INSTITUTE OF SCIENCE, TECHNOLOGY & ADVANCED STUDIES (VISTAS)
(Deemed to be University Estd. u/s 3 of the UGC Act, 1956)
PALLAVARAM - CHENNAI
INSTITUTION WITH UGC 12B STATUS

DCECN - 11

Financial Economics-I

B.A (Hons) Economics
ODL MODE
[Semester Pattern]

School of Management Studies and Commerce
Centre for Distance and Online Education
Vels Institute of Science, Technology and Advanced Studies (VISTAS)
Pallavaram, Chennai - 600 117

Vels Institute of Science, Technology and Advanced Studies

Centre for Distance and Online Education

BA (Hons)-Economics- ODL Mode

(Semester Pattern)

DCECN-12: Financial Economics-I

(4 Credits)

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FOREWORD

Dr.Ishari K Ganesh
Chancellor

Vels Institute of Science, Technology and Advanced Studies (VISTAS), deemed to be a University, was established in 2008 under section 3 of the Act of 1956 of the University Grants Commission, Government of India, New Delhi.

VISTAS has blossomed into a multi-disciplinary Institute offering more than 100 UG & PG Programmes, besides Doctoral Programmes, through 18 Schools and 46 Departments. All the Programmes have the approval of the relevant Statutory Regulating Authorities such as UGC, UGC-DEB, AICTE, PCI, BCI, NCTE and DGS.

The deemed to be University aims to provide innovative syllabi and industry-oriented courses, and hence, the revision of curricula is a continuous and ongoing process. The revision is initiated by the faculty depending on the requirement and approved by the Board of Studies of the concerned Department/School. The courses are under Choice Based Credit Systems that enable students to get adequate freedom in choosing subjects.

I am pleased to inform you that VISTAS has been rendering its services to society to democratize the opportunities of higher education for those who are in need through Open and Distance Learning (ODL) mode.

VISTAS ODL Programmes offered have been approved by the University Grants Commission (UGC) – Distance Education Bureau (DEB), New Delhi.

The curriculum and syllabi have been approved by the Board of Studies, Academic Council, and the Executive Committee of the VISTAS, and they are designed to help provide employment opportunities to the students.

The ODL Programme BA (Hons)-Economics study material have been prepared in the Self Instructional Mode (SIM) format as per the UGC-DEB (ODL & OL) Regulations 2020. It is highly helpful to the students, faculties and other professionals. It gives me immense pleasure to bring out the ODL programme with a noble cause of enriching learners' knowledge. I extend my congratulations and appreciation to the Programme Coordinator and the entire team for bringing up the ODL Programme in an elegant manner.

At this juncture, I am glad to announce that the syllabus of this ODL Programme has been made available on our website, www.vistas.ac.in, for the benefit of the student fraternity and other knowledge seekers. I wish that this Self Learning Materials (SLM) would be a nice treatise to the academic community and everyone.

CHANCELLOR

FOREWORD

Dr.S.Sriman Narayanan
Vice-Chancellor

My Dear Students!

Open and Distance Learning (ODL) of VISTAS gives you the flexibility to acquire a University degree without the need to visit the campus often. VISTAS-CDOE involves the creation of an educational experience of qualitative value for the learner that is best suited to the needs outside the classroom. My wholehearted congratulations and delightful greetings to all those who have availed themselves of the wonderful leveraged opportunity of pursuing higher education through this Open and Distance Learning Programme.

Across the world, pursuing higher education through Open and Distance Learning Systems is on the rise. In India, distance education constitutes a considerable portion of the total enrollment in higher education, and innovative approaches and programmes are needed to improve it further, comparable to Western countries where close to 50% of students are enrolled in higher education through ODL systems.

Recent advancements in information and communications technologies, as well as digital teaching and e-learning, provide an opportunity for non-traditional learners who are at a disadvantage in the conventional system due to age, occupation, and social background to upgrade their skills.

VISTAS has a noble intent to take higher education closer to the oppressed, underprivileged women and the rural folk to whom higher education has remained a dream for a long time.

I assure you all that the Vels Institute of Science, Technology and Advanced Studies would extend all possible support to every registered student of this deemed to be university to pursue her/his education without any constraints. We will facilitate an excellent ambience for your pleasant learning and satisfy your learning needs through our professionally designed curriculum, providing Open Educational Resources, continuous mentoring and assessments by faculty members through interactive counselling sessions.

This University brings to reality the dreams of the great poet of modern times, Mahakavi Bharathi, who envisioned that all our citizens be offered education so that the globe grows and advances forever.

I hope that you achieve all your dreams, aspirations, and goals by associating yourself with our ODL System for never-ending continuous learning.

With warm regards,

VICE-CHANCELLOR

Course Introduction

The DCECN-12: **Financial Economics** Course has been divided in to five Blocks consisting of 20 Units.

The **Block-1 Introduction to Financial Economics** has been divided in to four Units. Unit-1 describes about the Introduction to Money Market, Unit-2 explains about the Role of Money Supply in India, Unit-3 deals with the Process and Functions of Monetary Policy and the Unit-4 presents about the Banking System in India.

The **Block-2: Banking and Financial System** has been divided in to four Units. Unit-5 describes about the Introduction of Banking and Financial System, Unit-6 explains about the Types of Banks, Unit-7 deals with the RBI's Regulation and Function of Commercial Bank-Credit Creation and the Unit-8 presents about the concept of Modern Function of Banks.

The **Block-3: Capital Market** has been divided in to four Units. Unit-9 describes about the Concepts of Capital Market, Unit-10 explains about the SEBI and its Regulations, Unit-11 deals with the Non-Banking Institutions in India and the Unit-12 presents about the Stock Exchange.

The **Block-4: Share Market** has been divided in to four Units. Unit-13 describes about the Share Market, Unit-14 explains about the types of Equities and Bonds, Unit-15 deals with the Types of Investment and the Unit -16 presents about the concept of Share Market Indices

The **Block-5: Insurance** has been divided in to four Units. Unit-17 describes about the introduction of Insurance, Unit-18 explains about the Role of IRDA, Unit-19 deals with the concept of Financial Derivatives and the Unit -20 presents about the Health Insurance in India.

DCECN-12: Financial Economics-I

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Block-1: Introduction

Block-1: Introduction To Financial Economics has been divided in to four Units.

Unit-1 : Introduction to Financial Economics deals with Introduction, Topics of Financial Economics, Finance vs. Economics, Benefits of Financial Economics, Meaning of Money Market, Definitions of Money Market, Objectives of Money Market, Features of Money Market, Importance of Money Market, Scope of Money Market, Characteristics of Money Market Instruments, Types of Money Market Instruments and Purpose of Money Market.

Unit-2: Money Supply explains about the Money Supply Meaning, Components of Money Supply, Characters of Money Supply, Functions of Money Supply and the Types of Money Market Instrument in India.

Unit-3: Monetary Policy describes about the Introduction of Monetary Policy, Meaning and Definition of Monetary Policy, Objectives of Monetary Policy, Types of Monetary Policy, Monetary Policy Instruments and Monetary Policy: Stabilizing Prices and Output.

Unit-4: Banking System in India discuss with the Introduction to Indian Banking system, Evolution of Indian Banking, Banking Structure in India and Recent development in Indian Banking Sector.

In all the units of Block -1 **Introduction To Financial Economics**, the Check your progress, Glossary, Answers to Check your progress and Suggested Reading has been provided and the Learners are expected to attempt all the Check your progress as part of study.

