,

- Investor
- The issuer.

Benefits to the Investors

- Assessment of risk
- Information at low cost
- Advantage of continuous monitoring
- Provides the investors a choice of Investment

Benefits to the Issuer

- Ease in borrowing
- Borrowing at cheaper rates
- Facilitates growth
- Recognition of lesser-known companies
- Imposes financial discipline on borrowers
- Greater information disclosure

Factors Considered While Rating Companies/Instruments

Issuer's ability to service its debt:

For this, credit rating agencies take into consideration:

- The issuer Company's past and future cash flows.
- Assess how much money the company will have to pay as interest on borrowed funds and how much will be its earnings.
- The current outstanding debts of the Company.
- The company's short-term liquidity position
- Value of assets pledged as collateral security by the company.
- Availability and quality of raw material to be used, advantages of its location, its cost advantage in operations.
- Track record of the promoters and directors.

Market position of the company

- What is the market share of various products of the company, whether the Company's market shares will be stable, does the company possess any competitive advantage due its distribution network, customer base research and development facilities, etc.

Quality of management

- The CRA will also take into consideration the Company's track record, strategies, competency and philosophy of senior management.

Industry risks

- Industry risks are studied in relation to position of demand and supply relating to the products of that industry, how much is the international competition, what are the future prospects of that industry, etc.

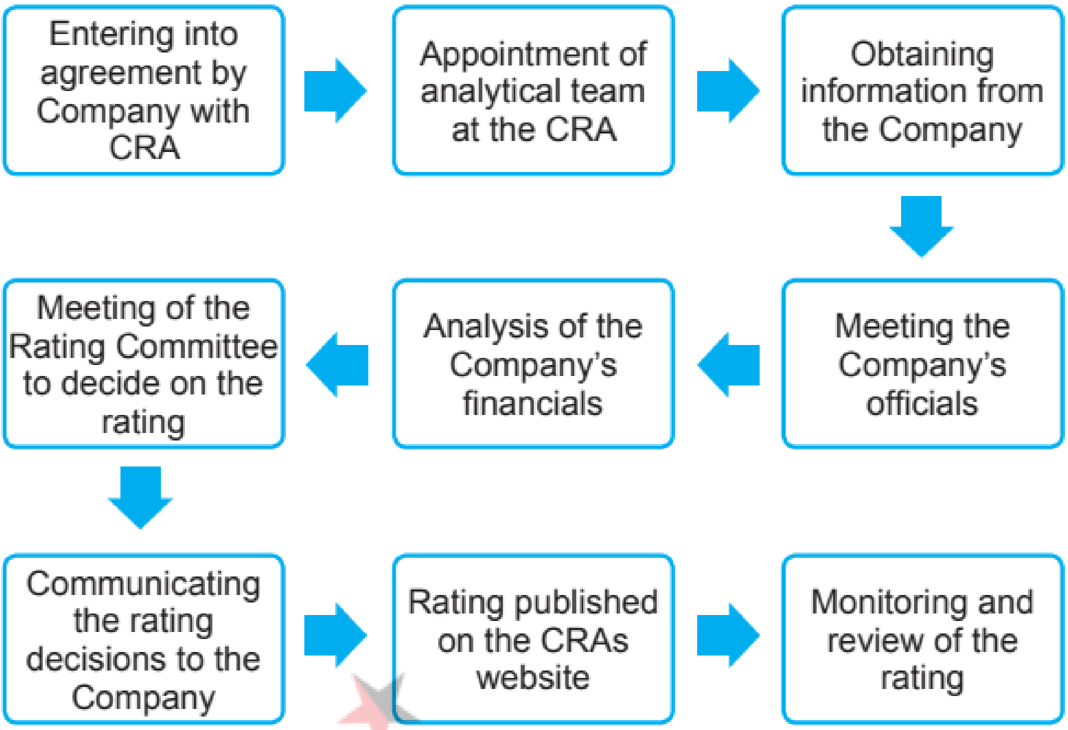
Regulatory environment

- Whether that industry is being regulated by government (like liquor industry), whether there is a price control on it, Whether there is government support for it, can it take advantage of any tax concessions, etc.

Other factors

- In addition to the above, certain other factors to be noted for credit rating of a company are its cost structure, accounting quality, market reputation, quality of working capital management, human resource quality, funding policy.

Process Of Credit Rating



Credit Rating Symbols

Presently, in India, there are seven CRAs which have been approved by SEBI. These are:

- CRISIL Ratings Limited
- India Ratings and Research Pvt. Ltd. (Ind-Ra, formerly Fitch Ratings India Pvt. Ltd.)
- ICRA Limited
- CARE Ratings Ltd.
- Brickwork Ratings India Pvt. Ltd.
- Infomerics Valuation and Rating Pvt. Ltd.
- Acuite Ratings & Research Limited

Presently, in India, there are 7 CRAs which have been approved by SEBI.

These are:

- **All these 7 CRAs also have been accredited by RBI, for the purpose of risk weighting banks' claims for capital adequacy purposes.**

Ratings are classified into 3 grades viz.,

High investment grades,
investment grades
speculative grades.

Ratings are divided by the CRAs into three levels,

Investment-grade,
Noninvestment grade and
Default grade.

- The investment-grade is considered by CRAs to be a significantly safer grade than the rest.
- Rating agencies use symbols such as AAA, AA, BBB, B, C, D, to convey the credit rating to the investors for long tenor instruments of the issuers.
- In all, risk is classified into 14 or 15 categories.
- Signs '+' or '-', are used to further fine tune the rating.
- The suffix + or - is also used to indicate the comparative position of the instrument within the group covered by the symbol.
- Thus, BBB- : lies one notch above (better) BB+.

High Investment Grades AAA

Triple A denotes highest safety in terms of timely payment of interest and principal. The issuer is fundamentally strong and any adverse changes are not going to affect it.

AA: Double A denotes high safety in terms of timely payment of interest and principal.
A: denotes adequate safety in terms of timely payment of interest and principal.
Changes in circumstances can adversely affect such issues.

BBB: Triple B denotes moderate safety in terms of timely payment of interest and principal speculative grades.

Speculative Grades

BB: Double B denotes inadequate safety in terms of timely payment of interest and principal. Uncertain changes can lead to inadequate financial capacity to make timely payments in the immediate future.

B: Denotes high risk. Adverse changes could lead to inability or unwillingness to make timely payment.

C: Denotes substantial risk. Issue rated is vulnerable to default.

D: Denotes default in terms of timely payment of interest and principal. These symbols are just a current opinion of an agency and they are not recommendations to invest or not to invest. The rating assigned applies to a particular instrument of the company and is not a general evaluation of the company.

CRAs are required to give uniform credit rating codes, so that there is no confusion amongst the stake holders, with regard to interpretation of a credit rating. Example of the ratings given by CRISIL are as tabulated in table, AAA being the highest and D being the lowest credit

Long-Term	Short-Term
CRISIL AAA	CRISIL A1
CRISIL AA	CRISIL A2
CRISIL A	CRISIL A3
CRISIL BBB	CRISIL A4
CRISIL BB	CRISIL D
CRISIL B	
CRISIL C	
CRISIL D	

Ratings Outlook

- Credit Ratings are forward-looking opinions on the relative credit risk associated with the rated debt instrument, as represented by an appropriate symbol, on the relevant rating scale.
- A rating outlook gives additional information to lenders, investors or other users, about the expected direction of rating movement in the near to medium term (typically six months to two years).

The rating outlooks assigned by CRAs generally fall into four categories:

- Stable,
- Positive,
- Negative,
- No Outlook.

Regulations For CRAs In India

- In India, CRAs are regulated by the Securities and Exchange Board of India (SEBI).
- SEBI was one of the first regulators globally, to put forth a comprehensive framework, for the regulation of CRAs, through the SEBI (Credit Rating Agencies) Regulations, 1999 (‘CRA Regulations’).
- Some of the CRA Regulations cover the following areas:

Registration:

- Broadly, the CRA Regulations require that the CRAs should be companies promoted by persons who have experience in the field of credit rating, i.e., by financial institutions or
- by persons who have a net worth **of more than Rs. 100 crores**.
- CRAs need to have a **minimum net worth of Rs. 5 crores**, and adequate infrastructure, professionals and employees to carry on the activity of issuing credit ratings.
- Additionally, registration would only be granted, if it is registering the applicant in the interest of investors and the securities market**.**

Obligations:

- The CRA Regulations envisage that the CRAs need to carry out their activities, in accordance with the terms of their engagement with the issuer, and the baseline principles in the Regulations.
- **Comply with the Code of Conduct prescribed by SEBI :** Duties with integrity, professional competence, independence and confidentiality.
- CRAs are required to monitor their rating throughout the lifetime of the securities rated and carry out periodic reviews of their rating as well.

Fees For Credit Rating

- In the credit rating business, the users of rating services, i.e., investors, financial intermediaries and other end-users, do not pay the rating fees.
- The issuer of the financial instrument pays fees to the credit rating agency and this is the major source of revenue of the CRA.
- The issuer's fees constitute 95% of the total revenues of rating agencies.
- In addition to rating fees, CRAs also charge an annual surveillance fee to monitor the rated instrument/company.

What Is Credit Scoring

- **Credit scoring is a statistical analysis performed by lenders and financial** institutions to determine the creditworthiness of an individual.
- A credit score can impact many financial transactions, including home loans, auto loans, credit cards, and personal loans.
- Lenders also use credit scoring in risk-based pricing, in which, the terms of a loan, including the interest rate, offered to borrowers are based on the probability of default.

- While credit ratings apply to corporations and governments, credit scoring applies to individuals.
- In India, credit scores are evaluated and monitored by Credit Information Companies (CICs).
- Originated in USA, where consumer credit, in the form of personal and home loans and credit cards, has been established for a long time.

The three major credit bureaus, globally, are

- **Experian,**
- **Equifax and**
- **TransUnion.**

Credit Information Companies (CICs) In India

- A Credit Information Company (CIC) collects and maintains records of an individual's payments and dues pertaining to loans and credit cards.
- These records are submitted by the respective banks and other credit institutions to the CIC.
- This information is then used to create credit information reports, which is provided to credit institutions, in order to access the credit worthiness and capacity of a borrower to repay his loan and advances and discharge his other obligations in respect of credit facility availed or to be availed by him.
- This requirement has been fulfilled by **The Credit Information Companies (Regulations) Act, 2005,** under which, CICs in India are licensed by the RBI and governed by the various other rules and regulations prescribed for them.

Credit Information Companies (Regulations) Act, 2005

- **Objective -** An Act to provide for regulation of credit information companies and to facilitate efficient distribution of credit and for matters connected therewith or incidental thereto.
- **Other features -** The CIC Act, 2005 further provides for the functioning of CIC, its registration procedure, settlement of dispute, privacy principles and furnishing of credit information. The RBI has further issued Credit Information Companies Regulations, 2006 to facilitate the smooth working of CIC.

At present, there are 4 CICs operating in India.

TransUnion CIBIL

- CIBIL is the first entrant in the country.
- **Incorporated**: August 2000
- **Recommendations by**: Siddiqui Committee.
- **Commenced commercial bureau operations**: in May 2004.
- **Prepares credit information reports for**: Individuals & corporate entities.

- Apart from compiling a credit history, a credit score is also compiled and is made available to lenders as well as proponents.
- **Members:** 500 members including more than 200 cooperative banks.
- Credit score varies from 300 to 900.
- A credit score gives an indication about the borrower's propensity to pay, so that a lender can decide quickly on the request received for a loan/credit card.

Experian

- **2006:** Established as a joint venture with several banks and financial institutions in India.
- Prepares credit reports of individuals, based on the information provided by banks and other financial institutions about the financial history of the individual.

Equifax

- **1899:** Founded in Atlanta.
- One of the oldest CIC as of now
- **2010:** Started operations in India.

CRIF High Mark Credit Information Services

- An RBI approved credit bureau in India.
- It serves retail, agriculture and rural, MSME, commercial and microfinance.

Membership To CICs

Available to the following institutions-

- Credit Institutions (banks, RRBs, Cooperative banks, NBFCs, Public Financial Institutions, Housing Finance Institutions, etc., companies engaged in the business of credit cards and other similar cards and companies dealing with distribution of credit in any other manner or any other institution, which the Reserve Bank may specify, from time to time, for this purpose).
- Insurance Companies,
- Companies providing cellular or telephone services,
- Credit Rating Agencies and Asset Reconstruction Companies

Regulatory Guidelines Governing CICs

- Following enactment of the **Credit Information Companies (Regulation) Act (CICRA) in 2005, t**hree other Credit Information Companies (CICs) were also set up.
- **Section 15 of the CICRA**, every Credit Institution is required become member of at least one CIC.

- **Section 17 of CICRA** stipulates that a CIC may seek and obtain credit information from its members only (that is, member banks and other credit institutions).
- As a result, whenever there was any enquiry, the enquiring bank was able to obtain credit information on a particular borrower/client as **maintained by that CIC.**
- Accordingly, the information was incomplete as it did not include credit history related to those non-member Credit Institutions with which the borrower had a current or a past exposures.
- To overcome such issues, RBI appointed a committee, under the Chairmanship of Mr. Aditya Puri, which submitted its Report in January 2014.
- **Recommendations:** RBI issued guidelines to the effect that all Credit Institutions should become members of all CICs and the CICs should, therefore, moderate their membership and annual fees suitably. Consequently, now:
  - ✓ All banks and concerned financial institutions are members of all CICs, and,
  - ✓ No CIC should charge membership fee and annual renewal fees exceeding Rs.10,000 and Rs 5,000, respectively.

Credit Scores

- A credit score is a statistical number that evaluates a consumer's creditworthiness and is based on credit history.
- Lenders use credit scores to evaluate the probability that an individual will repay his/her debts.
- A credit score is a three-digit summary of the credit history of an individual.
- All CICs use a uniform system of scoring so that interpretation is uniform across the entire spectrum of CICs.
- Credit scores range from **300 to 900 – with 900** being the **best score and 300 being the worst.**
- Consequently, applications with higher credit scores have better chances of success in sanctions and those with lower scores have lesser chances of sanctions.
- Nearly 90% of all loans sanctioned are those with credit scores of 700 and above

A typical credit report has six sections, which sum up the applicant's demographic and credit profile and provide details of his/her credit history.

- ❑ Credit score
- ❑ Personal information
- ❑ Contact information

- Employment information
- Account information
- Enquiry information

	Credit Rating	Credit Scores
1	These are given by Credit Rating Agencies (CRAs).	These are given by Credit Information Companies (CICs).
2	The rating is normally alphanumeric and may contain a plus or minus sign to denote the outlook for the future. For example, Credit Rating Baa3 with negative outlook.	The scoring is by means of a three-digit number, ranging from 300 to 900.
3	Credit Rating is for large corporates and governments and their entities.	Credit scoring is for individuals and small business entities.

JAIIB Paper 1 IE & IFS Module D Unit 13-Mutual Funds

Introduction

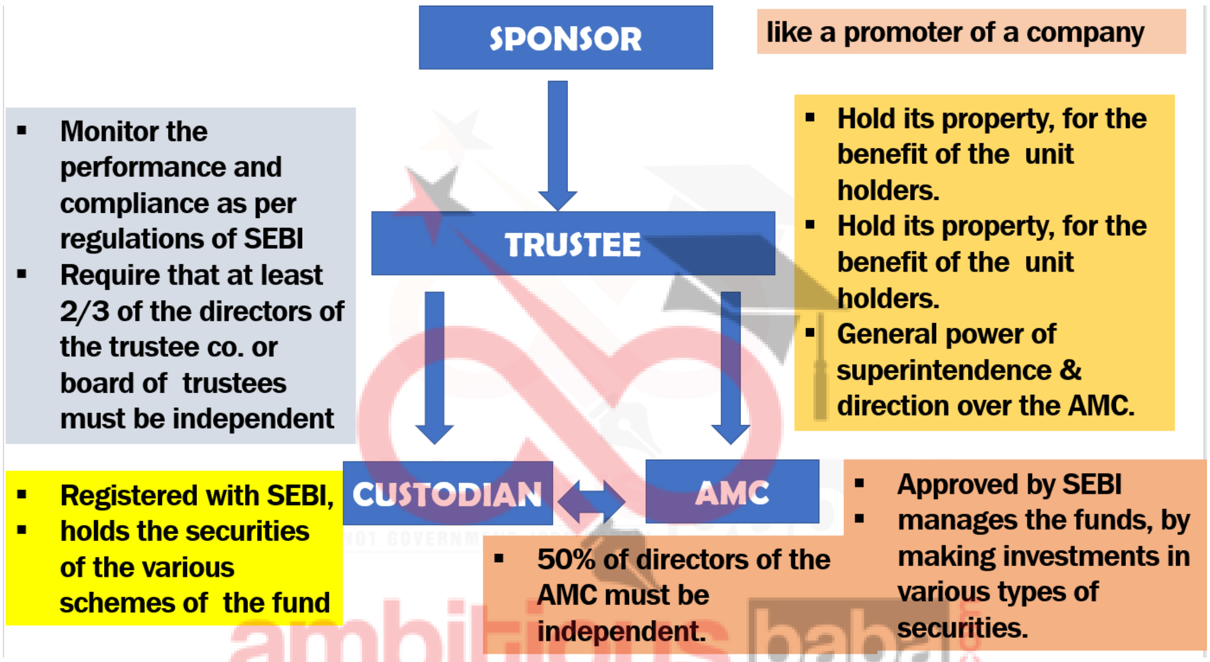
- Mutual funds perform an important role of financial intermediary, by mopping up savings from investors and channelling them towards productive investments.
- They also form a dependable avenue for those investors, who want to invest in the capital market, but keep away from it, due to lack of expertise.
- Mutual Funds are supervised by SEBI and there are various types by which, they can be classified.

Mutual Funds and Their Functions

- Mutual fund is a mechanism for pooling resources from the public
- by issuing units to them and investing the funds so collected, in securities,
- in accordance with objectives, as disclosed in an offer document.
- Investors of mutual funds are known as unit holders.
- The profits or losses of fund/plan are shared by the investors in proportion to their investments.
- A mutual fund is required to be registered with SEBI, which regulates the securities markets, before it can collect funds from the public. SEBI formulates the policies and regulates the mutual funds to protect the interest of the investors.

Management Of Mutual Funds

- A mutual fund is set up in the form of a trust, which has sponsors, trustees, Asset Management Companies (AMCs) and custodians.
- The trust is established by a sponsor or more than one sponsor.
- The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV).
- The NAV per unit is the market value of securities of a scheme - the expenses incurred on the scheme / by the total number of units of the scheme, on any particular date.
- **Disclosed by on a regular basis – daily or weekly – depending upon the type of scheme.**



Evolution Of Mutual Funds

- **1963: The mutual fund industry in India started,**
- **with the formation of Unit Trust of India, at the initiative of the Government of India and RBI.**
- **The evolution of mutual funds in India can be broadly divided into four distinct phases, as follows:**

Phase-I

- **1963:** Unit Trust of India (UTI) was established by an Act of Parliament.
- Set up by the RBI and functioned under the Regulatory and administrative control of the RBI.
- **The first scheme launched by UTI:** Unit Scheme, 1964 (US-64).
- **1978**: UTI was de-linked from the RBI

- Industrial Development Bank of India (IDBI), took over the regulatory and administrative control of UTI
- **At the end of the year 1988, UTI had Rs. 6,700 crores of assets, under its management.**

Phase-II

- **1987**: marked the entry of non-UTI, public sector mutual funds set up by PSU banks, LIC and GIC.
- **1st non-UTI Mutual Fund:** SBI Mutual Fund in June 1987
- ✓ **Dec 1987:** Canbank Mutual Fund
- ✓ **Aug 1989:** Punjab National Bank Mutual Fund
- ✓ **Nov 1989:** Indian Bank Mutual Fund
- ✓ **Jun 1990:** Bank of India MF
- ✓ **Oct 1992:** Bank of Baroda MF
- ✓ **Jun 1989:** LIC established its mutual fund
- ✓ **Dec 1990:** GIC had set up its mutual fund
- ✓ **At the end of the year 1993, the mutual fund industry had about Rs. 47,000 crores of assets under their management.**

Phase-III

- **1993:** With the entry of private sector funds
- A new era started in the Indian MF industry, giving the Indian investors, a wider choice of funds.
- **1993:** First Mutual Fund Regulations came into being, under which, all mutual funds, except UTI, were to be registered and governed.
- **1st private sector mutual fund registered in July 1993:** Kothari Pioneer (now merged with Franklin Templeton)
- **The 1993 SEBI (Mutual Fund)** Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996, which is still in force.
- The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions.

Phase-IV

- **February 2003:** Repeal of the Unit Trust of India Act, 1963,
- UTI was bifurcated into two separate entities.
- With recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth.

Classification Of Mutual Funds

SEBI, which is the regulator of Mutual Funds has classified mutual funds in the following categories:

- Equity Schemes
- Debt schemes
- Hybrid Schemes
- Solution Oriented Schemes
- Other Schemes

Equity Schemes

No.	Category of Schemes	Type of scheme/Scheme Characteristics
1.	Multi Cap Fund	An open-ended equity scheme investing across large cap, mid cap, small cap stocks – Minimum investment in equity & equity related instruments – 65% of total assets (Also referred to as Diversified Equity Funds)
2.	Large Cap Fund	An open-ended equity scheme predominantly investing in large cap stocks – Minimum investment in equity & equity related instruments of large cap companies – 80% of total assets
3.	Large & Mid Cap Fund	An open-ended equity scheme investing in both large cap and mid cap stocks – Minimum investment in equity & equity related instruments of large cap companies – 35% of total assets Minimum investment in equity & equity related instruments of mid cap stocks – 35% of total assets
4.	Mid Cap Fund	An open-ended equity scheme predominantly investing in mid cap stocks – Minimum investment in equity & equity related instruments of mid cap companies – 65% of total assets
5.	Small cap Fund	An open-ended equity scheme predominantly investing in small cap stocks – Minimum investment in equity & equity related instruments of small cap companies – 65% of total assets
6.	Dividend Yield Fund	An open-ended equity scheme predominantly investing in dividend yielding stocks – Scheme should predominantly invest in dividend yielding stocks. Minimum investment in equity – 65% of total assets

7.	Value Fund*	An open-ended equity scheme following a value investment strategy – Scheme should follow a value investment strategy. Minimum investment in equity & equity related instruments – 65% of total assets
8.	Contra Fund*	An open-ended equity scheme following contrarian investment strategy – Scheme should follow a contrarian investment strategy. Minimum investment in equity & equity related instruments – 65% of total assets
9.	Focused Fund	An open- ended equity scheme investing in maximum 30 stocks (mention where the scheme intends to focus, viz., multi cap, large cap, mid cap, small cap) – A scheme focused on the number of stocks (maximum 30) Minimum investment in equity & equity related instruments – 65% of total assets
10.	Sectoral/ Thematic	An open-ended equity scheme investing in sector (name of the sector)/ An open-ended equity scheme following the specified theme (name of the theme) – Minimum investment in equity & equity related instruments of a particular sector/ particular theme – 80% of total assets
11.	Equity Linked Savings Scheme (ELSS)	An open-ended equity linked saving scheme with a statutory lock in period of 3 years and tax benefit – Minimum investment in equity & equity related instruments – 80% of total assets (in accordance with Equity Linked Saving Scheme, 2005 notified by the Ministry of Finance)

Debt Schemes

No.	Category of Schemes	Type of scheme/Scheme Characteristics
1.	Overnight Fund	An open-ended debt scheme investing in overnight securities, i.e., securities having maturity of 1 day
2.	Liquid Fund	An open-ended liquid scheme investing in Debt and money market securities with maturity of up to 91 days only
3.	Ultra-Short Duration Fund	An open ended ultra-short-term debt scheme investing in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 3 months and 6 months
4.	Low Duration Fund	An open-ended low duration debt scheme investing in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 6 months and 12 months
5.	Money Market Fund	An open-ended debt scheme investing in money market instruments having maturity up to 1-year
6.	Short Duration Fund	An open-ended short-term debt scheme investing in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 1-year and 3 years

7.	Medium Duration Fund	An open-ended medium-term debt scheme investing in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 3 years – 4 years. Portfolio Macaulay duration under anticipated adverse situation is 1-year to 4 years
8.	Medium to Long Duration Fund	An open-ended medium-term debt scheme investing in Debt & Money Market instruments such that the Macaulay duration of the portfolio is in the range of 4 years – 7 years. Portfolio Macaulay duration under anticipated adverse situation is 1-year to 7 years
9.	Long Duration Fund	An open-ended debt scheme investing in Debt & Money Market Instruments such that the Macaulay duration of the portfolio is greater than 7 years
10.	Dynamic Bond	An open-ended dynamic debt scheme investing across duration
11.	Corporate Bond Fund	An open-ended debt scheme predominantly investing in highest rated corporate bonds. Minimum investment in such corporate bonds – 80% of total assets.
12.	Credit Risk Fund	An open-ended debt scheme predominantly investing in below highest rated corporate bonds. Minimum investment in such corporate bonds – 65% of total assets.
13.	Banking and PSU Fund	An open-ended debt scheme predominantly investing in debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds. Minimum investment in such instruments – 80% of total assets
14.	Gilt Fund	An open-ended debt scheme investing in government securities across maturity. Minimum investment in G secs – 80% of total assets (across maturity)
15.	Gilt Fund with 10-year constant duration	An open-ended debt scheme investing in government securities having a constant maturity of 10 years. Minimum investment in G secs – 80% of total assets
16.	Floater Fund	An open-ended debt scheme predominantly investing in floating rate instruments. Minimum investment in such instruments – 65% of total assets

Hybrid Schemes

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No.	Category of Schemes	Type of scheme/Scheme Characteristics
1	Conservative Hybrid Fund	An open-ended hybrid scheme investing predominantly in debt instruments – Investment in equity & equity related instruments – between 10% and 25% of total assets; Investment in Debt instruments between 75% and 90% of total assets
2	Balanced Hybrid Fund @	An open-ended balanced scheme investing in equity and debt instruments – Equity & Equity related instruments between 40% and 60% of total assets; Debt instruments – between 40% and 60% of total assets. No Arbitrage would be permitted in this scheme
3	Aggressive Hybrid Fund @	An open-ended hybrid scheme investing predominantly in equity and equity related instruments – Equity & Equity related instruments between 65% and 80% of total assets; Debt instruments – between 20% 35% of total assets
4	Dynamic Asset Allocation or Balanced Advantage	An open-ended dynamic asset allocation fund – Investment in equity/ debt that is managed dynamically
5	Multi Asset Allocation ##	An open-ended scheme investing in, (names of the three different asset classes) – Invests in at least three asset classes with a minimum allocation of at least 10% each in all three asset classes
6	Arbitrage Fund	An open-ended scheme investing in arbitrage opportunities – Scheme following arbitrage strategy. Minimum investment in equity & equity related instruments– 65% of total assets
7	Equity Savings	An open-ended scheme investing in equity, arbitrage and debt – Minimum investment in equity & equity related instruments – 65% of total assets and minimum investment in debt – 10% of total assets. Minimum hedged & unhedged to be stated in the Scheme Information Document (SID). Asset Allocation under defensive considerations may also be stated in the Offer Document

Solution Oriented Scheme

No.	Category of Schemes	Type of scheme/Scheme Characteristics
1	Retirement Fund	An open-ended retirement solution-oriented scheme, having a lock-in period of 5 years or till retirement age (whichever is earlier)
2	Children's Fund	An open-ended fund for investment for children having a lock-in period of at least 5 years or till the child attains the age of majority, (whichever is earlier)

Other Schemes

No.	Category of Schemes	Type of scheme/Scheme Characteristics
1	Index Funds/ ETFs	An open-ended scheme replicating/ tracking index - Minimum investment in securities of a particular index (which is being replicated/ tracked)- 95% of total assets
2	Fund of Funds (FoFs) (Overseas/ Domestic)	An open-ended fund of fund scheme investing in fund (mention the underlying fund) – Minimum investment in the underlying fund – 95% of total assets

Role Of Mutual Funds

- MFs allow investors to invest their savings across a wide range of securities and diversify their portfolios, as per their objectives and goals.

- MFs are managed by professional fund managers, who are responsible for taking smart decisions, in order to maximise yields, while mitigating risks in the investing decisions.
- MFs offer relatively high liquidity.
- MFs provide investors the freedom to earn on their personal savings. Investments can be as less as Rs. 500.
- Certain mutual fund investments are tax efficient and serve as income tax shields for the investors.

Supervision Of Mutual Funds

- There are two institutions that play the role of supervising or maintaining standards in the mutual fund's landscape.

These are:

- Securities and Exchange Board of India (SEBI), and,
- Association of Mutual Funds of India (AMFI).

While the role of SEBI is regulator of the MF industry,

AMFI – Which is a Self- Regulatory Organisation (SRO) - plays the role of a facilitator and upholder of industry best practices.

SEBI:

- The objective of SEBI is to protect the interest of investors in securities and to promote the development of and to regulate the securities market.
- As far as mutual funds are concerned, SEBI formulates policies, regulates and supervises mutual funds to protect the interest of the investors.
- SEBI, first notified regulations for mutual funds in 1993.
- Fully revised in 1996
- SEBI has also issued guidelines through circulars to mutual funds from time to time, to protect the interests of investors.
- All mutual funds are governed by the same set of Regulations.

AMFI:

- **Incorporated:** On August 22, 1995 as a non-profit organisation.

Objectives

- To promote best business practices and code of conduct, in all areas of operation of Mutual Fund Industry.
- To maintain high professional and ethical standards in the Mutual Fund industry.
- To interact with the SEBI for betterment of the MF industry.
- To make representations to the Government, RBI and other regulatory bodies on matters relating to the Mutual Fund Industry.
- To develop a well-trained agent distributors network, for the Mutual Fund Industry.