Unit-1

Introduction to Financial Economics

STRUCTURE

Overview

Objectives

1.1. Introduction

1.2. Topics of Financial Economics

1.3. Finance vs. Economics

1.4. Benefits of Financial Economics

1.5. Meaning of Money Market

1.6. Definitions of Money Market

1.7. Objectives of Money Market

1.8. Features of Money Market

1.9. Importance of Money Market

1.10. Scope of Money Market

1.11. Characteristics of Money Market Instruments

1.12. Types of Money Market Instruments

1.13. Purpose of Money Market

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the introductory concept of financial economics has been explained. The money market involves the purchase and sales of large volumes of very short-term debt products such as overnight reserves or commercial paper. An individual may invest in the money market by purchasing a money market mutual fund, buying a Treasury bill, or opening a money market account at a bank.

Objectives

After reading this unit, students should be able:

- To explain the concept of Financial Economics
- To define the term Money market
- To state the meaning of Money market

- To state the Objectives of Money Market
- To state the features of Money Market
- To state the importance of Money Market
- To state the characteristics of Money Market Instruments
- To state the types of Money Market Instruments

1.1. Introduction

Financial economics is a branch of economics that analyzes the use and distribution of resources in markets. Financial decisions must often take into account future events, whether those be related to individual stocks, portfolios, or the market as a whole. It is the branch of economics characterized by a "concentration on monetary activities“. It is the study of how individuals allocates scarce resources over time, under conditions of uncertainty.

It is a branch of economics that focuses on the study of how individuals and institutions make financial decisions, as well as the implications of these decisions on the allocation of resources over time. It combines principles of economics, finance, mathematics, statistics, and sometimes psychology to understand and analyze financial markets and economic phenomena related to finance.

1.2. Topics of Financial Economics

- Corporate finance
- Corporate governance
- Microeconomics of banking
- Pricing of financial instruments
- Risk management and financial markets infrastructure
- Financial choices under uncertainty and general equilibrium.

1.3. Finance vs. Economics:

Management as a systematic process helps identify a group of people who carry out particular activities, thereby improving an organization’s efficiency and effectiveness. Here are the salient features that highlight the nature of management in businesses.

Key areas of study within financial economics include:

1. **Portfolio Theory:** Developed by Harry Markowitz, portfolio theory examines how investors can optimize their portfolios to maximize returns for a given level of risk. It involves diversification and the trade-off between risk and return.

2. **Capital Market Theory:** This theory explores the relationship between risk and return in financial markets, particularly in the context of the Capital Asset Pricing Model (CAPM). CAPM provides a framework for valuing risky assets and determining expected returns.
3. **Efficient Market Hypothesis (EMH):** EMH suggests that financial markets are efficient, meaning that prices fully reflect all available information. The theory has different forms, including weak, semi-strong, and strong forms, depending on the level of information reflected in market prices.
4. **Behavioral Finance:** This area incorporates psychological factors into financial decision-making. Behavioral finance explores how individuals and market participants deviate from rational decision-making due to cognitive biases, emotions, and other psychological factors.
5. **Corporate Finance:** Corporate finance focuses on the financial decisions made by corporations, including capital budgeting, financing decisions, dividend policy, and risk management.
6. **Derivatives and Risk Management:** This involves the study of financial instruments like options and futures, as well as strategies to manage and mitigate financial risks faced by individuals and institutions.
7. **Financial Econometrics:** This field applies statistical techniques to financial data to model and analyze financial markets. Time series analysis and other econometric methods are used to study patterns and relationships in financial data.
8. **Financial Institutions:** Examining the role and functioning of financial institutions such as banks, investment firms, and insurance companies is also a crucial aspect of financial economics.

1.4. Benefits of Financial Economics

The ultimate benefit of financial economics is providing investors with the information to make sound and informed decisions in relation to their investment options. They are presented with the risks and risk factors involved in their investments, the fair value of the asset they wish to acquire, and the regulations in the financial markets where they are involved.

1.5. Meaning of Money Market

The money market refers to a segment of the financial market where

short-term borrowing and lending take place. It deals with instruments with maturities typically ranging from overnight to one year. The money market is crucial for the functioning of the overall financial system and plays a vital role in the monetary policy of a country.

It is a financial market where short-term financial assets having liquidity of one year or less are traded on stock exchanges. The securities or trading bills are highly liquid. Also, these facilitate the participant's short-term borrowing needs through trading bills.

The participants in this financial market are usually banks, large institutional investors, and individual investors. There are a variety of instruments traded in the money market in both the stock exchanges, NSE and BSE. These include treasury bills, certificates of deposit, commercial paper, repurchase agreements, etc. Since the securities being traded are highly liquid in nature, the money market is considered as a safe place for investment.

The Reserve Bank controls the interest rate of various instruments in the money market. The degree of risk is smaller in the money market. This is because most of the instruments have a maturity of one year or less. Hence, this gives minimal time for any default to occur. The money market thus can be defined as a market for financial assets that are near substitutes for money.

The money market refers to a segment of the financial market where short-term borrowing and lending take place. It deals with instruments with maturities typically ranging from overnight to one year. The money market is crucial for the functioning of the overall financial system and plays a vital role in the monetary policy of a country.

1.6. Definition of Money Market

Money Market may be defined in many different ways. Many eminent authors on the subject have defined the term "Money Market", some of these definitions are reproduced below:

According to **Crowther**, "Money Market is a name given to the various firms and institutions that deal in the various grades of near money".

According to **RBI,** "The Money Market is the centre for dealing mainly of short character, in monetary assets: it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers again comprising institutions and individuals and also by the government".

1.7. Objectives of Money Market

Below are the main objectives of the money market:

- Providing borrowers such as individual investors, government, etc. with short-term funds at a reasonable price. Lenders will also have the advantage of liquidity as the securities in the money market are short-term.
- It also enables lenders to turn their idle funds into an effective investment. In this way, both the lender and borrower are at a benefit.
- RBI regulates the money market. Therefore, in turn, helps to regulate the level of liquidity in the economy.
- Since most organizations are short on their working capital requirements. The money market helps such organizations to have the necessary funds to meet their working capital requirements.
- It is an important source of finance for the government sector for both national and international trade. And hence, provides an opportunity for the banks to park their surplus funds.

1.8. Features of Money Market

- **Short-Term Instruments:** Money market instruments have short maturities, ranging from one day to one year. This characteristic allows participants to quickly access funds or invest for a short duration.
- **High Liquidity:** Money market instruments are highly liquid, meaning they can be easily bought or sold in the market without significantly affecting their prices. This liquidity is essential for investors who may need to convert their assets into cash quickly.
- **Low Risk:** Generally, money market instruments are considered low-risk investments compared to other financial instruments. This is because they typically involve highly creditworthy issuers, such as governments, financial institutions, and corporations with strong credit ratings.
- **Market Participants:** Participants in the money market include central banks, commercial banks, corporations, government-sponsored enterprises, and other financial institutions. They engage in activities such as borrowing, lending, and trading short-term financial instruments.
- **Types of Instruments:** Money market instruments include Treasury bills, commercial paper, certificates of deposit (CDs),

repurchase agreements (repos), and short-term government securities. These instruments serve various purposes, such as financing short-term needs, managing liquidity, and investing excess cash.