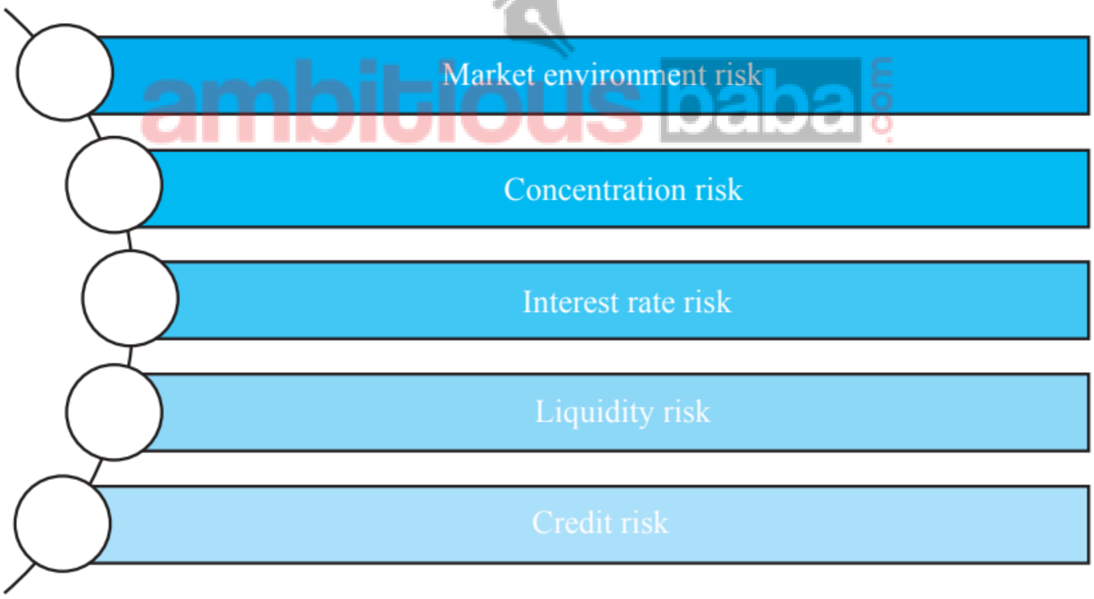
- To promote nationwide investor awareness programmes, in order to make the investors understand the concept and working of Mutual Funds.

New Fund Offer

- The process through which a mutual fund scheme launches a new mutual fund is called a New Fund Offer or NFO.
- In case of open ended and close ended schemes (except ELSS schemes), **the NFO should be open for 15 days**
- The minimum subscription amount of debt oriented and balanced schemes at the time of new fund offer should be at **least Rs 20 crores and that of other schemes shall be at least Rs 10 crores.**
- An average **Assets Under Management (AUM) of Rs 20 crore on half -yearly** rolling basis should be maintained for open ended debt-oriented schemes.
- The scheme, for which there has been an NFO, should be available for ongoing re-purchase, sale or trading, within 5 business days of allotment.
- The NFO can make its investments only after the offer period closes and it must allot the units and send the account statements to the investors within 5 days of closure of the NFO.

Risks Associated With Mutual Funds

Investing in mutual funds involves entering the securities market – both equity and debt. There are a number of risks associated with investing in mutual funds.



Calculating Return on the Mutual Fund Units:

There are mainly two methods to calculate returns from Mutual Fund Investments:

- Absolute Return Method

- Annalised Return Method

Absolute Return method

It is about simple increase(decrease) in the investment in terms of percentage and does not consider the time taken for the change in values of investment.

Illustration

Suppose the current Market Value of the investment is Rs 700,000 and the original amount invested was Rs. 500,000, then the absolute return will be:

[(700000-500000)/500000] =40%

Here, date of investment or the date of redemption is not important. This method is ideal if the period of investment is less than one year. 2.

Annualised Return Method

This method is ideal for investment period exceeding one year. An investor needs to calculate the compound average growth rate (CAGR) over the investment period. It measures the growth of an investment as if it had grown at a steady rate on an annual compounded basis.

Formula

CAGR = [(Current Value/Beginning Value) ^ (1/number of Years)]-1

It can also be measured using the XIRR function in Excel.

Net Asset Value (NAV)

- The Net Asset Value (NAV) of schemes need to be published on a daily basis, by the Mutual Funds, at least in two daily newspapers.
- NAV and sale/repurchase price of all Mutual Fund schemes, except for Fund of Fund Schemes, are updated on Association of Mutual Funds in India's (AMFI) website and the Mutual Funds' websites by 9 P.M. of the same day.
- Fund of Fund Schemes shall have an extended time up to 10 AM, the following business day in this regard and the NAVs are published in newspapers, with an asterisk to indicate the one-day time lag/or the actual time lag.
- To ensure uniformity, Mutual Funds have to round off NAV, up to four decimal places for index funds and all types of debt & liquid/money market schemes.

Total Expense Ratio

- The Expense Ratio of any Mutual Fund scheme is an important parameter that determines the yield that an investor will be able to derive from the scheme.
- Expense ratio represents the annual fund operating expenses of a scheme, expressed as a percentage of the fund's daily net assets.

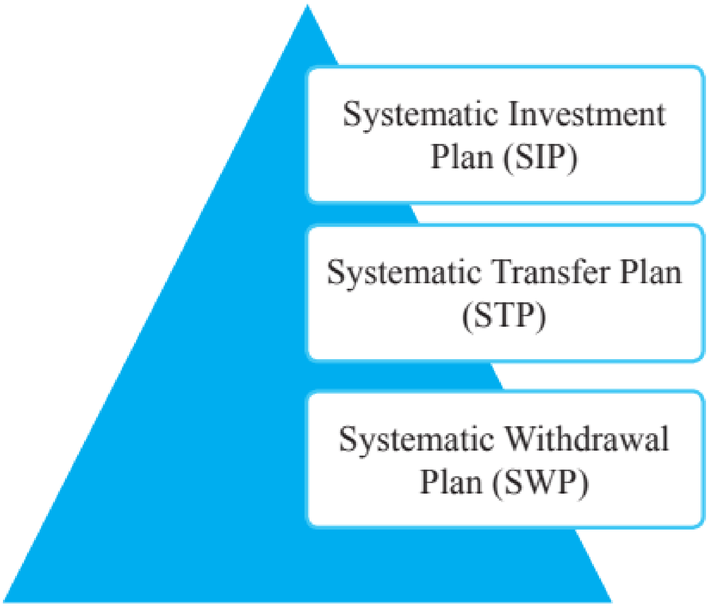
- Operating expenses of a scheme constitute of its administration, management, advertising related expenses, etc.
- An expense ratio of 1% per annum means that each year 1% of the fund's total assets will be used to cover expenses.
- Information on expense ratio that are applicable to a scheme is mentioned in the offer document.
- Currently, in India, the expense ratio is fungible, that is, there is no limit on any particular type of allowed expense as long as the total expense ratio is within the prescribed limits, laid down by SEBI.

LOAD/NO-Load Funds

- A Load Fund is one that charges a percentage of NAV for entry or exit.
- The load structure in a scheme has to be disclosed by the Fund house, in its offer documents.
- Suppose the NAV per unit is Rs 10 and if the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs 10.10 (10 + 1% of 10) per unit and those who offer their units for repurchase to the mutual fund will get only INR 9.90 (10 – 1% of 10) per unit.
- A no-load fund is one that does not charge for entry or exit.
- It means the investors can enter the fund/ scheme at NAV and no additional charges are payable on purchase or sale of units. SEBI has mandated that no entry load can be charged for any mutual fund scheme in India.

Strategies for Investment In Mutual Funds

- Mutual funds provide an alternate avenue for investments by small savers.
- Moreover, there is a proportion of the investing population which may not require the redemptions to be in lump-sum, but would prefer to have the repayment in instalments.
- Keeping in view the needs of the investors, there **are 3 strategic methods of investment and redemption**



Systematic Investment Plan (SIP)

- SIP is a mode of investment in Mutual Funds, by which individuals invest small amounts at regular intervals in the Mutual Fund.
- SIP is also known as goal-based investment and
- SIP is generally referred in the context of Equity Funds.
- In SIPs, individual purchase Mutual Fund units at regular intervals in small quantities.
- Individuals can start investing in Mutual Funds through SIP mode with amounts as low as Rs 500.
- SIP has advantages such as the power of compounding, rupee cost averaging, and disciplined savings habit.
- The frequency of SIP can be fortnightly, monthly or quarterly.

Systematic Transfer Plan (STP)

- STP is a technique through which, an individual gives consent to the Mutual Fund company to transfer money from one scheme to another in a systematic and periodic manner.
- In STP, individuals can transfer their money only from one scheme to another of the same fund house and not of other fund houses.
- The STP is suitable for individuals who have excess idle money lying in their account and are reluctant to invest the entire amounts into equity funds.
- As a result, through STP, individuals can first invest the money in Liquid Funds and then, transfer it to equity funds of their choice.

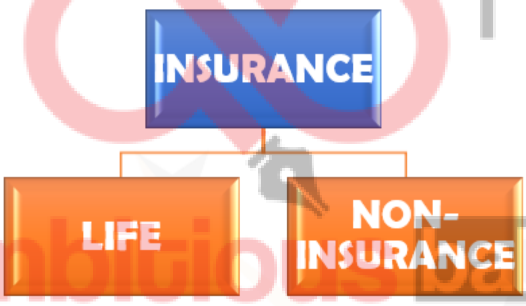
Systematic Withdrawal Plan (SWP)

- SWP is the opposite of SIP.
- In SWP, individuals redeem money from Mutual Fund schemes in small amounts.
- In this situation, individuals first deposit the money in a Mutual Fund scheme whose risk is generally low, such as liquid funds.
- Thereafter, the individuals can redeem the money from the Mutual Fund scheme at regular intervals, depending on their requirements. The frequency of SWP can be weekly, monthly, or quarterly, and the SWP can be used as a source of regular income for individuals, especially retirees.

JAIIB Paper IE & IFS Module D Unit 14: Insurance Products

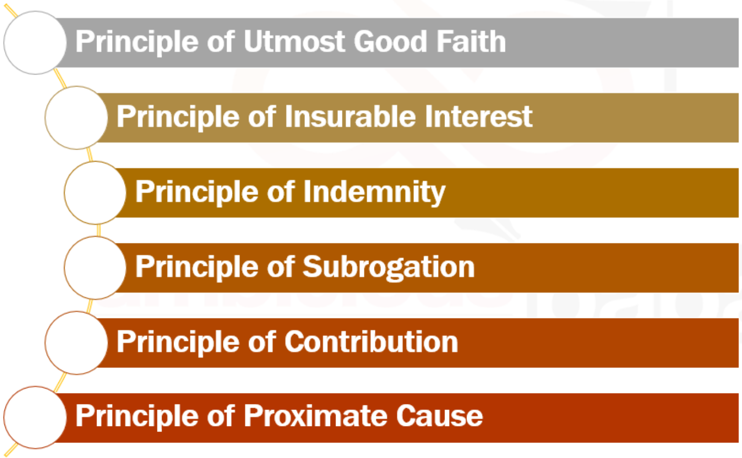
What Is Insurance

- Insurance can be defined as a contract between two parties, where one promises the other to indemnify or make good any financial loss suffered by the latter (the insured), in consideration for an amount received by way **of 'premium'**.
- The contract of insurance is referred to as the **'policy'**.



Fundamental Principles Governing Insurance Products

- The business of insurance aims to protect the economic value of assets or life of a person.
- Apart from the above essentials of a valid contract, insurance contracts are subject to additional principles**. These are:**



The Principle of Utmost Good Faith (Principle of Uberrimae fidei)

- It is a positive duty voluntarily to disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not.
- Non-disclosure of any material fact may be unintentional on the part of the insured.
- Even so, such a contract is rendered voidable, at the insurer's option and it can refuse any compensation.
- An application for life and health insurance is the applicant's proposal to the insurer for protection and is the beginning of the policy contract.
- The proposed insured is required to give accurate answers to questions in the application, relating to his personal and family history, habits, employment, insurance already in force and other applications for insurance that either are pending or have been postponed or refused, etc.
- Any concealment of material facts is considered **'intentional'.**

Principle of Insurable Interest

- The legal right to insure arising out of a financial relationship recognised under the law, between the insured and the subject matter of insurance.
- Insurable interest simply means **"right to insure".**
- The policyholder must have a pecuniary or monetary interest in the property, which he has insured.
- For example, the subject matter of insurance under a fire policy can be a building, stocks, machinery, under a liability policy, it can be a person's legal liability for injury or damage, a ship in a marine policy, etc.
- Any damage to the property must result in financial loss to the policyholder.
- Only then, an insurable interest is said to exist.

- Insurable interest normally arises out of ownership where the insured is the owner of the subject matter of insurance, such as a car or a house.

Principle of Indemnity

- The meaning **of 'indemnity' is** 'the protection or security against damage or loss or security against legal responsibility'.
- Indemnity may be referred to as a mechanism by which, insurers provide financial compensation in an attempt to place the insured in the same pecuniary position, after the loss, as enjoyed just before it.
- The literal meaning of the term **"indemnity"** is making good the loss.
- On the happening of the insured event, for which, the insurance policy is taken up, the insured should be replenished, the amount of loss.
- Life insurance is not a contract of indemnity.
- However, property insurance or personnel accident insurance contracts are contracts of **'indemnity'.**
- Indemnity merely means to make good any financial loss suffered by the insured and to put him or her back in the same financial position, as he or she was, before the occurrence of the loss**.**

The principle of indemnity also aims to control moral hazard. It is possible that the insured may try to secure the maximum amount through dubious and unfair means. For example, he may:

- Deliberately inflict loss upon the property, in order to seek compensation
- Resort to exaggerating the loss
- Make false claims, etc.

Example

Mr. Rajesh owns a restaurant, which he had bought three years ago, for Rs.10 lakhs. He had bought fire insurance worth Rs.8 lakhs (which is the written down value of his insured property). His restaurant caught fire and he suffered a loss of Rs.6.00 lakhs. The amount of compensation to be paid by the insurance company

= `(sum insured/value of insured asset) * actual loss

= `(8 lakhs/10 lakhs) * 6,00,000

= Rs.4,80,000

Principle of Subrogation

- Subrogation means the restitution of the rights of an assured in favour of the insurer.
- In accordance with the principle of subrogation, the insurance company acquires the right of the insured to sue the third-party to compensate for his negligence

and loss inflicted upon, when it indemnifies the insured for the losses suffered by him.

Principle of Contribution

- Contribution is the right of an insurer to call upon others similarly, but not necessarily equally liable to the same insured to share the cost of an indemnity payment. This principle of contribution enables the total claim to be shared in a fair way.
- The amount of total compensation or indemnity provided to the insured by all the insurers should not exceed the amount of loss. In case, one insurer indemnifies the insured in full, the insurance company concerned can claim the share of compensation from other insurance companies.

Principle of Proximate Cause

- It is not the latest, but the direct, dominant, operative and efficient cause that must be regarded as proximate. The term "**Proximate Cause**" literally means the nearest cause or direct cause.
- In insurance parlance, it relates to the immediate cause of the mishap, which resulted in the loss. If a person has bought fire insurance for his house the protection will be from the loss caused by fire, which may have resulted from the sources mentioned in the policy.
- In case the fire occurs from any source other than that mentioned in the policy, the insurer is not liable to compensate the insured.