- **Interest Rates:** Money market instruments are sensitive to changes in short-term interest rates. The yields on these instruments are influenced by prevailing market interest rates, making them attractive to investors seeking short-term returns.
- **Regulation:** The money market is subject to regulatory oversight to ensure the stability and integrity of financial markets. Regulatory authorities set guidelines to govern the issuance and trading of money market instruments.
- **Role in Monetary Policy:** Central banks often use money market operations as a tool to implement monetary policy. By buying or selling money market instruments, central banks can influence short-term interest rates, affecting overall economic conditions.
- **Primary and Secondary Markets:** Money market instruments are traded in both primary and secondary markets. The primary market involves the issuance of new instruments, while the secondary market facilitates the trading of existing instruments among investors.
- **Discount Basis:** Some money market instruments, such as Treasury bills, are issued at a discount to their face value. The difference between the purchase price and face value represents the interest earned by the investor.

1.9. Importance of Money Market

The money market is a market for short term transactions. Hence it is responsible for the liquidity in the market. Following are the reasons why the money market is essential.

- It maintains a balance between the supply of and demand for the monetary transactions done in the market within a period of 6 months to one year.
- It enables funds for businesses to grow and hence is responsible for the growth and development of the economy.
- It aids in the implementation of monetary policies.
- It helps develop trade and industry in the country. Through various money market instruments, it finances working capital requirements. It helps develop the trade in and out of the country.

- The short term interest rates influence long term interest rates. The money market mobilizes the resources to the capital markets by way of interest rate control.
- It helps in the functioning of the banks. It sets the cash reserve ratio and statutory liquid ratio for the banks. It also engages their surplus funds towards short term assets to maintain money supply in the market.
- The current money market conditions are the result of previous monetary policies. Hence it acts as a guide for devising new policies regarding short term money supply.

1.10. Scope of the money market

The scope of the money market is extensive, and it serves as a crucial component of the overall financial system. Here are some key aspects that highlight the scope of the money market:

1. **Short-Term Borrowing and Lending:** The primary function of the money market is to facilitate short-term borrowing and lending among financial institutions, corporations, governments, and other entities. This short-term financing is essential for managing day-to-day liquidity needs.
2. **High Liquidity:** Money market instruments are highly liquid, allowing participants to quickly convert their holdings into cash without significant price impact. This high liquidity is vital for the efficient functioning of the financial system.
3. **Diverse Range of Instruments:** The money market includes a variety of instruments, such as Treasury bills, commercial paper, certificates of deposit, repurchase agreements, and short-term government securities. Each instrument serves specific needs and provides flexibility to market participants.
4. **Interest Rate Benchmark:** Money market interest rates, such as the federal funds rate, serve as benchmarks for other interest rates in the financial system. Central banks use these rates to implement monetary policy and control the overall money supply.
5. **Risk Management:** Money market instruments are generally considered low-risk compared to longer-term securities. Their short maturities and high credit quality make them attractive for risk-averse investors looking for capital preservation.
6. **Central Bank Operations:** Central banks actively participate in the money market through open market operations. By buying or selling short-term government securities, central banks influence

the level of liquidity in the financial system and implement monetary policy.

7. **Corporate Financing:** Corporations use money market instruments like commercial paper to raise short-term funds for operational needs, such as inventory management or covering working capital requirements.
8. **Government Funding:** Governments issue money market instruments, such as Treasury bills, to fund short-term budgetary needs. These instruments are a vital source of short-term financing for government activities.
9. **Investor Access:** Money market instruments provide individual and institutional investors with a range of options to park their funds temporarily. Money market mutual funds allow individual investors to gain exposure to a diversified portfolio of these instruments.
10. **International Money Markets:** The money market operates globally, with participants engaging in cross-border transactions. Instruments like Eurodollar deposits and Euro-commercial paper contribute to the international scope of the money market.
11. **Arbitrage Opportunities:** Traders and investors use money market instruments to exploit short-term arbitrage opportunities, taking advantage of price differentials and interest rate differentials between various instruments.

In summary, the money market plays a vital role in providing short-term liquidity, managing risk, setting interest rate benchmarks, and supporting the efficient functioning of financial markets. Its broad scope encompasses a diverse range of instruments and participants, making it an integral part of the broader financial system.

1.11. Characteristics of Money Market Instruments

- **Short Maturity Period:** Money market instruments have relatively short maturities, typically ranging from one day to one year. This short-term nature allows investors to access their funds quickly and provides flexibility in managing cash flows.
- **High Liquidity:** One of the primary features of money market instruments is their high liquidity. These instruments can be easily bought or sold in the market with minimal impact on their prices. This liquidity is crucial for investors who may need to convert their investments into cash on short notice.

- **Low Default Risk:** Money market instruments are generally considered low-risk investments because they are issued by creditworthy entities, such as governments, financial institutions, and highly rated corporations. The low default risk is a result of the short-term nature and the credit quality of the issuers.
- **Discounted Issuance or Interest Rates:** Some money market instruments, such as Treasury bills, are issued at a discount to their face value. The difference between the purchase price and face value represents the interest earned by the investor. Other instruments, like Certificates of Deposit (CDs), offer fixed interest rates.
- **Fixed Income:** Money market instruments typically provide fixed-income returns. Investors receive interest income based on the instrument's stated interest rate or the difference between the purchase price and face value (in the case of discounted instruments).
- **Diversification of Investment Portfolios:** Investors often use money market instruments to diversify their investment portfolios. While these instruments may offer lower returns compared to some other investments, they provide stability and safety, especially during times of market volatility.
- **Government Regulation:** Money market instruments are subject to regulatory oversight to ensure the stability and integrity of financial markets. Regulations govern the issuance, trading, and disclosure practices associated with these instruments.
- **High Credit Quality:** Issuers of money market instruments typically have high credit ratings. Governments, financial institutions, and corporations with strong creditworthiness issue these instruments, contributing to their low default risk.
- **Minimal Capital Appreciation:** Unlike some longer-term securities, money market instruments generally do not experience significant capital appreciation. Instead, their value is closely tied to their face value and the interest earned.
- **Market Discount Rates:** Yields on money market instruments are influenced by prevailing market interest rates. Changes in short-term interest rates can impact the returns on these instruments.
- **Wide Range of Instruments:** The money market includes various instruments such as Treasury bills, commercial paper, certificates of deposit (CDs), repurchase agreements (repos),

and short-term government securities, each serving different purposes for investors and issuers.

1.12. Types of Money Market Instruments

Treasury Bills

Treasury Bills are one of the most popular money market instruments. They have varying short-term maturities. The Government of India issues it at a discount for 14 days to 364 days. These instruments are issued at a discount and repaid at par at the time of maturity. Also, a company, firm, or person can purchase TB's. And are issued in lots of Rs. 25,000 for 14 days & 91 days and Rs. 1,00,000/- for 364 days.

Commercial Bills

Commercial bills, also a money market instrument, works more like the bill of exchange. Businesses issue them to meet their short-term money requirements. These instruments provide much better liquidity. As the same can be transferred from one person to another in case of immediate cash requirements.

Certificate of Deposit

Certificate of Deposit is a negotiable term deposit accepted by commercial banks. It is usually issued through a promissory note. CD's can be issued to individuals, corporations, trusts, etc. Also, the CD's can be issued by scheduled commercial banks at a discount. And the duration of these varies between 3 months to 1 year. The same, when issued by a financial institution, is issued for a minimum of 1 year and a maximum of 3 years.

Commercial Paper

Corporates issue CP's to meet their short-term working capital requirements. Hence serves as an alternative to borrowing from a bank. Also, the period of commercial paper ranges from 15 days to 1 year. The Reserve Bank of India lays down the policies related to the issue of CP's. As a result, a company requires RBI‘s prior approval to issue a CP in the market. Also, CP has to be issued at a discount to face value. And the market decides the discount rate. Denomination and the size of CP: Minimum size – Rs. 25 lakhs. Maximum size – 100% of the issuer's working capital

Call Money

It is a segment of the market where scheduled commercial banks lend or borrow on short notice (say a period of 14 days). In order to manage day-to-day cash flows. The interest rates in the market are market-driven and hence highly sensitive to demand and supply. Also, the interest

rates have been known to fluctuate by a large % at certain times

1.13 Purposes of Money Market

1. **Maintains Liquidity in the Market:** One of the most crucial functions of the money market is to maintain liquidity in the economy. Some of the money market instruments are an important part of the monetary policy framework. RBI uses these short-term securities to get liquidity in the market within the required range.

2. **Provides Funds at a Short Notice**: Money Market offers an excellent opportunity to individuals, small and big corporations, and banks of borrowing money at very short notice. These institutions can borrow money by selling money market instruments and finance their short-term needs. It is better for institutions to borrow funds from the market instead of borrowing from banks, as the process is hassle-free and the interest rate of these assets is also lower than that of commercial loans. Sometimes, commercial banks also use these money market instruments to maintain the minimum cash reserve ratio as per the RBI guidelines.

3. **Utilization of Surplus Funds:** Money Market makes it easier for investors to dispose of their surplus funds, retaining their liquid nature, and earn significant profits on the same. It facilitates investors' savings into investment channels. These investors include banks, non-financial corporations as well as state and local government.

4. **Aids in Financial Mobility:** Money Market helps in financial mobility by allowing easy transfer of funds from one sector to another. This ensures transparency in the system. High financial mobility is important for the overall growth of the economy, by promoting industrial and commercial development.

5. **Helps in monetary policy:** A developed money market helps RBI in efficiently implementing monetary policies. Transactions in the money market affect short term interest rate, and short-term interest rates gives an overview of the current monetary and banking state of the country. This further helps RBI in formulating the future monetary policy, deciding long term interest rates, and a suitable banking policy.

Let Us Sum Up

In this unit you have learned about the following:

The money market involves the purchase and sales of large volumes of

very short-term debt products such as overnight reserves or commercial paper. An individual may invest in the money market by purchasing a money market mutual fund, buying a Treasury bill, or opening a money market account at a bank.

Check your progress

1. ______________ is providing investors with the information to make sound and informed decisions in relation to their investment options
2. According to ______________ "Money Market is a name given to the various firms and institutions that deal in the various grades of near money".
3. ______________ is a negotiable term deposit accepted by commercial banks. It is usually issued through a promissory note.

Glossary

Financial market: It is a market in which people trade. Financial securities and derivatives at low transaction costs.

Stock exchanges: It is a marketplace where securities, such as stocks and bonds, are bought and sold.

NSE: National Stock Exchange

BSE: Bombay Stock Exchange

Lenders: A lender is a financial institution that lends money to a corporate or an individual borrower with the expectation that the money will be repaid at a later.

Answers to Check Your Progress

1. Financial Economics
2. Crowther
3. Certificate of Deposit

Suggested Readings

1. Bhole (2009) "**Financial Institutions and Markets**", 4th Edition,McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), **Financial Markets and Institutions**, Sathyabawan Publications, Chennai.

Unit-2

Money Supply

STRUCTURE

Overview

Objectives

2.1. Money Supply Meaning

2.2. Components of Money Supply

2.3. Characters of Money Supply

2.4. Functions of Money Supply

2.5. Types of Money Market Instrument in India

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of money supply has been clearly explained. Study the role of money supply is the total amount of money-cash, coins, and balances in bank accounts-in circulation. The money supply is commonly defined to be a group of safe assets that households and businesses can use to make payments or to hold as short-term investments

Objectives

After reading this unit, student should be able to:

- Know the components, characters and functions of money.
- Understand the Money Market Instrument in India.

2.1. Meaning of Money Supply:

Money supply means the total stock of money in circulation among the people at a particular point of time in an economy. It consists of various components as follows: Demand, time and saving deposits in commercial banks and other types of deposits are the total amount of money in an economy.

2.2. Components of Money Supply

The money supply, also known as the money stock, refers to the total amount of money in circulation within an economy. It includes various

forms of money, ranging from physical currency to different types of deposits. The money supply is typically categorized into different measures or components, often referred to as M1, M2, and M3. The components can vary by country, but here are the commonly recognized components:

1. **M0 (MB) - Central Bank Money:**
   - **Currency in Circulation (CIC):** The physical cash (coins and banknotes) held by the non-banking public and businesses.
   - **Reserves (R):** The reserves held by commercial banks in their accounts with the central bank. This includes required reserves and excess reserves.
2. **M1 - Narrow Money:**
   - **Currency in Circulation (CIC):** Same as in M0.
   - **Demand Deposits (DD):** The total value of funds held in checking accounts and other types of demand deposits that can be quickly converted into cash.
3. **M2 - Broad Money:**
   - **M1 (Currency in Circulation + Demand Deposits):** Same as in M1.
   - **Savings Deposits (SD):** Funds held in savings accounts, which may have restrictions on withdrawals.
   - **Time Deposits (TD):** Fixed-term deposits, where funds are deposited for a specific period, and withdrawals may have penalties.
   - **Retail Money Market Funds (MMF):** These are mutual funds that invest in short-term money market instruments and are considered part of M2.
4. **M3 - Broadest Money:**
   - **M2 (M1 + Savings Deposits + Time Deposits + Retail Money Market Funds):** Same as in M2.
   - **Large Time Deposits:** Larger, institutional time deposits that are not included in M2.
   - **Institutional Money Market Funds:** Similar to retail money market funds but designed for institutional investors.

It's important to note that the definitions and categorizations of money supply components can vary from country to country. Central banks and financial authorities closely monitor the money supply as part of their

efforts to understand and manage monetary policy. Changes in the money supply can have implications for inflation, interest rates, and overall economic stability. The definitions and classifications may also be subject to revision or adjustment based on changes in financial markets and banking practices.

2.3. Characters of Money

- **General Acceptability:** An important quality of money is its acceptance. Good money requires acceptance to all without any hesitation. Since the law declares Money as the legal tender, it has an inherent quality of general acceptability.
- **Portability**: Apart from its acceptance, good money also requires portability. If people can carry or transfer money from one place to another, then it is good money.
- **Indestructibility or Durability:** Acceptance and portability aside, the material used to make money must last for a long time without losing its value. For example, ice and fruits are not good money since they lose their value quickly with the passage of time. After all, ice melts and fruits perish. Therefore, durability is an essential quality of good money.
- **Homogeneity**: Look at two 100 rupee notes. They look and feel identical, right? They also have the same value. In fact, nobody can distinguish between two currency notes right out of the mint. This is an important quality of good money – homogeneity. If money is not homogeneous, then transactions will become uncertain as people would be unsure of what they are receiving.
- **Divisibility:** Talking about the qualities of good money, it is important to remember the divisibility of money. If someone wants to buy a smaller unit of a commodity, then divisibility of money can make it possible. For example, cows cannot function as good money. This is because you cannot divide a cow without making it lose its value.
- **Malleability:** The money material should be capable of being melted, beaten and given convenient shapes. It should be neither too hard nor too soft. If the former, it cannot be easily coined; If the latter, it would not last long.
- **Cognizability:** The ability to recognize money is critically important. Today, we can look at a currency note and tell its value. If money is not cognizable, then people can find it difficult to determine if they are dealing with money or some inferior asset.
- **Stability of Value**: Of all the qualities of good money, stability is probably the most essential one. The value of money cannot change

for a long period of time and hence remain stable. If the value of money keeps changing, then it will fail to function as a measure of value and as a standard of deferred payment.