Classification Of Insurance

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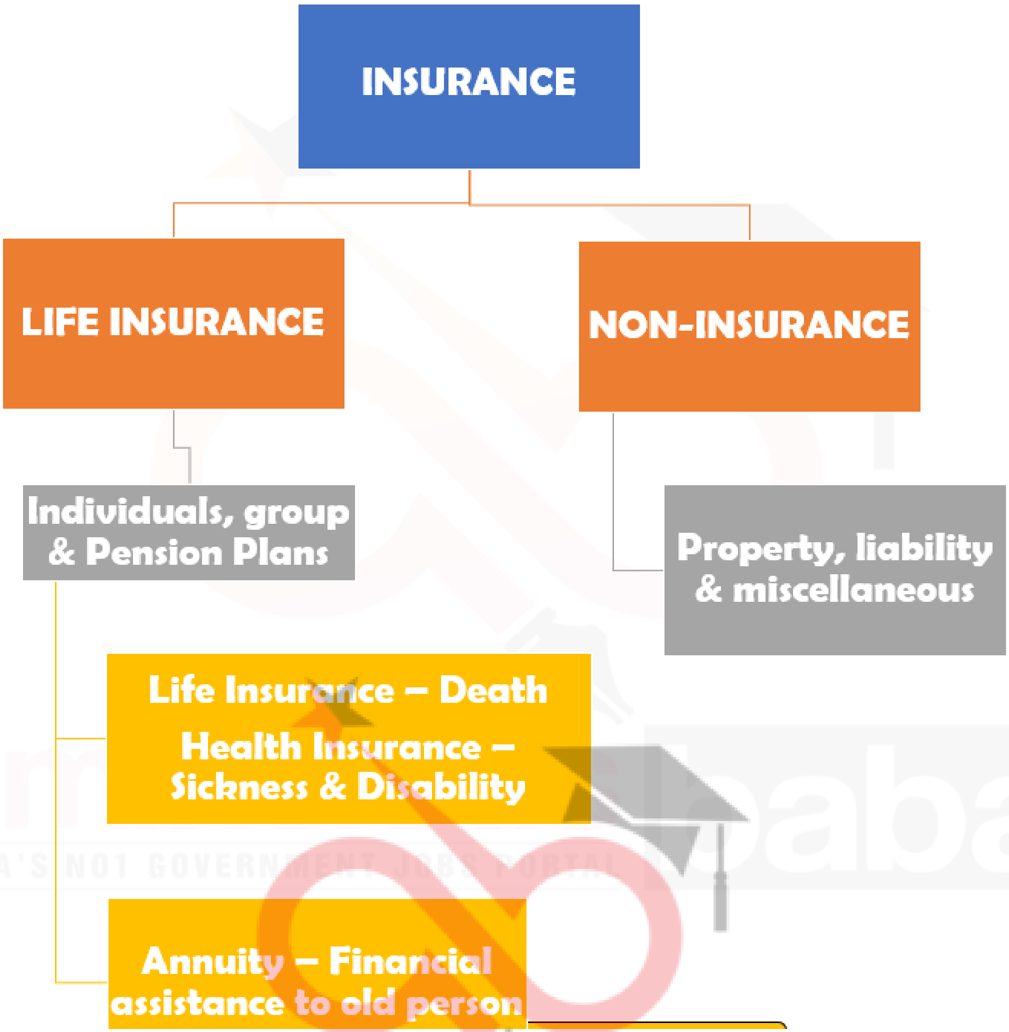


Types Of Insurance Business

The various types of insurance are

Life Insurance Products

Life insurance benefit patterns fit into one or a combination of the following three classes:

- ❑ Term life insurance
- ❑ Whole life insurance
- ❑ Endowment insurance

Term Insurance Plans

- This type of insurance furnishes protection for a limited number of years.
- Terminates with no maturity value.
- The face amount of the policy is payable only if the insured's death occurs, during the stipulated term.
- Nothing is paid in case of survival.
- Issued for a short period but customarily provides protection for at least a set number of years**, such as 10 or 20 years, or to a stipulated age, such as 65 or 70 years.**
- It is more comparable to property and liability insurance contracts than to any other life insurance contract.
- Initial premium rates are low compared to other life products, because the period of protection is limited.

Whole Life Insurance Policies:

- Whole life insurance is intended to provide insurance protection over one's entire lifetime.
- It provides for the payment of the face amount upon the insured's death regardless of when death occurs.
- Universal life policies can function as whole life insurance, if they have sufficient cash value.
- The face amounts payable under whole life policies typically remain at the same level, throughout the policy duration, although dividends are often used to increase the total amount paid on death.

Endowment Insurance Policies

- Unlike term policies, endowment policies promise not only to pay the policy face amount on the death of the insured during a fixed term of years, but also to pay the full-face amount, at the end of the term, if the insured survives the term.

An endowment policy has the following features:

- Endowment plans promise protection from risk in the event of death of the insured during the policy term as well as an assured sum, upon the maturity of the policy. In this type of policy, the maturity of the policy is usually chosen to coincide with the retirement of the person.
- These policies are issued for specific terms chosen by the proposer, who can choose the duration of the polic**y, which may be 10, 15, 20 or 30 years.**

- Where the duration is short the premium involved is higher. It is to be noted that whether the assured meets a premature death or not, the full amount of the policy has to be paid by the insurance company, provided the premiums have been paid, as stipulated in the policy.

Money Back Plans or Cash Back Plans

- Under this plan, certain percentage of the sum assured is returned to the insured person periodically as survival benefit. On the expiry of the term, the balance amount is paid as maturity value.
- The life risk may be covered for the full sum assured during the term of the policy irrespective of the survival benefits paid.

Annuity (Pension) Plans

- When an employee retires, he/she no longer gets his/her salary, while his/her need for a regular income continues. Retirement benefits like Provident Fund and gratuity are paid in lump sum, which are often spent too quickly or not invested prudently with the result that the employee finds himself without regular income in his post - retirement days.

Immediate Annuity

- In case of immediate annuity, the annuity payment from the Insurance Company starts immediately. Purchase price (premium) for immediate annuity is to be paid in lump sum, in one installment only.

Deferred Annuity

- Under deferred annuity policy, the person pays regular contributions to the Insurance Company, till the vesting age/vesting date. The policy holder has the option to pay as single premium also.
- The fund will accumulate with interest and fund will be available on the vesting date. The insurance company will take care of the investment of funds and the policyholder has the option to encash 1/3rd of this corpus fund on the vesting age/vesting date tax free. The balance 2/3rd amount of the fund will be utilised for purchase of annuity (pension) to the annuitant.

Unit Linked Insurance Policy

- Unit Linked Insurance Policies (ULIPs) offer a combination of investment and protection and allow insured the flexibility and choice on how his/her premiums are invested.
- Typically, the policy will provide the insured with a choice of funds in which, he/she may invest. One also has the flexibility to switch between different funds, during the tenure of the policy.

Paid-up Value

- After premiums are paid for a certain defined period or beyond and if subsequent premiums are not paid, the sum assured is reduced to a proportionate sum, which bears the same ratio to the full sum assured

Health Insurance

- **The term 'Health Insurance'** relates to a type of insurance that essentially covers medical expenses.
- A health insurance policy, like other types of policies, is a contract between an insurer and an individual/group in which**,** the insurer agrees to provide specified health insurance cover at a particular **"premium", subject to terms and** conditions specified in the policy.

Coverage of Health Insurance Policy

Expenses reasonably and necessarily incurred under the following heads in respect of the insured person, subject to the overall ceiling of sum insured (for all claims during one policy period**) are covered.**

- Room, Boarding expenses
- Nursing expenses
- Fees of surgeon, anesthetist, physician, consultants, specialists
- Anesthesia, blood, oxygen, operation theatre charges, surgical appliances, medicines, drugs, diagnostic materials, X-ray, Dialysis, chemotherapy, Radio therapy, cost of pace maker, Artificial limbs, cost or organs and similar expenses.

There are some exclusions under health policies which can vary from product to product and from insurance company to company.

The sum insured may be on an individual basis or on a floater basis, for the family as a whole.

Health insurance comes with attractive tax benefits as added incentive. There is an exclusive " **Section 80D,** and which is unlike the section 80C applicable to Life Insurance, wherein, other form of investments/ expenditure also qualify for the deduction.

Travel Insurance

- Travel Insurance offers insurance protection to the policy holder, while on travel.
- It is important for a person to check and understand whether the policy covers domestic travel or overseas travel or both.
- Travel Insurance protects self and/ or family against travel related accidents, unexpected medical expenditure during travel, losses such as baggage loss, loss of passport, etc., and interruption or delays in flights or delayed arrival of baggage, etc.

Motor Insurance

Motor insurance gives protection to the vehicle owner against

- ✓ Damages to his/her vehicle and
- ✓ Pays for any Third-Party Liability, determined as per law, against the owner of the vehicle.

- Third Party Insurance is a statutory requirement.
- The owner of the vehicle is legally liable for any injury or damage to third-party life or property, caused by or arising out of the use of the vehicle in a public place.
- Driving a motor vehicle in a public place, without insurance, is a punishable offence, in terms of the **Motor Vehicles Act, 1988.**

Broadly, there are two types of insurance policies that offer motor insurance cover:

- ✓ Liability Only Policy (Statutory requirement)
- ✓ Comprehensive Policy (Liability Only Policy + Damage to owner's Vehicle usually called O.D. Cover)

- If a person takes only a Liability Only Policy, damage to his/her vehicle will not be covered.
- Hence, it would be prudent to take a Comprehensive Policy, which would give a wider cover, including cover for the vehicle.

Motor Insurance Inclusions:

- ✓ Fire, explosion, self-ignition, lightning
- ✓ Burglary/house-breaking/theft
- ✓ Riot & strike
- ✓ Earthquake
- ✓ Flood, storm, cyclone, hurricane, tempest, inundation, hailstorm, frost
- ✓ Accidental external means
- ✓ Malicious act
- ✓ Terrorism acts
- ✓ While in transit by rail/road, inland waterways, lift, elevator or air
- ✓ Land slide/rock slide Motor Insurance

Third-Party Liability Insurance:

- Mandatory for all vehicles plying on public roads in India.
- This covers liability for injuries and damages to others that a person is responsible for.
- In addition, it is prudent to cover loss or damages to the vehicle itself by way of Comprehensive/ Package policy, which covers both "**Liability" as well as "Own damage" to Insured vehicle.**

Certificate of Insurance under Motor Vehicle Act: As per Rule 141 of Central Motor Vehicle Rules 1989, a certificate of Insurance is to be issued only in Form 51.

It is only in Motor Vehicle Insurance, apart from policy, a separate certificate of insurance

Property Insurance

- Insurance of buildings, machinery, stocks, etc., against fire and allied perils, burglary and so on.
- Goods in transit via sea, air, railways, roads and courier can be insured under Marine Cargo Insurance.
- Hulls of ship and boats can be insured under Marine Hull Insurance.
- Further, there are specialised policies available such as Aviation Insurance Policy, for insurance of planes and helicopters.
- Thus, Property Insurance is a very vast category of General Insurance and the type of cover that a person needs depends upon the type of property a person is seeking to cover.

Fire Insurance

- The most popular property insurance is the standard fire insurance policy. The fire insurance policy offers protection against any unforeseen loss or damage to/destruction of property, due to fire or other perils covered under the policy.
- The different types of property that could be covered under a fire insurance policy are dwellings, offices, shops, hospitals, places of worship, etc., industrial/manufacturing risks and contents such as machinery, plants, equipment and accessories;
- Goods including raw material, material in process, semi-finished goods, finished goods, packing materials, etc., in factories, godowns and in the open.

Burglary Insurance

- **For a business enterprise or for a residential house.**

Covers:

- ✓ Property contained in the premises including stocks/goods owned or held in trust, if specifically covered.
- ✓ Cash, valuables, securities kept in a locked safe or cash box in locked steel cupboard, if a person specifically requests for it.
- ✓ Damage to the house or premises caused by burglars during burglary or attempts at burglary.

- The Policy pays actual loss/damage to the insured property caused by burglary/ house breaking subject to the limit of sum insured.

- If sum insured is not adequate, policy pays only proportionate loss. Hence, one must ensure that the value the property is covered correctly to ensure that there is no under insurance.

Marine Cargo Insurance

Covers

- ✓ Transits by water, air, road or rail, registered post parcel, courier or a combination of two or more of these.
- ✓ The interest in the cargo and also extend to cover the interests of any third party who has acquired interest upon transfer of ownership, as determined by the Terms of Sale.

- **Meaning of Salvage:** In case of claims under various types of insurance policies, the partly damaged goods or the wreck of a car or any machinery or any other property settled on Total Loss Basis is known **as "Salvage".**

Group Insurance Schemes

- Group insurance is a plan of insurance which provides life cover to a number of persons, under a single policy called **the 'Master Policy'.**
- It becomes possible to issue a cover to the group at a low cost, on account of savings in the administrative and medical examination expenses.
- One important feature is with regard to selection and underwriting of lives.

Micro Insurance

- To provide a hedge against these unforeseen risks, micro insurance is widely accepted as one of the essential ingredients of financial inclusion packages.
- Micro insurance regulations issued by IRDA have provided a fillip in propagating micro insurance as a conceptual issue.
- Effective from 2005.
- These regulations are in addition to the obligations for rural and social sector business to be done by all insurers, on an annual basis.
- The IRDAI Micro-Insurance Regulations, 2005 defines a micro-insurance policy, as a general or life insurance policy, **with a sum assured of Rs. 50,000 or less. A general micro-insurance product could be:**
  - ✓ Health insurance contract
  - ✓ Any contract covering belongings such as huts, livestock, etc.
  - ✓ Tools or instruments or Any personal accident contracts

Insurance Based Social Security Schemes

In its drive to achieve a high degree of financial inclusion, including banking and insurance, the Government has introduced two insurance schemes, viz.,

- Prime Minister Jeevan Jyoti Bima Yojana (PMJJBY) and
- Prime Minister Suraksha Bima Yojana (PMSBY)

Prime Minister Jeevan Jyoti Bima Yojana (PMJJBY)

- **Life insurance scheme.**
- **Age group**: 18 to 50 years having a bank/post office account – who give their consent to join/enable auto-debit**.**
- **Primary KYC:** Aadhaar (bank account)
- Life cover, which is for **Rs. 2 lakhs, is available for a 1-year period**, stretching from 1st June to 31st May of each year and is renewable every year.
- Risk coverage under this scheme **is for Rs 2 lakhs in case of death of the insured, due to any reason.**
- **Premium:** Rs. 436 per annum
- Offered through LIC and all other life insurers, who are offering the product on similar terms, with necessary approvals and tie up with banks and Post Offices, for this purpose.
- Payment of pro-rata premium is permitted**.**
- **The premium is Rs. 436 per annum** as per the option given by him on or before 31st May of each annual coverage period under the scheme**.**

Prime Minister Suraksha Bima Yojana (PMSBY)

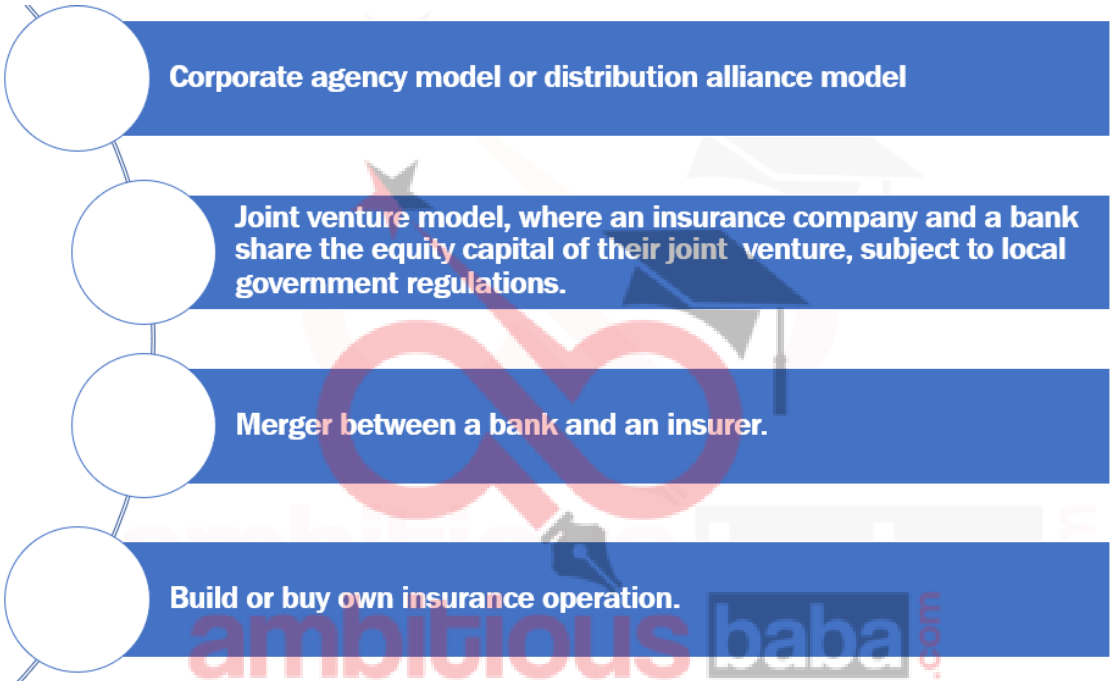
- **An accident insurance scheme.**
- **Age group 18 to 70 years,** with a bank/post office account, who give their consent to join/enable auto-debit on or before 31st May, for the coverage period 1st June to 31st May, on an annual renewal basis.
- **Aadhaar is the primary KYC for the bank account.**
- **Risk coverage:** Rs. 2 lakhs for accidental death and full disability and Rs. 1 lakh for partial disability.
- While full disability has been defined as loss of use in both eyes, hands or feet, partial disability has been defined as loss of use in one eye, hand or foot.
- Further, death due to suicide, alcohol, drug abuse, etc., are not covered.
- **Premium:** Rs. 20 per annum
- The scheme is offered by Public Sector General Insurance Companies or any other General Insurance Company who are offering the product on similar terms, with necessary approvals and tie up with Banks and Post Offices for this purpose.