2.4. Functions of Money

- **Medium of exchange**: First, money serves as a medium of exchange, which means that money acts as an intermediary between the buyer and the seller. Instead of exchanging accounting services for shoes, the accountant now exchanges accounting services for money. This money is then used to buy shoes. To serve as a medium of exchange, money must be very widely accepted as a method of payment in the markets for goods, labor, and financial capital.
- **Store of value:** Second, money must serve as a store of value. In a barter system, we saw the example of the shoemaker trading shoes for accounting services. But she risks having her shoes go out of style, especially if she keeps them in a warehouse for future use their value will decrease with each season. Shoes are not a good store of value.

  Holding money is a much easier way of storing value. You know that you do not need to spend it immediately because it will still hold its value the next day, or the next year. This function of money does not require that money is a perfect store of value. In an economy with inflation, money loses some buying power each year, but it remains money.
- **Standard of deferred payment:** Another function of money is that money must serve as a standard of deferred payment**.** This means that if money is usable today to make purchases, it must also be acceptable to make purchases today that will be paid in the future*.* Loans and future agreements are stated in monetary terms and the standard of deferred payment is what allows us to buy goods and services today and pay in the future.
- **Measure of value:** Money as a measure of value, helps in determining the value of goods and services in the economy. Money is taken as the common denominator while measuring the value of goods and services in the economy. Therefore, with the help of this function everything can be measure in a common denominator or unit.
- **The basis of credit:** Money facilitates the functioning of credit instruments such as cheques, promissory notes, bills of exchange, etc. Such credit instruments facilitate transfer of value

from one person to another. In this way. Money forms the basis of credit.

- **A unit of account:** Third, money serves as a unit of account, which means that it is the ruler by which other values are measured. For example, an accountant may charge $100 to file your tax return. That $100 can purchase two pair of shoes at $50 a pair. Money acts as a common denominator, an accounting method that simplifies thinking about trade-offs.

2.5. Types of Money Market Instruments in India

1) **Treasury Bills:** Treasury bills are issued when the government needs money for a short period. These bills are issued only by the central government, and the interest on them is determined by market forces. Treasury bills, or T-bills, have a maximum maturity period of 364 days.
2) **Commercial Bills**: Commercial bills are unsecured, short-term debt issued by a corporation, often times for the financing of short-term liabilities and inventory. Meanwhile, a Treasury bill (T-Bill) is short-term debt backed by the U.S. government with a maturity of under one year.
3) **Certificate of Deposit:** Certificate of Deposit or CD is a fixed-income financial instrument governed under the Reserve Bank of India issued in a dematerialized form where the amount at withdrawal is assured from the beginning. A CD can be issued by any All-India Financial Institution or Scheduled Commercial Bank.
4) **Commercial Paper:** Commercial paper, also called CP, is a short-term debt instrument issued by companies to raise funds generally for a time period up to one year. It is an unsecured money market instrument issued in the form of a promissory note and was introduced in India for the first time in 1990.
5) **Call Money**: Banks and PDs borrow and lend overnight or for the short period to meet their short term mismatches in fund positions. This borrowing and lending is on unsecured basis. 'Call Money' is the borrowing or lending of funds for 1day.

2.6. Bank rate

The term "bank rate" can have different meanings depending on the context. Here are two common interpretations:

1. Central Bank Rate:

In many countries, the bank rate refers to the interest rate at which a country's central bank lends money to commercial banks. It is also known as the policy rate or discount rate. The central bank sets this rate as part of its monetary policy tools to influence the overall level of interest rates in the economy. By adjusting the bank rate, the central bank aims to achieve monetary policy objectives such as controlling inflation, supporting economic growth, or stabilizing the currency.

2. Interest Rate Charged by Commercial Banks:

In some contexts, the term "bank rate" may also refer to the interest rate that commercial banks charge their customers for various types of loans, such as personal loans, business loans, or mortgages. This rate is determined by individual banks based on their cost of funds, operational expenses, and the risk associated with lending.

It's essential to be clear about the specific context in which the term "bank rate" is used to understand whether it refers to the central bank rate or the interest rate charged by commercial banks. Central banks use their policy rates strategically to influence economic conditions, while commercial banks set their interest rates based on a variety of factors, including market conditions and their own lending policies.

Let Us Sum Up

In this unit you have learned about the following:

The money supply is the total amount of money cash, coins, and balances in bank accounts in circulation. The money supply is commonly defined to be a group of safe assets that households and businesses can use to make payments or to hold as short-term investments

Check Your Progress

1. ____________ means the total stock of money in circulation among the people at a particular point of time in an economy
2. If the value of money keeps changing, then it will fail to function as a measure of value and as a ____________
3. Money facilitates the functioning of ____________ such as cheques, promissory notes, bills of exchange, etc.

Glossary

Stock: It is a general term used to describe the ownership certificates of any company.

Financial institution: It is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange

Liquidity: It refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price.

Answers to Check Your Progress

1. Money supply
2. Standard
3. Credit

Suggested Readings

1. Bhole (2009) "**Financial Institutions and Markets**", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), **Financial Markets and Institutions**, Sathyabawan Publications, Chennai.

Unit -3
Monetary Policy

STRUCTURE

Overview

Objectives

3.1. Introduction of Monetary Policy

3.2. Meaning and Definition of Monetary Policy

3.3. Objectives of Monetary Policy

3.4. Types of Monetary Policy

3.5. Monetary Policy Instruments

3.6. Monetary Policy: Stabilizing Prices and Output

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of monetary policy has been clearly explained. Monetary policy, measures employed by governments to influence economic activity, specifically by manipulating the money supply and interest rates. Monetary and fiscal policy are two ways in which governments attempt to achieve or maintain high levels of employment, price stability, and economic growth.

Objectives

After reading this unit, Student should be able to:

- Understand the Objective and instruments of Monetary Policy
- Identify the monetary policy is helpful in Stabilizing Prices and Output

3.1. Introduction of Monetary Policy

In India, monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth. The RBI implements the monetary policy through open market operations, bank rate policy, reserve system, credit control policy, moral persuasion and through many other instruments. Using any of these instruments will lead to changes in the interest rate, or the money supply

in the economy. Monetary policy can be expansionary and contractionary in nature. Increasing money supply and reducing interest rates indicate an expansionary policy. The reverse of this is a contractionary monetary policy.

3.2. Meaning of Monetary Policy

Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

3.3. Objectives of Monetary Policy

1. **Price Stability / Low and Stable Inflation:** One of the primary goals of monetary policy is often to maintain price stability by controlling inflation. Central banks target a specific inflation rate (usually a low, positive percentage) to ensure that the purchasing power of the currency remains relatively stable over time.
2. **Full Employment / Low Unemployment:** Central banks may aim to support full employment or a low level of unemployment in the economy. By influencing interest rates and the money supply, monetary policy can impact investment, consumption, and economic growth, which, in turn, affects employment levels.
3. **Economic Growth:** Stimulating or moderating economic growth is another objective of monetary policy. Central banks may adjust interest rates to encourage borrowing and spending during periods of economic slowdown or to cool down an overheating economy during periods of rapid growth.
4. **Exchange Rate Stability:** Some countries may target exchange rate stability as an objective of monetary policy. Central banks intervene in currency markets or adjust interest rates to prevent excessive volatility in exchange rates, which can impact trade and economic stability.
5. **Interest Rate Stability:** Central banks aim to maintain stability in interest rates to provide a predictable and supportive environment for businesses and households. Stability in interest rates can also contribute to overall economic stability.
6. **Financial Market Stability:** Promoting stability in financial markets is crucial for the proper functioning of the economy. Central banks may use monetary policy tools to address disruptions in financial markets and prevent systemic risks.

7. **Maintaining Confidence in the Currency:** Central banks work to maintain public confidence in the domestic currency. Confidence is essential for the currency to serve as a reliable store of value, medium of exchange, and unit of account.
8. **Avoiding Deflation:** Central banks aim to avoid deflation, which is a sustained decrease in the general price level. Deflation can have negative effects on economic growth by encouraging consumers and businesses to postpone spending and investment.
9. **Sustainable Development:** In some cases, central banks consider broader economic objectives such as sustainable development, environmental sustainability, and income distribution. These considerations may become more prominent as central banks adapt to evolving economic challenges.

3.4. Types of Monetary Policy

Broadly speaking, there are two types in the monetary policy.

1. Expansionary Monetary Policy:

Objective: Stimulate economic growth, reduce unemployment, and increase inflation.

Tools:

- **Lowering Policy Interest Rates:** Central banks can decrease the policy interest rate (such as the federal funds rate in the United States or the key policy rate in other countries). Lower interest rates encourage borrowing and spending by consumers and businesses, thereby stimulating economic activity.
- **Open Market Operations (OMO):** The central bank can engage in the purchase of government securities in the open market. This increases the money supply, lowers interest rates, and supports lending and investment.
- **Discount Rate Reduction:** The central bank can lower the discount rate, which is the interest rate at which commercial banks can borrow directly from the central bank. This encourages banks to borrow more and lend to businesses and individuals at lower rates.

2. Contractionary Monetary Policy:

Objective: Control inflation, stabilize prices, and prevent an overheated economy.

Tools:

- **Raising Policy Interest Rates:** Central banks can increase the policy interest rate to make borrowing more expensive. Higher interest rates can reduce spending and investment, helping to cool down an economy experiencing inflationary pressures.
- **Open Market Operations (OMO):** The central bank can sell government securities in the open market. This reduces the money supply, increases interest rates, and restrains lending and spending.
- **Discount Rate Increase:** The central bank can raise the discount rate, making it more expensive for banks to borrow from the central bank. This, in turn, can lead to higher interest rates in the broader economy.

3.5. Monetary Policy Instruments

The implementation of RBI's Quantitative and Qualitative (Called as Monetary Policy) instruments plays an important role in the development of the country. If the required money supply for the economy is not available in the market, it leads to a decline in investment in the economy. On the other hand, if the money supply in the economy is more than what is required, then the poor section of the economy will suffer because the price of essential commodities will rise.

In the Indian Economy, RBI is the sole authority that decides the money supply in the economy. And to control this, RBI implements the monetary policy's Quantitative and Qualitative instruments to achieve economic goals. The main instruments of these policies are CRR, SLR, Bank Rate, Repo Rate, Reverse Repo Rate, Open Market Operations, etc. Let's understand the Quantitative and Qualitative instruments of RBI's monetary policy individually.

1) Quantitative Methods

The quantitative instruments are also known as general tools used by the RBI (Reserve Bank of India). As the name suggests, these instruments are related to the quantity and volume of the money. These instruments are designed to control the total volume/money of the bank credit in the economy. These instruments are indirect in their nature and are used to influence the quantity of credit in the economy.

Bank Rate Policy

The bank rate is the minimum rate at which the central bank lends money and rediscounts first-class bills of exchange and securities held by commercial banks. When RBI gets a hint that inflation is rising, it

increases the bank interest rates so that commercial banks borrow less money and the inflation stays under control.

Commercial banks also increase their lending rate to the public and business enterprises so that people borrow less money, which will eventually help to control inflation. On the other hand, when RBI reduces bank rates, that means borrowing for commercial banks will become cheap and easier. This allows the commercial banks to lend money to borrowers on a lower lending rate, which will further encourage borrowers and businessmen.

Legal Reserve Ratios

The commercial banks have to keep a certain amount of reserve assets in the form of reserve cash. Some portion of these cash reserves is their total assets in the form of cash. To maintain liquidity and to control credit in the economy, the RBI also keeps a certain amount of cash reserves. These reserve ratios are known as SLR (Statutory Liquidity Ratio) and CRR (Cash Reserve Ratio).

Cash Reserve Ratio: It refers to a certain percentage of commercial bank's net demand and time liability that commercial banks have to maintain with the RBI at all times. In India, the CRR remains between 3-15 per cent by the law.

Statutory Liquidity Ratio: It refers to a certain percentage of reserves to be maintained in the form of gold and foreign securities. In India, SLR remains 25-40% by the law. Any changes in SLR and CRR bring out the change in the position of commercial banks.

Open Market Operations (OMO)

The sale and purchase of security in the long run/short run by the RBI in the money market is known as open market operations. This is a popular instrument of the RBI's monetary policy.

To influence the term and structure of the interest rate and to stabilize the market for government securities, etc., the RBI uses OMO, and this operation is also used to wipe out the shortage of money in the money market. If RBI sells securities in the money market, private and commercial banks and even individuals buy it.

This leads to a reduction in the existing money supply as money gets transferred from commercial banks to the RBI. On the other hand, when RBI buys securities from the commercial banks, the commercial banks that sell receive the amount they had invested in RBI before.

There are certain factors that affect OMOwhich include underdeveloped securities market, excess reserves with the commercial banks, indebtedness of the commercial banks, etc.

Repo Rate

A Repo rate is a rate at which commercial banks borrow money by selling their securities to the RBI to maintain liquidity. Commercial banks sell their securities in case of a shortage of funds or due to some statutory measures. It is one of the main instruments of the RBI to keep inflation under control.

Reverse Repo Rate

Sometimes, the RBI borrows money from commercial banks when there is excess liquidity in the market. In that case, commercial banks get benefits by receiving the interest on their holdings with the RBI. At the time of higher inflation in the country, RBI increases the reverse repo rate that encourages banks to park more funds with the RBI, which will help it earn higher returns on excess funds.

2. Qualitative Methods

Qualitative instruments are also known as selective instruments of the RBI's monetary policy. These instruments are used for discriminating between various uses of credit; for example, they can be used for favoring export over import or essential over non-essential credit supply. This method has an influence on both borrowers and lenders. Following are some selective tools of credit control used by the RBI:

Rationing of Credit

RBI fixes a credit amount to be granted for commercial banks. Credit is given by limiting the amount available for each commercial bank. For certain purposes, the upper credit limit can be fixed, and banks have to stick to that limit. This helps in lowering the bank's credit exposure to unwanted sectors. This instrument also controls the bill rediscounting.