Bancassurance

- **Bancassurance is defined as selling of insurance products through banks.** However, it is not just about selling insurance products to bank customers but exploiting the true synergies between the bank and insurer and optimally utilising their respective strengths.
- The concept of Bancassurance has roots in France in 1980s, and has spread across different parts of Continental Europe since then. It has also spread its wings in Asia, particularly in India. It commenced in India in the year 2000, when the Government issued a notification under the Banking Regulation Act, which allowed Indian Banks to undertake insurance distribution business.

Bancassurance Models

Internationally, 4 models of Bancassurance are in vogue



JAIIB Paper 1 IE & IFS Module D Unit 15: Pension Products

Pension System and Its Aspects

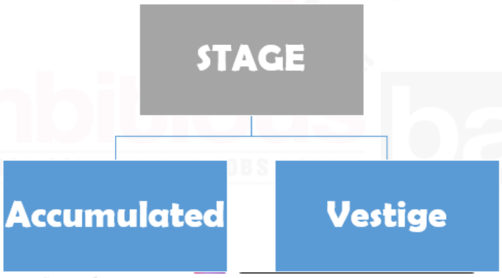
A Pension provides a monthly income to the people during their unproductive years. ***Pension is necessary for the following reasons*****:**

- Decreased income earning potential, with increase in age,
- The rise of nuclear family,
- Migration of earning members,
- Rise in cost of living,
- Increased longevity, and
- Dignified life in the old age due to less financial dependence.

Pension Products

- While both pension and life insurance products help individual to take care of one's future and the future of one's family members, there are a few differences between life insurance plans and pension plans.
- While life insurance protects the individual from the financial consequences of premature death, pension products address the risk of living too long so that one's resources are adequate to support one's standard of living during the old age.

They generally have two stages of operation of pension products:



Accumulation stage

When one pays a specific amount regularly until the person's retirement.

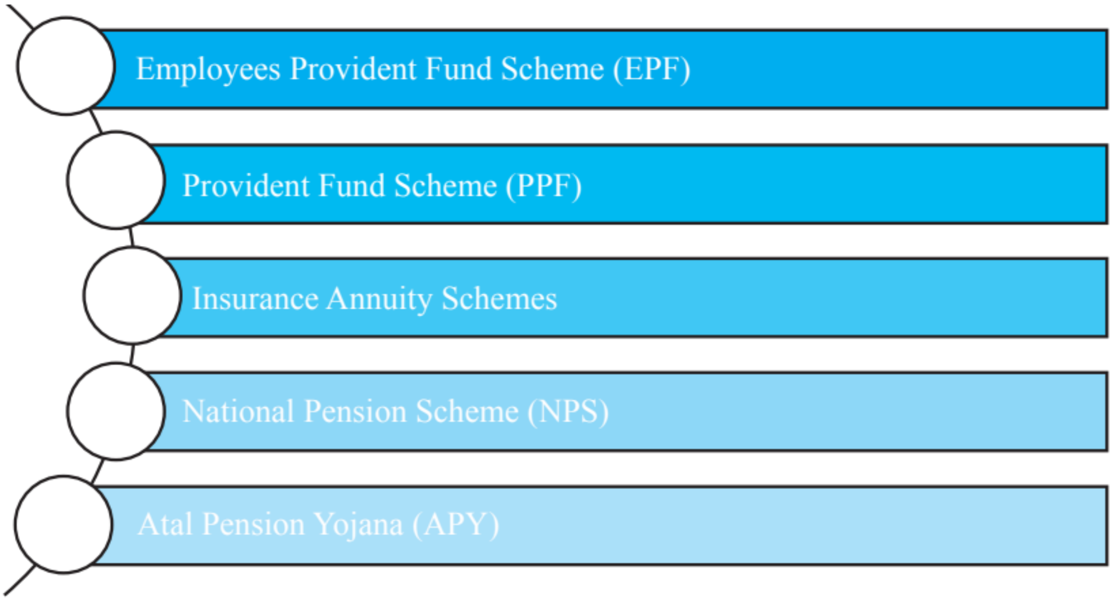
Vesting stage

Once the individual retires, he gets a steady flow of income for the rest of his life. Any pension product must perform the following five core functions with a reasonable degree of competence and efficiency.

- Reliable collection of contributions, taxes and other receipts (including any loan payments in the security systems);
- Payment of benefits for each of the schemes, in a timely and correct way;
- Securing financial management and productive investment of pension fund assets;

Different Types Of Pension Schemes

Some of the different types of Pension schemes that are prevalent



Employees Provident Funds Scheme

- This mandatory pension scheme for the private sector is managed **by the Employees'** Provident Fund Organisation (EPFO).
- **Set up :1952**
- Covers employees in specified economic sectors at firms with more than 20 employees.
- It is a statutory body under the Ministry of Labour, GOI,
- Responsible for regulation and management of provident funds in India.
- The EPFO administers the mandatory provident fund, while outsourcing the management of the scheme's assets to fund managers. Traditionally, assets have been managed by PSU banks. Employers can be exempted from participation, if their pension plans provide at least the same level of benefits (see Exempted Funds).
- Taking into account the **Employees' Provident Fund and Miscellaneous Provisions Act, 1952,** the schemes of EPFO are administered by a **tri-partite board called the Central Board of Trustees.**

The board comprises representatives of the

- Government (both Central and State),
- employers, and employees.
- Chaired by the Ministry of Labour and Employment, Government of India.

The EPFO operates the following three major schemes:

- Employees' Pension Scheme (EPS),
- Employees' Deposit Linked Insurance Scheme (EDLIS) and

- Employees' Provident Fund Scheme (EPF).
- All the three schemes are mandatory for employees.
- EPFO assists the Central Board of Trustees (EPF) in the administration of a provident fund scheme, pension scheme and an insurance scheme for the registered establishments in India and includes employees of such establishments and international workers who are covered.

EPFO's functioning includes:

- Enforcement of the Act across the country
- Maintenance of individual accounts
- Settlement of claims
- Investment of funds
- Ensuring prompt pension payment
- Updating records

Benefits of EPF

- **High Interest** – An individual gets an interest rate of 8-9 per cent on the EPF balance held in the account. Currently, the interest rate in India is 8.10 per cent for the financial year 2021-22. This high rate of interest facilitates retirement planning.
- **Exemption from Tax** – EPF falls under the EEE (Exempt Exempt Exempt) category. That is, the money invested in EPF, the interest that is earned, and the money that is withdrawn – are all exempted from payment of income tax. (Note – If one withdraws money in case of emergencies before a specified period of 5 years, there will not be any exemption from tax).
- **Low Risk** – EPF is an extremely low-risk investment. Hence, it gives the individual a safe option to invest his money with the added advantage of government backing.
- **Life Insurance–** EPF also acts as life insurance. In case of death of the employee, the corpus goes to the family of the deceased.
- **Hassle-free –** Owing to the UAN, an employee needs to open an EPF account only once and then, it can be transferred to his subsequent employers.

Public Provident Fund (PPF) Scheme

- Launched by the National Savings Institute and is one of the post office savings schemes.
- PPF is one of the popular government investment instruments.
- The **lock-in period is 15 years for a PPF**, and one can extend their investment in PPF for another five years.
- Eligible for a tax deduction.

- **Investments up to Rs 1,50,000**, can be claimed for tax deduction **under Section 80C of the Income Tax Act.**
- Moreover, returns from PPF are completely tax exempted.
- **Minimum investment each year**: Rs 500
- **Maximum investment** is: Rs. 1,50,000.
- Investors cannot open multiple accounts.
- The interest is compounded annually.
- Can be deposited in the form of a lump sum amount or in instalments**, up to 12 instalments, per financial year.**
- Any Indian citizen can avail the benefits of this savings plan.
- NRIs and HUFs are not eligible to open a PPF account.
- Additionally, investors can avail a loan against PPF investments, and such **loans can be availed between the 3 and the 15 year.**
- **As PPF has a lock-in period of 15 years, their** benefits can be reaped during retirement, by the investors.

Insurance Annuity Schemes

- The term annuity simply means a regular and periodic payment.
- Insurance companies pay pension annuities to individuals (annuitants) or their dependents after their death, over a number of years (term), in return for money paid earlier to the insurance company, either in a lump sum or in instalments.
- Annuities start where life insurance ends. It is called as the reverse of life insurance.
- Annuity stops upon death of a person, whereas theoretically, life insurance starts on the death of the assured.

Annuities are of two broad types

Immediate Annuity

- Immediate Annuity begins at once.
- Immediate annuity is purchased with a single premium called purchase price.
- This type of annuity is typically purchased, when a person reaches retirement age and has a lump sum to invest.
- In the event of unfortunate death of the person buying annuity during the term, his/her legal heirs or nominees shall get the remaining instalments of the annuity.

Deferred Annuity

- Under a deferred annuity plan, the annuity payments to the annuitant commence at some specified time or specified age of the annuitant. This type of annuity can be funded either by a single payment or a series of regular payments.

National Pension Scheme (NPS)

- The National Pension Scheme is a social security initiative by the Central Government.
- This pension programme is open to employees from the public, private and even the unorganised sectors.
- Employees of the armed forces are, however, excluded.
- The scheme encourages people to invest in a pension account, at regular intervals, during the course of their employment.
- After retirement, the subscribers can take out a certain percentage (up **to 60%) of the corpus.**
- As an NPS account holder, the subscriber will receive the remaining amount, as a monthly pension, during the post-retirement period.
- Now, as per PFRDA guidelines, it is open to all the Indian citizens, on a voluntary basis
- The scheme is portable across jobs and locations, with tax benefits, under **Section 80C and Section 80CCD of the Income Tax Act.**
- Administered and regulated by Pension Fund Regulatory and Development Authority (PFRDA), set up **under the PFRDA Act, 2013.**
- NPS is a market linked, defined contribution product.
- Under NPS, a unique Permanent Retirement Account Number (PRAN) is generated and maintained by the Central Recordkeeping Agency (CRA), for individual subscriber.
- **NPS offers two types of accounts, namely Tier-I and Tier-II.**
- **Tier-I** account is the pension account having restricted withdrawals**.**
- **Tier-II** account is a voluntary account, which offers liquidity of investments and withdrawals.
- It is allowed only when there is an active Tier-I account in the name of the subscriber.
- The contributions accumulate over a period of time; till retirement the contributions made to the fund grow with market linked returns.
- NPS platform offers different models to suit the different segments of users**.**

Tax Benefits available under NPS

- Own Contribution towards NPS Tier-I is eligible for tax deduction, **under section 80 CCD (1) of the Income Tax Act, within the overall ceiling of Rs. 1.50 lakhs,** under **section 80 C of the Income Tax Act.** From FY 2015-16, the subscriber is also allowed an additional **tax deduction of Rs 50,000 maximum, under section 80CCD 1(B) of the IT Act**
- Employer's contribution towards **NPS Tier-I is eligible for tax deduction** under **Section 80CCD (2) (14% of salary for Central Government employees and 10% for others).** This rebate is over and above the limit prescribed under Section 80C
- Interim/Partial **withdrawal up to 25% of the contributions** made by the subscriber from NPS Tier-I is tax free.
- With effect from 1 April, 2019, **lump sum withdrawal up to 60%** of total pension wealth from NPS Tier-I at the time of superannuation is tax exempt.

Atal Pension Yojana (APY)

- **Focus:** Unorganised sector workers
- **Minimum guaranteed pension of Rs. 1,000 or Rs. 2,000 or Rs. 3,000 or Rs. 4,000 or Rs. 5,000 per month** will start after attaining **the age of 60 years,** depending on the contributions made by the subscribers for their chosen pension amount.
- **Any citizen of India, including an NRI, is eligible to join the APY scheme.**

Eligibility criteria:

- **Age:** between 18 - 40 years.
- He/ She should have a savings bank account/ post office savings bank account. In case, the person does not have a savings account, he/she should approach a bank branch/post office to open a savings account.

Taxation Benefits

- Under APY Under Section 80CCD (1) of the Income Tax Act, investment in APY up to Rs 1.5 lakhs, qualifies for income tax deduction.
- It should, however, be noted that the total amount of deductions under sections 80C, 80CCC and 80CCD under the Income Tax Act, cannot exceed Rs 1.5 lakhs.
- In addition, an investment up to Rs 50,000 in the APY is deductible from taxable income, under Section 80CCD (1B) of the Income Tax Act, 1961.

JAIIB Paper 1 IE & IFS Module D Unit 16: Para Banking and Financial Services Provided By Banks

Introduction

- Banks are permitted to conduct a number of other activities, which are called para banking and Financial Services activities.

Types Of Para Banking And Financial Services Activities

- These services were earlier named as Para Banking Services (RBI Master Circular dated 1st July 2015).
- Subsequently, RBI has come out with Master Direction, 2016, wherein, Prudential Regulations for Investment by a bank in a subsidiary or in a financial services company (not being a subsidiary) or a non-financial services company have been provided. RBI, in its **Master Direction (2016) has further expanded the scope of these services by adding the following financial activities:**
- Investment advisory services
- Agency Business by Banks
- Broking services for commodity trading segment

Activities of banks which come under para banking and Financial Services, as per the RBI Master Circular dated 1st July 2015 and the Master Directions (2016) on "Financial Services provided by Banks" dated 26th May 2016 (updated 10th August 2021) are as follows:

- Sponsoring of an Infrastructure Debt Fund
- Equipment Leasing and Hire Purchase Business
- Factoring Services
- Primary Dealership Business
- Underwriting Activities
- Mutual Fund Business
- Insurance Business
- Pension Fund Management by Banks
- Investment Advisory Services
- Portfolio Management Services
- Agency Business by Banks
- Referral Services
- Retailing of Government Securities
- Membership of SEBI approved Stock Exchanges
- Broking services for Commodity Derivatives Segment
- Banks' investment in Venture Capital funds
- Cheque writing facility for investors of money market mutual funds
- Safety net Services

Organisation Of Para Banking and Financial Services Activities By A Bank

- Banks can undertake certain eligible financial services or para-banking activities, either departmentally or by setting up subsidiaries for the purpose.