Regulation of Consumer Credit

In this instrument, consumers' credit supply is regulated through the instalment of sale and hire purchase of consumer goods. Here, features like instalment amount, down payment, loan duration, etc., are all fixed in advance, which helps to check the credit and inflation in the country.

Change in Marginal Requirement

Margin is referred to the certain proportion of the loan amount that is not offered or financed by the bank. Change in marginal can lead to change in the loan size. This instrument is used to encourage the credit supply for the necessary sectors and avoid it for the unnecessary sectors. That can be done by increasing the marginal of unnecessary sectors and reducing the marginal of other needy sectors. Suppose, RBI feels that

more credit supply should be allotted to the agricultural sector, then RBI will reduce the margin, and even 80-90% of the loan can be allotted.

Moral Suasion

Moral suasion refers to the suggestions to commercial banks from the RBI that helps in restraining credits in the inflationary period. RBI implies pressure on the Indian banking system without taking any strict action for compliance with rules. Through monetary policy, commercial banks get informed of the expectations of RBI. The RBI can issue directives, guidelines, and suggestions for commercial banks regarding reducing credit supply for speculative purposes under the moral suasion.

Both methods affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements (cash reserve ratio, statutory reserve ratio). Policy instruments are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit

3.6. Monetary Policy: Stabilizing Prices and Output

Monetary policy has lived under many guises. But however it may appear, it generally boils down to adjusting the supply of money in the economy to achieve some combination of inflation and output stabilization.

Most economists would agree that in the long run, output usually measured by Gross Domestic Product (GDP) is fixed, so any changes in the money supply only cause prices to change. But in the short run, because prices and wages usually do not adjust immediately, changes in the money supply can affect the actual production of goods and services. This is why monetary policy generally conducted by central banks such as the U.S. Federal Reserve (Fed) or the European Central Bank (ECB) is a meaningful policy tool for achieving both inflation and growth objectives.

In a recession, for example, consumers stop spending as much as they used to; business production declines, leading firms to lay off workers and stop investing in new capacity; and foreign appetite for the country's exports may also fall. In short, there is a decline in overall, or aggregate, demand to which government can respond with a policy that leans against the direction in which the economy is headed. Monetary policy is often that countercyclical tool of choice. Such a countercyclical policy would lead to the desired expansion of output (and employment), but,

because it entails an increase in the money supply, would also result in an increase in prices. As an economy gets closer to producing at full capacity, increasing demand will put pressure on input costs, including wages. Workers then use their increased income to buy more goods and services, further bidding up prices and wages and pushing generalized inflation upward an outcome policymakers usually want to avoid.

Twin objectives

The monetary policymaker, then, must balance price and output objectives. Indeed, even central banks, like the ECB, that target only inflation would generally admit that they also pay attention to stabilizing output and keeping the economy near full employment. And at the Fed, which has an explicit "dual mandate" from the U.S. Congress, the employment goal is formally recognized and placed on an equal footing with the inflation goal.

Monetary policy is not the only tool for managing aggregate demand for goods and services. Fiscal policy taxing and spending is another, and governments have used it extensively during the recent global crisis. However, it typically takes time to legislate tax and spending changes, and once such changes have become law, they are politically difficult to reverse. Add to that concerns that consumers may not respond in the intended way to fiscal stimulus (for example, they may save rather than spend a tax cut), and it is easy to understand why monetary policy is generally viewed as the first line of defense in stabilizing the economy during a downturn. (The exception is in countries with a fixed exchange rate, where monetary policy is completely tied to the exchange rate objective.)

Independent policy

Although it is one of the government's most important economic tools, most economists think monetary policy is best conducted by a central bank (or some similar agency) that is independent of the elected government. This belief stems from academic research, some 30 years ago, that emphasized the problem of time inconsistency.

Monetary policymakers who were less independent of the government would find it in their interest to promise low inflation to keep down inflation expectations among consumers and businesses. But later, in response to subsequent developments, they might find it hard to resist expanding the money supply, delivering an "inflation surprise." That surprise would at first boost output, by making labor relatively cheap (wages change slowly), and would also reduce the real, or inflation-adjusted, value of government debt. But people would soon recognize

this “inflation bias” and ratchet up their expectations of price increases, making it difficult for policymakers ever to achieve low inflation.

To overcome the problem of time inconsistency, some economists suggested that policymakers should commit to a rule that removes full discretion in adjusting monetary policy. In practice, though, committing credibly to a (possibly complicated) rule proved difficult. An alternative solution, which would still shield the process from politics and strengthen the public’s confidence in the authorities’ commitment to low inflation, was to delegate monetary policy to an independent central bank that was insulated from much of the political process as was the case already in a number of economies. The evidence suggests that central bank independence is indeed associated with lower and more stable inflation.

Conducting monetary policy

How does a central bank go about changing monetary policy? The basic approach is simply to change the size of the money supply. This is usually done through open-market operations, in which short-term government debt is exchanged with the private sector. If the Fed, for example, buys or borrows Treasury bills from commercial banks, the central bank will add cash to the accounts, called reserves, that banks are required keep with it. That expands the money supply. By contrast, if the Fed sells or lends treasury securities to banks, the payment it receives in exchange will reduce the money supply.

While many central banks have experimented over the years with explicit targets for money growth, such targets have become much less common, because the correlation between money and prices is harder to gauge than it once was. Many central banks have switched to inflation as their target either alone or with a possibly implicit goal for growth and/or employment. When a central bank speaks publicly about monetary policy, it usually focuses on the interest rates it would like to see, rather than on any specific amount of money (although the desired interest rates may need to be achieved through changes in the money supply).

Central banks tend to focus on one “policy rate” generally a short-term, often overnight, rate that banks charge one another to borrow funds. When the central bank puts money into the system by buying or borrowing securities, colloquially called loosening policy, the rate declines. It usually rises when the central bank tightens by soaking up reserves. The central bank expects that changes in the policy rate will feed through to all the other interest rates that are relevant in the economy.

Transmission mechanisms

Changing monetary policy has important effects on aggregate demand, and thus on both output and prices. There are a number of ways in which policy actions get transmitted to the real economy (Ireland, 2008). The one people traditionally focus on is the interest rate channel. If the central bank tightens, for example, borrowing costs rise, consumers are less likely to buy things they would normally finance such as houses or cars and businesses are less likely to invest in new equipment, software, or buildings. This reduced level of economic activity would be consistent with lower inflation because lower demand usually means lower prices. But this is not the end of the story.

A rise in interest rates also tends to reduce the net worth of businesses and individuals the so-called balance sheet channel making it tougher for them to qualify for loans at any interest rate, thus reducing spending and price pressures. A rate hike also makes banks less profitable in general and thus less willing to lend the bank lending channel. High rates normally lead to an appreciation of the currency, as foreign investors seek higher returns and increase their demand for the currency. Through the exchange rate channel, exports are reduced as they become more expensive, and imports rise as they become cheaper. In turn, GDP shrinks.

Monetary policy has an important additional effect on inflation through expectations the self-fulfilling component of inflation. Many wage and price contracts are agreed to in advance, based on projections of inflation. If policymakers hike interest rates and communicate that further hikes are coming, this may convince the public that policymakers are serious about keeping inflation under control. Long-term contracts will then build in more modest wage and price increases over time, which in turn will keep actual inflation low.