- Banks may form a subsidiary company, for undertaking the types of businesses, which a banking company is otherwise permitted to undertake, with prior approval of Reserve Bank of India.

General Guidelines

- ✓ Bank desirous of undertaking the businesses permitted **under Section 6(1) of the Banking Regulation Act, 1949** may do so, either departmentally or through a separate subsidiary set up for the purpose, under the provisions of **Section 19(1) of the Banking Regulation Act, 1949.**
- ✓ An activity undertaken departmentally shall follow RBI guidelines on KYC compliance and Charter of Customer Rights issued. In addition, all the instructions/regulations of respective regulators such as SEBI, IRDA and PFRDA, as applicable, shall also be complied with. Master Directions on '**Prudential Norms for Banks Exposures'** wherever applicable, shall also be complied with.
- ✓ Banks are also allowed to hold equity in both financial services companies as well as companies not engaged in financial services activities, within the limits specified **under the provisions of Section 19(2**) of the **Banking Regulation Act, 1949**, and subject to the prudential limits, as enumerated in this chapter.

- **Factoring:** Means factoring as defined in the Factoring Regulation Act, 2011.
- **Financial Services Company:** Means a company engaged in the 'business of financial services'
- **Hire Purchase**: Means hire purchase as defined in the Hire Purchase Act, 1972.
- **Infrastructure Debt Fund**: means an infrastructure debt fund as defined in the Notification no. DNBS.233/CGM (US)-2011 dated November 21, 2011, as amended from time to time.
- **Investment Advisory Service:** Means the service offered by an investment advisor, as defined in the SEBI (Investment Advisors) Regulations, 2013.
- **Mutual Fund**: means a fund as defined in SEBI (Mutual Funds) Regulations, 1996.
- **Non-Financial Services Company**: Means a company not engaged in any of the business mentioned in Section 3(vi) of these Directions.
- **Pension Fund Management**: Means management of a pension fund, as defined in the Pension Fund Regulatory Development Authority (Exit and Withdrawals under National Pension System) Regulations, 2014.
- **Portfolio Management Services**: Means the service offered by a portfolio manager, as defined in the SEBI (Portfolio Managers) Regulations, 1993.
- **Referral Services**: Means the arrangement between a bank and a third-party financial product provider, for referring the customers of the bank to the third-party financial product provider.

Prudential Regulation for Banks' Investments in a subsidiary or in a financial services company

Limits on investments:

- Equity investment in a subsidiary company, or a financial services company, not being a subsidiary, individually, shall not exceed: 10% of the bank's paid-up share capital and reserves, as per the last audited balance sheet or a subsequent balance sheet, whichever is lower.
- The aggregate of equity investment in factoring subsidiaries and factoring companies shall not exceed 10% of the bank's paid- up capital and reserves
- Bank shall not contribute more than 49% of the equity of Infrastructure Debt Fund, set up as a Non-Banking Finance Company (IDF-NBFC
- A bank contributing less than 30% of the equity of IDF-NBFC shall not be a sponsor.
- **Restrictions on Exposure**:
  - ✓ Banks are not allowed to hold more than 10% in the equity of a deposit taking NBFC (other than a housing finance company).
  - ✓ Further, Banks should not invest more than 10% of the unit capital of a Real Estate Investment Trust/Infrastructure Investment Trust, subject to overall ceiling of 20% of its net worth permitted for direct investments in shares, convertible bonds/debentures, units of equity oriented mutual funds and exposures to Alternative Investment Funds Besides, Banks should not hold more than 10% of the paid-up capital of a company, not being its subsidiary engaged in non-financial services or 10% of the bank's paid-up capital and reserve, whichever is lower.
  - ✓ However, investments in excess of 10% but not exceeding 30% of the paid-up share capital of such investee company shall be permissible, if the investee company is engaged in nonfinancial activities permitted for banks in terms of Section 6(1) of the Banking Regulation Act, 1949; or the additional acquisition is through restructuring of debt or to protect the banks' interest on loans/investments made to a company.
  - ✓ Banks should not hold along with their subsidiaries, associates or joint ventures or entities directly or indirectly controlled by the bank; and mutual funds managed by Asset Management Companies (AMCs) controlled by the bank, more than 20% of the investee
  - ✓ company's paid-up share capital engaged in non-financial services. However, this cap doesn't apply to the investee company engaged in non-financial activities permitted for banks or in case the additional acquisition is through restructuring of debt or to protect the banks' interest on loans/investments made to a company.
  - ✓ Any investment by a bank's subsidiary in a Category III Alternative Investment Fund (AIF) shall be governed by the SEBI Regulations. Hence, Banks are not allowed to invest in AIF (category –III)

Banks' aggregate equity investments made in all subsidiaries and other entities engaged in financial services and non-financial services, including overseas investments shall **not exceed 20% of the bank's paid-up share capital and reserves (not applicable for investments held under 'Held for Trading' category [90-day defeasance**

period]) and investments in excess of 10% in non-financial companies acquired through restructuring of debt or to protect the banks' interest on loans/investments.

Banks are required to take prior approval of RBI

Before making investment in a subsidiary and a financial services company that is not a subsidiary. However, in following cases, such prior approval shall not be necessary:

- ✓ The investment is in a company engaged in financial services; and
- ✓ The bank has the minimum prescribed capital (including Capital Conservation Buffer) and has also made a net profit in the immediately preceding financial year; and
- ✓ The shareholding of the bank including the proposed investment is less than 10% of the investee company's paid-up capital; and
- ✓ The aggregate shareholding of the bank along with shareholdings, if any, by its subsidiaries or joint ventures or other entities directly or indirectly controlled by the bank, is less than 20% of the investee company's paid-up capital.
- ✓ It may be explained that prior approval of RBI shall not be required, if the investments in the financial services companies are held **under the 'Held for Trading' category and are not held beyond 90 days.**
- ✓ As directed by the RBI, prior permission of the RBI is required for making investment in a nonfinancial services company in **excess of 10% of such** investee company's paid-up share capital, where the investee company is engaged in non-financial activities permitted for banks in terms **of Section 6(1) of the Banking Regulation Act, 1949.**

Besides, prior permission of the RBI is also needed before making investment **of more than 10% of the paid-up capital/ unit capital in a Category I/ Category II Alternative Investment Fund (AIF).**

Para-Banking and Financial Services Undertaken By A Bank

Sponsoring of an Infrastructure Debt Fund

- Infrastructure Debt Funds (IDFs) can be set up either as a Mutual Fund (IDF-MF) or a Non-Banking Finance Company (IDF-NBFC), subject to Board approval and after making proper disclosure in the prospectus/offer document that the sponsoring bank's liability is limited to the extent of its contribution to the paid-up capital.

Equipment Leasing and Hire Purchase Business

- Banks can form subsidiary companies for undertaking equipment leasing and hire purchase, with prior approval of RBI.

The following guidelines should govern the conduct of such business by the banking companies:

- ✓ The subsidiaries/joint ventures formed should primarily be engaged in any of the above-mentioned activities and such other activities as are incidental to equipment leasing, hire purchase business and factoring services.
- ✓ While banks may invest in other equipment leasing/hire purchase/factoring companies, within the limits specified in **Section 19(2) of Banking Regulation Act, 1949,** with the Reserve Bank's prior approval, they shall not act as promoters of such companies.
- ✓ They should be undertaken only by certain select branches of banks having such facilities/arrangements.
- ✓ The facilities extended by way of equipment leasing, hire purchase finance and factoring services would be covered within the extant exposure ceilings. Banks should maintain a balanced portfolio of equipment leasing, hire purchase and factoring services vis-à-vis the aggregate credit.
- ✓ Banks are required to frame an appropriate policy on leasing business with the approval of their Boards and evolve safeguards to avoid possible asset liability mismatch.
- ✓ Any changes brought about in respect of guidelines in asset classification, income recognition and provisioning for loans/advances and other credit facilities would also be applicable to leased assets of banks, undertaking leasing activity departmentally.
- ✓ Equipment Leasing and Hire Purchase business through a subsidiary shall be subject to compliance with all Prudential Regulations for Banks' Investments.

Factoring Services

The following aspects to be kept in view by banks in relation to the factoring of receivables by factors vis-a-vis borrowings of the clients from banks:

- ✓ Banks and factors should share information about common borrowers.
- ✓ Banks are required to issue letters of disclaimer to the factor/s on book debts factored, to facilitate assignment of debt and factors in turn, should route the proceeds of repayment and final adjustment through the borrowers' bank.
- ✓ Borrowers should declare separately the extent of book debts proposed to be factored and those against which, bank finance is to be obtained in their projection for assessment of bank credit. Banks may also take into account, the finance availed under factoring, while sanctioning loans to the borrower.

The borrower's bank may also obtain from the borrower, periodical certificates regarding factored receivables, to avoid double financing.

i)Factor may intimate the limits sanctioned to the borrower to the concerned bank/s and details of debts factored to avoid double financing. This could be cross checked with the certificate obtained by banks from borrowers.

ii)All Prudential Regulation for Banks' Investments have to be complied with, while undertaking business through a subsidiary.

- ✓ Factoring services shall be subject to extant prudential norms on loans and advances.
- ✓ Credit information of any default on dues by the person on whom exposure was booked shall be furnished to the Credit Information Companies authorised by RBI, subject to the guidelines under **Credit Information Companies (Regulation) Act, 2005.**

Primary Dealership (PD) Business

- For undertaking the PD business through a subsidiary, a bank should be registered as an NBFC with RBI (DNBR)
- For undertaking the PD business departmentally the bank is required to be registered with RBI(IDMD) for the same.
- A primary dealer (PD) is an RBI registered entity that is authorised in buying and selling government securities.
- There are two types of primary dealers in India

Standalone primary dealers: Either subsidiaries of scheduled commercial banks, Indian subsidiaries of entities incorporated abroad or

companies incorporated under Companies Act and are registered as Non-Banking Financial Companies (NBFCs).

Banks fulfilling the following minimum eligibility criteria may apply to RBI for approval, for undertaking primary dealership business, provided they fulfil the following criteria:

- ✓ Minimum Net Owned Fund of Rs 1,000 crores
- ✓ Minimum CRAR of 9 %
- ✓ Net NPAs of less than 3% and a profit-making record for the last 3 years

Underwriting Activities

- Underwriting of issues of shares, debentures and bonds may be undertaken, either departmentally or through a merchant banking subsidiary.
- Underwriting business undertaken departmentally and through subsidiary, shall be subjected to Prudential Regulation for Banks' Investments Banks are

permitted to extend underwriting activities for corporate shares and debentures and PSU bonds, as part of para banking activities.

- While underwriting issues, as a part of their merchant banking activities, banks should ensure the prudential exposure norms, prescribed by RBI from time to time, as well as the statutory limits contained in **Sections 19(2) & (3) of the Banking Regulation Act, 1949 are** strictly adhered to. Further, while undertaking such activities, banks as well as their merchant banking subsidiaries would also be required to comply with relevant SEBI regulations.

Mutual Fund Business

Banks desirous of undertaking mutual fund business should obtain prior approval of RBI, for setting up such funds, subject to the following:

- Bank-sponsored mutual funds should comply with the guidelines issued by SEBI, from time to time.
- Where a bank's name has been associated with the mutual Fund, a suitable disclaimer clause should be inserted, while publicising new schemes that the bank is not liable or responsible for any loss or shortfall resulting from the operations of the scheme.

Insurance Business

No bank shall undertake insurance business with risk participation except through a subsidiary/joint venture set up for the purpose, ***subject to fulfilment of the eligibility criteria (as on March 31 of the previous year) as under:***

- It has a **net worth of `1000 crore and its minimum net worth** shall not be less than **`500 crore after investing in the equity of such company;**
- It has the minimum prescribed capital (including Capital Conservation Buffer) after investment
- Its level of net non-performing **assets is not more than 3 per cent;**
- It has made a net profit in the preceding three financial years; and
- The track record of the performance of its subsidiaries, if any, is satisfactory.

Undertaking of insurance broking/corporate agency by a subsidiary/joint venture:

No bank shall set up a subsidiary/joint venture company for undertaking insurance broking and corporate agency, until it fulfils the eligibility criteria (as on March 31 of the previous year) as under:

- Its net worth shall not be less **than `500 crore** after investing in the equity of such company;
- It complies with conditions **stated at 7(a) ii, iii, iv and v.**

Pension Fund Management by Banks

Banks may undertake the business of pension fund management only through a subsidiary set up for the purpose***, subject to the fulfilment of the eligibility criteria (as on March 31 of the previous year) listed below:***

- Banks shall not undertake the business of pension fund management departmentally.
- Its net worth shall not be **less than `500 crore after investing in the equity of such company;**
- It has the minimum prescribed capital (including Capital Conservation Buffer) after investment;
- Its level of net non-performing assets is not more than 3 per cent;
- It has made a net profit in the preceding three financial years; and
- The track record of the performance of its subsidiaries, if any, is satisfactory.

Investment Advisory Services (IAS)

- Banks may undertake the business of investment advisory services (IAS), through a separate subsidiary, set up for the purpose or one of its existing subsidiaries and after taking specific prior approval.
- IAS shall be provided only for products and services in which banks are permitted to deal in as per the **Banking Regulation Act, 1949.**

Agency Business by Banks

- Agency business shall be undertaken only for the products and services, in which, a bank is permitted to deal in, **as per Banking Regulation Act, 1949.**
- The service shall be provided on fee basis, without any risk participation.
- Agency business of mutual fund companies undertaken departmentally shall be subject to the **following additional conditions**:
  - ✓ The investors' applications for purchase/sale of mutual fund units shall be forwarded to the mutual funds/registrars/transfer agents.
  - ✓ The purchase of units shall be at the customers' risk without the bank guaranteeing any assured return.
  - ✓ No mutual fund units shall be acquired from the secondary market or bought back from a customer for selling it to other customers.
  - ✓ Extension of credit facility to individuals against the security of mutual fund units shall be in accordance with the Master Directions on Credit Management issued by the RBI.
  - ✓ A bank holding custody of mutual fund units on behalf of its customers shall keep the investments of the customers distinct from its own investments.

Referral Services

- Banks offering referral services shall do so only for financial products other than insurance, on a nonrisk participation basis.

- Referral Services means the arrangement between a bank and a third-party financial product provider, for referring the customers of the bank to the third-party financial product provider. Banks are permitted to offer referral services to their customers for financial products, **subject to the following conditions**:
  - ✓ The bank/third-party issuers of the financial products should strictly adhere to the Know Your Customer (KYC)/Anti-Money Laundering (AML) guidelines in respect of the customers, who are being referred to the third-party issuers of the products.
  - ✓ The bank should ensure that the selection of third-party issuers of the financial products is done in such a manner so as to take care of the reputational risks to which the bank may be exposed to, in dealing with the third-party issuers of the products.
  - ✓ The bank should make it explicitly clear upfront to the customer that it is providing purely a referral service strictly on a non-risk participation basis.
  - ✓ The third-party issuers should adhere to the relevant regulatory guidelines applicable to them, and while offering referral services, the bank should strictly adhere to the relevant RBI guidelines.

Retailing of Government Securities

As part of para banking and financial activities, banks are permitted to undertake the business of retailing of Government Securities with non-bank clients, in terms of the guidelines issued by RBI from time to time, as applicable. ***They also need to adhere to the following conditions:***

- Banks are free to buy and sell Government Securities, on an outright basis, at prevailing market prices, without any restriction on the period between sale and purchase.
- Banks shall not undertake ready forward transactions in Government Securities, with non-bank clients.
- The retailing of Government Securities should be on the basis of ongoing market rates/yields.
- No sale of Government Securities should be effected by banks, unless they hold the securities in their portfolio either in the form of physical scrips or in their SGL Account maintained with RBI.
- Immediately upon sale, the corresponding amount should be deducted by the bank from its investment account and also from its SLR assets.
- Banks should put in place adequate internal control checks/mechanism in this regard.
- These transactions should be subjected to concurrent audit, as per RBI's extant instructions and should also be looked into by the auditors, at the time of bank's statutory audit.

Membership of SEBI approved Stock Exchanges

The AD Category- I scheduled commercial bank shall not become a trading/clearing member of the currency derivatives segment of the ***SEBI recognised stock exchanges unless –***

- It has a minimum net worth of `500 crore;
- It has the minimum prescribed capital (including Capital Conservation Buffer);
- Its net NPA does not exceed 3 per cent and
- It has made a net profit in the preceding three financial years.

Broking services for Commodity Derivatives Segment

No bank shall offer broking services for the commodity derivatives segment of SEBI recognised stock exchanges except through a separate subsidiary set up for the purpose or one of its existing subsidiaries and shall do so subject to the following conditions:

- The subsidiary shall, with the approval of its Board, put in place effective risk control measures including prudential norms on risk exposure in respect of each of its clients, taking into account their net worth, business turnover, etc.
- The subsidiary shall not undertake proprietary positions in the commodity derivatives segments.
- The subsidiary shall ensure strict compliance with various margin requirements as may be prescribed by SEBI, its own board or the "**Commodity Exchanges.**"

Investment in Venture Capital Funds

- Various aspects of venture capital funds have been dealt with in a separate chapter covered earlier in this Module. In view of the significance of venture capital activities and the need for banks' involvement in financing of Venture Capital Funds (VCFs), it is important to address the relatively higher risks inherent in such exposures.
- As such, banks should obtain prior approval of RBI, for making strategic investment in VCFs, i.e., investments **equivalent to more than 10 per cent of** the equity/unit. All exposures to VCFs (both registered and unregistered) will be deemed to be on par with equity and hence will be reckoned for compliance with the capital market exposure ceilings (ceiling for direct investment in equity and equity linked instruments as well as ceiling for overall capital market exposure).

Money Market Mutual Funds (MMMFs)

- Money Market Mutual Funds (MMMFs) come under **the purview of SEBI regulations.**
- However, banks desirous of setting up MMMFs would have to, initially, seek necessary clearance from RBI for undertaking this additional activity before approaching SEBI for registration.

Cheque Writing Facility for Investors of Mutual Funds/Money Market Mutual Funds

Banks are permitted to tie-up with MMMFs as also with MFs, in respect of Gilt Funds and Liquid Income Schemes, which predominantly invest in money market instruments (not less than 80% of the corpus) to offer cheque writing facilities to investors, **subject to the following safeguards:**

- In the case of a MMMF set up by a bank, the tie-up arrangement should be with the sponsor bank. In other cases, the tie-up should be with a designated bank. The name of the bank should be clearly indicated in the Offer Document of the Scheme.
- The Offer Document should clearly indicate that the tie-up to offer cheque writing facility is purely a commercial arrangement between the MMMF/MF and the designated bank
- The facility to any single investor in the MMMF/MF can be permitted at the investor's option, in only one of the branches of the designated bank.
- This should be in the nature of a drawing account, distinct from any other account, with clear limits or drawals, the number of cheques that can be drawn, etc., as prescribed by the MMMF/MF. No deposits can be made in the account. Each drawal made by the investor under the facility should be consistent with the terms prescribed by the MMMF/MF and treated as redemption of the holdings in the MMMF/MF to that extent.
- The facility can be availed of by investors only after the **minimum lock-in period of 15 days for investments in MMMFs** (not applicable in the case of eligible Gilt Funds and Liquid Income Schemes of mutual funds and any prescription of lock-in-period in such cases will be governed by SEBI Regulations).
- The bank should ensure pre-funding of the drawing account by the MMMF/MF at all times and review the funds position on a daily basis.

Safety Net Schemes

- Safety Net is a scheme where the company's promoters assure that they will buy back shares from the retail applicants at the IPO price, if its stock falls sharply during the first six months after listing.
- **It was proposed by the market regulator SEBI in 2012.**
- **SEBI had formulated draft norms for safety net after its study showed that 62% of 117** companies listed between 2008 and 2011 fell below IPO price within the first six months of listing.
- SEBI, however, could not make it mandatory after the proposal
- RBI had observed that some banks/their subsidiaries were providing buy back facilities under Safety Net Schemes in respect of certain public issues as part of their merchant banking activities.
- Under such schemes, large exposures are assumed by way of commitments to buy the relative securities from the original investors at any time during a

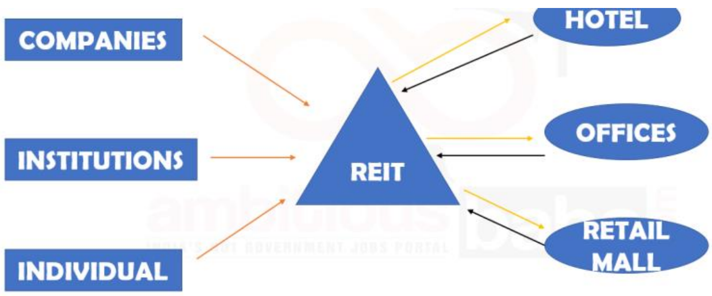
stipulated period at a price determined at the time of issue, irrespective of the prevailing market price.

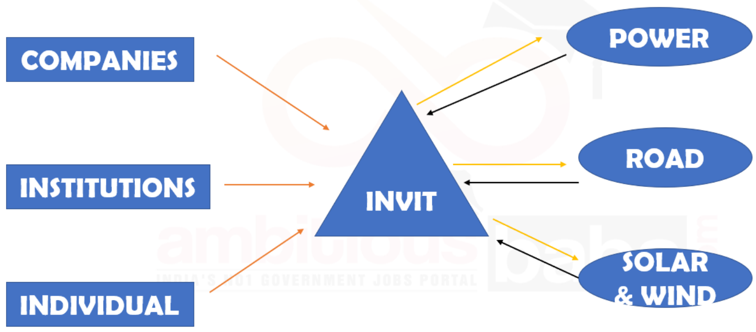
- Apparently, there was no undertaking in such cases from the issuers to buy the securities. There is also no income commensurate with the risk of loss built into these schemes.

JAIIB Paper 1 IE & IFS Module D Unit 17: Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (INVITs)

Introduction

- REITs are stock market listed investments that allow investors exposure to real estate, without having to purchase or manage properties by themselves.
- REITs are like Mutual Funds, as they permit the investors to pool in their resources and the assets are managed by a designated person in charge.
- But, while the underlying asset of Mutual Funds is usually equity, debt, gold or a combination of these, the underlying assets in the case of REITs is primarily real estate holdings or loans secured by real estate.
- Similarly, InvITs are listed investments that allow investors to become stake holders in the infrastructure development activities of the nation.
- When a company agrees to formulate the Trust, it become sponsor for the Trust and appoints a Trustee.
- The Trustees hold the underlying assets of such established trust in trusteeship and such assets are no longer controlled by the Sponsor. Companies owning or financing such assets must meet a number of organisational, operational, distribution and compliance requirement to qualify as a REIT/InvITs



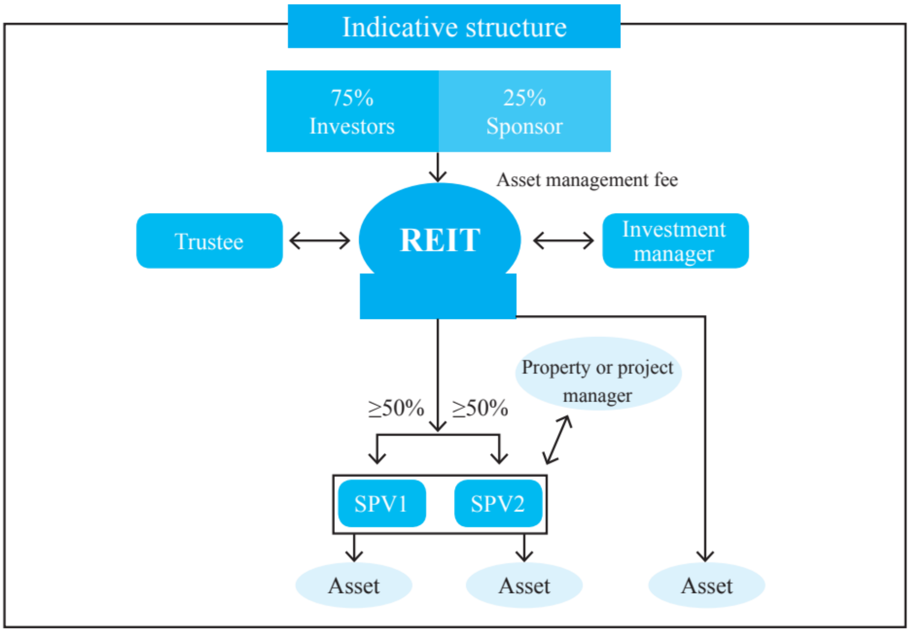


What are REITs?

- Real Estate investment often features large ticket sizes **of Rs 1 crore or more, especially in Metro and Tier-1 cities.**
- **There is another way to get exposure to real estate, i.e., investment in equity stock of listed Real Estate companies.**
- However, these investments are prone to market risk and though real estate is the underlying asset, these investments can be more appropriately termed as mid or small-cap equity investments, with a high degree of volatility.
- A viable solution to this situation is the Real Estate Investment Trusts, or REITs.
- REITs are investment vehicles that pool investor money like mutual funds and use them to buy a portfolio of real estate assets. They manage these assets to generate a regular income and capital appreciation.
- In order to ensure that the REIT is able to **generate income, 80%** of the portfolio of a REIT should be invested in completed and rent-generating properties.
- While REITs can invest in all kinds of income generating properties, such as residences, offices, hotels, malls, warehouses, etc., in India, the listed REITs are focused mainly on office space.

Organisation Of REITs

- **REITs are similar to Mutual Funds, as they allow multiple investors to pool their investments.**
- **Fund Manager:** Assets are professionally managed by a designated Fund Manager.
- Underlying asset in the case of REITs, is primarily Real Estate Holdings or loans secured by Real Estate



- **SPONSOR:** When a Real Estate Company decides to form a Real Estate Investment Trust, it becomes the Sponsor for the REIT and appoints a Trustee.
- The Trustee holds the Real Estate Assets of the Trust in its Trusteeship and these assets are no longer directly controlled by the Sponsor.
- **SPVs:** A REIT may control its Real Estate Holdings either directly or through the formation of one or more Special Purpose Vehicles (SPVs).
- **In the case of REITs, the SPV is a domestic company that holds the Real Estate Assets on behalf of the REIT, and as per regulations, the Trust must hold at least 50% of the equity in the SPV.**
- **Manager:** The Trustee appoints a Manager, to manage the Real Estate Assets on behalf of the Trust and also make investment decisions.
- After the Manager is appointed, the REIT can be registered.
- Once registered, a REIT can raise money through the sale of units either publicly on stock markets or through private investors.

Benefits to the Sponsor

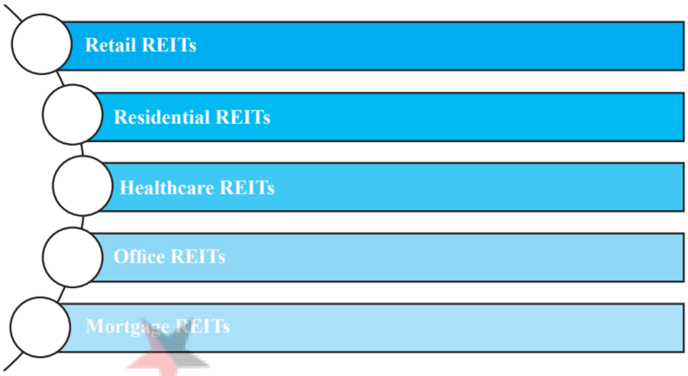
- Monetise revenue-generating real estate and infrastructure assets
- Lower the cost of capital, by tapping the right set of long-term investors (pension funds)
- Enjoy favourable tax treatment, including exemption from dividend distribution tax and relaxation of capital gains tax
- Have diverse sources of funding
- Once listed, provide regular source of capital to the sector Edition.

Benefits to the Investor

- Invest in real estate or infrastructure, without actually owning the asset
- Benefit from favourable tax norms (tax-exempt dividend income; no capital gains tax, if units are held for more than three years and sold through stock exchange; and withholding **tax at 5 per cent for** interest income to non-residential unit holders).

Types of REITs

Five Different types of REITs.



Retail REITs

- These REITs are required to invest at least 24% of their assets into commercial retail such as shopping malls and freestanding retail stores.

Residential REITs:

- Own and operate manufactured housing as well as rental apartment buildings and gated communities.
- Considering the never-ending demand for residential property in India, this is one of the most promising areas of growth.

Healthcare REITs:

- These trusts primarily invest in and operate healthcare-focused Real Estates such as hospitals, nursing facilities, retirement homes, and medical centres.

Office REITs:

- These primarily invest in and operate office space.
- Their main source of income for this type of REIT is thus, rental received from tenants under long-term lease arrangements.

Mortgage REITs:

- **In the case of these REITs, an estimated 10% of investments are made into** mortgages instead of physical real estate.
- Based on the types of funding that they provide, REITs can be of three different types, viz.,

- **Equity REITs:** They are owners of real estate properties and lease them to companies or individuals to make money. The income is then distributed among the REIT investors as dividends.
- **Mortgage REITs:** They are not the owners, but earn through EMIs against the property from the owners and builders. The earnings are via Net Interest Margin (difference of interest earned on mortgage and cost of funding the loan), which they distribute among the REIT investors, as a dividend.
- **Hybrid REITs:** These REITs invest in both Equity and Mortgage REITs**.**

Difference Between REITs And Real Estate Mutual Funds

- REITs and real estate mutual funds are similar, as they both offer liquidity and a cheap way to get exposure to diversified and substantial capital real estate assets.
- Long-term investors have the potential to reap the rewards of dividend income and capital appreciation over a long period.
- For retail or short term investors with a low investible surplus, these real estate funds present an opportunity to invest in properties that otherwise may not be feasible to invest in the sector.
- A real estate fund can invest in a real estate investment trust to offer benefits to investors, making REIT, a part of their investment portfolio. However, there are some differences, as well. Real Estate mutual funds offer wider diversification than the REITs, based on the investment strategy and have the benefit of experts and professionals managing their portfolio, unlike the REITs.
- The value of the real estate tends to increase during times of inflation as property prices and rent goes up, thus giving a better return to the REIT investors.
- As such, REITs distribute a higher amount of dividend every year to shareholders or investors than the real estate mutual funds.

Advantages And Disadvantages Of Investing In REITs

The following are the advantages of investing in REITs:

- **Diversification:** REITs allow an investor to diversify the investment portfolio through exposure to real estate, without the hassles related to owning and managing commercial properties. This diversification allows an investor to go beyond the usual asset classes of Equity, Debt, and Gold, as part of the overall Asset Allocation Strategy.
- **Small Initial Investment**: One of the key problems associated with making Real Estate investments is the large ticket size especially in the case of commercial properties. REITs require a much smaller initial investment of around Rs. 15,000 to provide similar portfolio diversification benefits.

- **Professional Management**: Properties owned by a REIT are managed professionally. This ensures smooth operations and with no effort on the part of the investor towards managing Commercial Real Estate.
- **Regular Income Generation**: REITs generate income from rental collections and are required to mandatorily distribute 90 per cent of this income to investors, as dividends and interest payments. In this way, REITs provide regular income to investors.
- **Capital Gains:** REITs are listed and traded on Stock Markets and their prices depend on their performance. An REIT that performs well can thus potentially increase in value over time and be sold at a profit. This provides capital gains to the investors.

There are also some disadvantages in investing in REITs:

- **Limited Options**: Currently, there are only few REITs in India. This significantly limits the choices for investors.
- **Low Liquidity**: While REITs are listed and traded on stock markets, the number of market participants is currently low, especially, with respect to retail investors. As a result, selling REIT investments profitably might be a challenge, especially in an emergency. This results in lower liquidity of the investment.

Advantages of Investing in REITs compared to Directly Investing in Real Estate

- Investing in REITs is not as capital intensive as a direct investment in properties.
- It is easier to invest in REITs, than in real estate.
- Compared to direct investment in real estate, REITs have lower liquidity risk.
- REITs are regulated by SEBI and, hence, the chances of fraud are low.
- REITs are transparent as they disclose their capital portfolio semi-annually.

Comparison Of Various Modes Of Investment In Real Estate

	REITs	Direct Property Ownership	Real Estate Company Equity	Corporate Property Bonds
Type of Investment	Units in a listed trust/ share of corporation owning real Estate	Investment in physical real estate	Shares of a listed company owning real estate and other business	Debt issued by the underlying real estate company
Payout	Majority of taxable income paid to unit holders	Majority of income paid to owner	Discretionary dividends to shareholders	Fixed Payout
Investment Strategy	Focused Activity	Focused Activity	Investment Choices Determined by the Company Board	Investment Choices Determined by the Company Board
Liquidity	Liquid investment	Illiquid investment	Liquid investment	Low Liquid investment
Diversity	Diversified portfolio	Concentration risk	Diversified portfolio	Concentration risk
Risk	Perceived low risk	Perceived high risk	Perceived high risk	Perceived low risk
Gearing	Gearing is limited by regulations	High gearing between 70% to 80%	Moderate gearing level between 60% to 70%	Moderate gearing level

Taxation Guidelines For Investors Of REITs

Taxation of Dividends:

- Taxable in the hands of investors
- Included in the annual income of the investors and taxed according to investor's tax slab.

Taxation & Capital Gains:

- **Capital Gains from sale of REITs units are covered by Short term capital gains or long term capital gains**
- **STCG:** If holding period is 1 year or less from the date of date of allocation [15% of capital gains]
- **LTCG:** If holding period is more than 1 year from the date of date of allocation [10% of capital gains in excess of Rs.1 lakh]

Regulatory Guidelines For REITs

- Governed by SEBI (Real Estate Investment Trusts) Regulations, 2014, and amendments to the same, issued thereafter.

Some of the important regulations governing functioning of REITs are as follows:

Structure of investment trust

- Sponsor to hold atleast 25% of the total units of the investment trust after initial offer, on a post-issue basis, for at least 3 years, from the date of listing of such units (unless such holding is disallowed by government or regulatory provisions)
- Invest atleast 80% of the value in completed and revenue-generating projects,
- Maximum 10% in 'under-construction' projects.

- Investment trusts to hold assets either directly or through special purpose vehicles (SPV)
- Investment trusts to hold controlling interest and min 50% equity share capital or interest in the SPVs (except in the case of public-private partnership projects, where such holding is disallowed, by the government or regulatory provisions)
- SPVs to hold not less than 80% of assets directly in properties and not invest in other SPVs
- SPVs not to engage in any activity other than those pertaining and incidental to the underlying projects.

Stipulations to ensure transparency

- Trustee to hold assets for the benefit of unit holders, oversee activities, and ensure compliance with respect to reporting and disclosure requirements
- A full valuation to be conducted by an independent valuer, at least once in a year All related-party transactions to be on an arm's length basis.

Distribution requirements

- Not less than 90% of net distributable cash flow of the SPV to be disbursed to the investment trust, in proportion to its holding in the SPV, subject to applicable provisions in the **Companies Act, 2013, or the Limited Liability Partnership Act, 2008**
- Not less than 90% of net distributable cash flow of the investment trust to be distributed to unit holders. Such distributions to be declared and made at least once, every six months.
- If any asset is sold by the investment trust or SPV, it can reinvest the proceeds into another property or infrastructure asset and will not be required to distribute the sale proceeds. However, if no such reinvestment is made, it will be required to distribute not less than 90% of the sales proceeds.

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Leverage restrictions

- The aggregate consolidated borrowing and deferred payment of the investment trust net of cash and cash equivalents should never exceed 49% of the value of the investment trust assets
- If the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, for any further borrowing, credit rating to be obtained, from a registered credit rating agency.

Investment regulations

- To improve liquidity in REITs and bring in more listings, SEBI recently announced that the minimum investment amount in a REIT be brought down to Rs 15,000, with the revised trading lot at one unit; the earlier investment amount was Rs 50,000, and the trading lot 200 units in the secondary market.

Infrastructure Investment Trusts (InvITs)

What are InvITs

- According to recent reports of the Finance Ministry, India needs to spend USD 4.5 trillion on infrastructure till the year 2040, to improve the economic growth and community well-being.
- Every country needs a defined infrastructure that can provide adequate facilities for each individual and which paves the way for capital mobilisation.
- While addressing the public on the occasion of the Independence Day of 2019, the Hon'ble Prime Minister announced that Rs 100 lakh crores would be invested in infrastructure over the next 5 years.
- An initiative called the National Infrastructure Pipeline was launched to enable this investment.

***While there is no hard and fast rule to define* infrastructure, the sectors that are included in infrastructure are:**

- Roads
- Ports
- Power
- Railways
- Airports
- Telecommunication
- Energy
- Coal, petroleum and cement production

Organisation Of InvITs

InvITs have a 3-tier management structure, consisting of Sponsor, Manager and Trustee.

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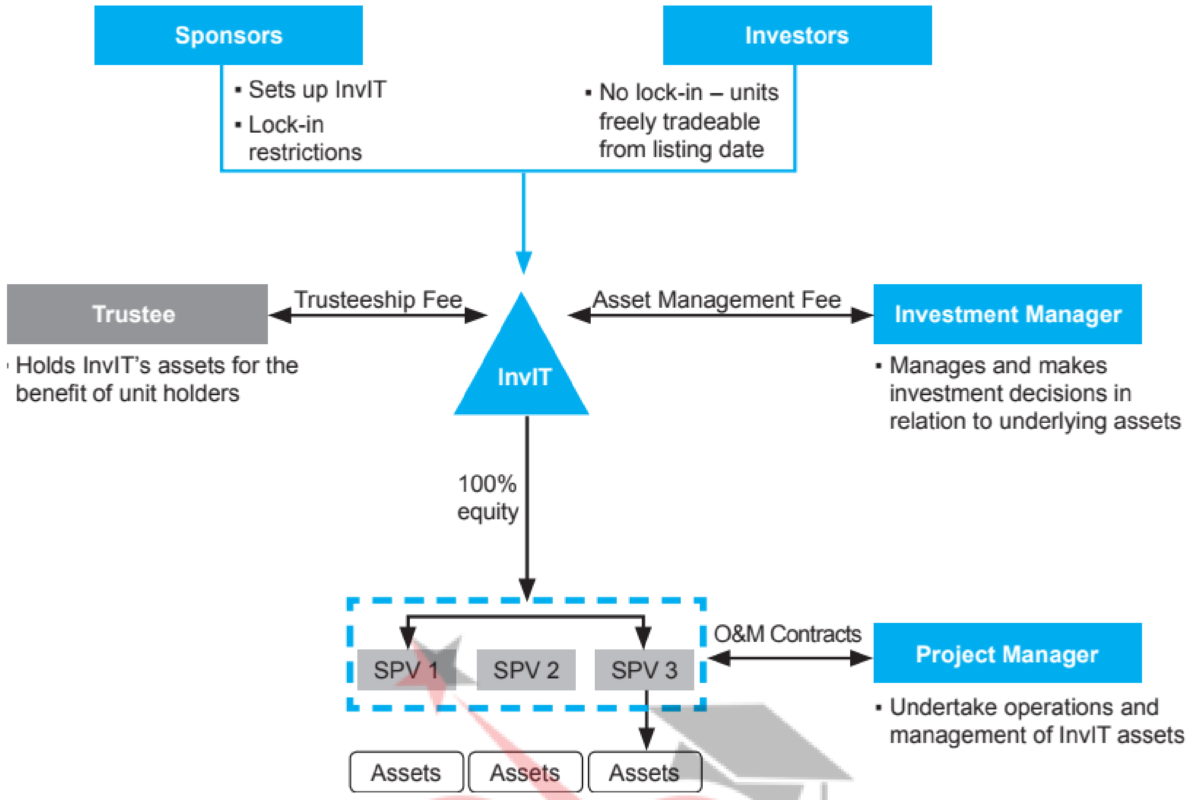

Sponsor

- An InvIT can have a maximum of 3 sponsors.
- Usually, a sponsor is an infrastructure development company that originally built, owned, and/or operated the infrastructure assets of the trust.
- The primary responsibility of the sponsor is to set up the Infrastructure Investment Trust and appoint a SEBI-approved Trustee.
- As per current regulations, InvIT Sponsors are mandatorily required to hold a minimum 15% stake in the Trust for at least **3 years, after the formation of the trust.**

Manager

Usually, an InvIT has two types of managers –

- An investment manage
- A project manager.
- The investment manager is responsible
- ✓ For ensuring that existing investments of the InvIT are providing returns, as per expectations.
- ✓ Responsible for making new investment decisions on behalf of the Trust to ensure further growth of InvIT assets.
- The project manager is usually a company that specialises in developing and operating infrastructure projects.
- ✓ **Responsibilities**: ensuring smooth operations in the case of completed projects of the Trust as well as timely delivery of under-construction projects.

Trustee

A SEBI-approved Trustee is a company that has a proven track record of providing Trusteeship services.

- **Key responsibilities:** Holding the assets of an InvIT in trusteeship to safeguard the interests of the unitholders.
- Other responsibilities of an InvIT trustee include ensuring timely distribution of dividends to unit holders and overseeing the activity of the InvIT managers.

Types Of InvITs

InvITs can be divided into 5 types depending on the types of infrastructure they own or operate:

- Energy such a power generation and distribution
- Transport & Logistics, such as roads and highways
- Communications, such as optical fibre networks and telecom towers
- Social and Commercial Infrastructure, such as parks
- Water and Sanitation such as irrigation networks

From the viewpoint of source of funds, InvITs can be categorised into two types, viz.,

- Public listed InvITs
- Privately held InvITs

Public-Listed InvITs

- After an Infrastructure Trust lists itself for trading on the stock exchange, it is known as a public-listed InvIT.
- Units of a public-listed InvIT can be bought and sold on stock exchanges by retail as well as institutional investors.

Privately-Held InvITs

- This type of InvIT is not listed on the stock exchange and units of this type of infrastructure trust cannot be bought or sold on a stock exchange.
- All units of this type of unit are held privately, by a very limited number of individuals or institutions.
- Under SEBI guidelines, at least 80% of an InvIT's assets should be generating operational income.
- Moreover, 90% of the net distributable cash flow is required to be distributed to the unit holders.

Advantages And Disadvantages Of InvITs

Diversification:

- Investors seeking to diversify their investments can choose to invest in listed InvITs.

- Through this route, InvITs allow investors to assume part ownership in infrastructure projects and this helps them to diversify their investments to a new asset class, viz., infrastructure projects.

Regular Income

- InvITs have to mandatorily distribute at least 90% of the income through dividends and interest pay-outs, on a bi-annual basis.
- Thus, the investments can provide investors, with regular income.

Professional Management

- While the investors assume part ownership of an infrastructure asset by purchasing InvITs units, the project is professionally managed by designated managers.
- This ensures optimal performance of the infrastructure project, with minimal hassles to the investors.

Capital Gains

- Units of an InvIT can be traded on stock exchanges similar to shares.
- Therefore, if the InvIT performs well, the price of units will increase, leading to capital gains.

Reduction in minimum subscription

- In 2019, capital market regulator SEBI reduced the minimum investment limits on InvITs, thereby, making them more easily accessible.
- Reduced from Rs 10 lakhs to 1 lakh.

Limitations:

- Income generated by infrastructure projects such as roads/highways, electrical distribution networks, and even telecommunications networks are dependent on two key factors –

✓ **Tariffs and**
✓ **Usage.**

- A change in either of these two variables can lead to an increase or decrease in the income generated by the project.
- Tariffs can change, as a result of Government regulations or interventions.
- Infrastructure usage levels can also change in certain cases.
- For example, a significant decrease in usage of roads and highways occurred during the COVID-19 lockdown of 2020. This had contributed to reduction in toll booth collections, i.e., income for highway projects, even though the tariffs had remained unchanged during that period.

InvIT's Revenue Model

- Under an InvIT transaction, infrastructure asset owners, transfer multiple revenue generating assets' special purpose vehicles (SPVs), through holding company or otherwise to a trust, which then issues units to investors for raising money.
- The upfront money so raised is utilised by the developers, for creation of new greenfield assets as also for repayment of debt, which enables availability of capital with lenders for investment/lending to new projects.
- The investors, in lieu of invested money, receive a share of Net Distributable Cash Flows (NDCF – similar to the dividend pay-outs) on a periodic basis, commensurate with their unit holding in the Trust.
- 90% of the net distributable cash flow is required to be distributed to the unit holders.

Improved yields for the unit holders can be insured, by adding revenue-generating projects and expanding its portfolio.

NDCF for FY-18

Sr. No.	Particulars	Year ended March 31, 2018
1	Cash flows received from Project SPVs in the form of interest	51,122.81
2	Cash flows received from Project SPVs in the form of Dividend	-
3	Any other income accruing at the Trust level and not captured above, including but not limited to interest/return on surplus cash invested by the Trust	446.14
4	Cash flow received from the project SPVs towards the repayment (Net) of the debt issued to the Project SPVs by the Trust	21,911.71
5	**Total cash inflow at the Trust level (A)**	**73,480.66**
	Less:	
6	Any payment of fees, interest and expense incurred at the Trust level, including but not limited to the fees of the investment Manager	(7,546.97)
7	Income tax (if applicable) at the Standalone Trust Level	-
8	Repayment of external debt	(389.50)
9	**Total cash outflows/retention at the Trust level (B)**	**(7,936.47)**
10	**Net Distributable Cash Flows (C) = (A + B)**	**65,544.19**

Taxation On Investments In InvITs

There are two aspects of taxation on income received from investment in InvITs. These are as follows:

Tax on Dividend and Interest Income

- ✓ Any dividend or interest income from an InvIT is taxable as per the investor's Income Tax Slab rate.
- ✓ Hence, if the investor is, otherwise in the 30% tax bracket, the dividend/interest income from the InvIT will also be taxed at 30 per cent.

Tax on Capital Gains

- ✓ Capital Gains taxation rules are applicable only when the InvIT units are sold.
- ✓ If the investor has stayed invested in InvITs for a period up to 3 years - Short-Term Capital Gains (STCG) taxation rules are applicable. [15% on profits made by the sale of InvITs units]
- ✓ On the other hand, if the investor has held the InvITs units for over 3 years before selling them, Long-Term Capital Gains (LTCG) taxation rules are applicable[10% of long-term gains exceeding Rs. 1 lakh.]

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