When rates can go no lower

After the onset of the global financial crisis in 2008, central banks worldwide cut policy rates sharply in some cases to zero exhausting the potential for cuts. Nonetheless, they have found unconventional ways to continue easing policy. One approach has been to purchase large quantities of financial instruments from the market. This so-called quantitative easing increases the size of the central bank's balance sheet and injects new cash into the economy. Banks get additional reserves (the deposits they maintain at the central bank) and the money supply grows.

A closely related option, credit easing, may also expand the size of the central bank's balance sheet, but the focus is more on the composition

of that balance sheet that is, the types of assets acquired. During the recent crisis, many specific credit markets became blocked, and the result was that the interest rate channel did not work. Central banks responded by targeting those problem markets directly. For instance, the Fed set up a special facility to buy commercial paper (very short-term corporate debt) to ensure that businesses had continued access to working capital. It also bought mortgage-backed securities to sustain housing finance.

Some argue that credit easing moves monetary policy too close to industrial policy, with the central bank ensuring the flow of finance to particular parts of the market. But quantitative easing is no less controversial. It entails purchasing a more “neutral” asset, like government debt, but it moves the central bank toward financing the government’s fiscal deficit, possibly calling its independence into question.

Let Us Sum Up

In this unit you have learned about the following:

Monetary policy, measures employed by governments to influence economic activity, specifically by manipulating the money supply and interest rates. Monetary and fiscal policy are two ways in which governments attempt to achieve or maintain high levels of employment, price stability, and economic growth.

Check Your Progress

1. The RBI implements the ________ through open market operations, bank rate policy, reserve system etc.,
2. ________ is a rate at which commercial banks borrow money by selling their securities to the RBI to maintain liquidity’
3. The sale and purchase of security in the long run/short run by the RBI in the money market is known as ________

Glossary

Open market operation: The purchase and sale of securities in the open market by a central bank.

Bank rate policy: A bank rate is the interest rate at which anation's central bank lends money to domestic banks, often in the form of very short-term loans.

Federal Reserve System: It is the Central Bank and Monetary Authority of the United States.

Credit control policy: It is a business strategy that promotes the selling of goods or services by extending credit to customers.

Answers to Check Your Progress

1. Monetary Policy
2. Repo Rate
3. open market operations

Suggested Readings

1. Bhole (2009) "**Financial Institutions and Markets**", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), **Financial Markets and Institutions**, Sathyabawan Publications, Chennai.

Unit-4

Banking System in India

STRUCTURE

Overview

Objectives

4.1. Introduction to Indian Banking system

4.2. Evolution of Indian Banking

4.3. Banking Structure in India

4.4. Recent development in Indian Banking Sector

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Banking System in India has been clearly explained. Indian banking system consists of 12 public sector banks, 22 private sector banks, 46 foreign banks, 56 regional rural banks, 1485 urban cooperative banks and 96,000 rural cooperative banks in addition to cooperative credit institutions.

Objectives

After reading this unit, student should be able to:

- Describe the Banking Structure in India
- Know the Recent development in Indian Banking Sector.

4.1. Introduction to Indian Banking system

It supervises and administers exchange control and banking regulations and administers the government's monetary policy. The banking system in India works according to the guidelines issued by the RBI. The banking sector is the lifeline of the modern economy

4.2. Evolution of Indian Banking

Let's take a look at the evolution of banking in India from the time the first bank was established in India to the current mobile banking era– what happened in between. The history of banking in India can be broadly classified as:

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 nationalized in 1955 and was named The State Bank of India, which is currently the largest Public Sector Bank.

Given below is a list of other banks which were established during the Pre-Independence period:

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

Table 4.1 Pre-independence Banks in India

If we talk of the reasons as to why many major banks failed to survive during the pre-independence period, the following conclusions can be drawn:

- Indian account holders had become fraud-prone

- Lack of machines and technology
- Human errors & time-consuming
- Fewer facilities
- Lack of proper management skills

Following the Pre-Independence period was the post-independence period, which observed some significant changes in the banking industry scenario and has till date developed a lot.

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 nationalize the Banks. These banks were nationalized under the Banking Regulation Act, 1949. Whereas, the Reserve Bank of India was nationalized in 1949.

Following it was the formation of State Bank of India in 1955 and the other 14 banks were nationalized 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 nationalized 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 nationalized, taking the number to 20 banks. These banks included:

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Comm.
5. Punjab & Sind Bank
6. Vijaya Bank

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

1. State Bank of Patiala
2. State Bank of Hyderabad
3. State Bank of Bikaner & Jaipur
4. State Bank of Mysore
5. State Bank of Travancore
6. State Bank of Saurashtra
7. 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.

Liberalization 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 Nationalized 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:

1. Global Trust Bank

2. ICICI Bank
3. HDFC Bank
4. Axis Bank
5. Bank of Punjab
6. IndusInd Bank
7. Centurion Bank
8. IDBI Bank
9. Times Bank
10. Development Credit Bank

4.3. Banking Structure in India

Reserve Bank of India is the central bank of the country and regulates the banking system of India. The structure of the banking system of India can be broadly divided into scheduled banks, non- scheduled banks and development banks.

Banks that are included in the second schedule of the Reserve Bank of India Act, 1934 are considered to be scheduled banks.

All scheduled banks enjoy the following facilities:

- Such a bank becomes eligible for debts/loans on bank rate from the RBI
- Such a bank automatically acquires the membership of a clearing house.

All banks which are not included in the second section of the Reserve Bank of India Act, 1934 are Non-scheduled Banks. They are not eligible to borrow from the RBI for normal banking purposes except for emergencies.

Scheduled banks are further divided into commercial and cooperative banks.

Commercial Banks

The institutions that accept deposits from the general public and advance loans with the purpose of earning profits are known as Commercial banks. It can be broadly divided into public sector, private sector, foreign banks and RRBs.

- In **Public Sector Banks** the majority stake is held by the government. After the recent amalgamation of smaller banks with larger banks, there are 12 public sector banks in India as of now. An example of Public Sector Bank is State Bank of India.

- **Private Sector Banks** are banks where the major stakes in the equity are owned by private stakeholders or business houses. A few major private sector banks in India are HDFC Bank, Kotak Mahindra Bank, ICICI Bank etc.
- A **Foreign Bank** is a bank that has its headquarters outside the country but runs its offices as a private entity at any other location outside the country. Such banks are under an obligation to operate under the regulations provided by the central bank of the country as well as the rule prescribed by the parent organization located outside India. An example of Foreign Bank in India is Citi Bank.
- **Regional Rural Banks** were established under the Regional Rural Banks Ordinance, 1975 with the aim of ensuring sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area notified by the Government. RRBs are owned jointly by the Government of India, the State Government and Sponsor Banks. An example of RRB in India is Arunachal Pradesh Rural Bank.

Cooperative Banks

A **Cooperative Bank** is a financial entity that belongs to its members, who are also the owners as well as the customers of their bank. They provide their members with numerous banking and financial services. Cooperative banks are the primary supporters of agricultural activities, some small-scale industries and self-employed workers. An example of a Cooperative Bank in India is Mehsana Urban Co-operative Bank.

At the ground level, individuals come together to form a Credit Co-operative Society. The individuals in the society include an association of borrowers and non-borrowers residing in a particular locality and taking interest in the business affairs of one another. As membership is practically open to all inhabitants of a locality, people of different status are brought together into the common organization. All the societies in an area come together to form a Central Co-operative Banks.

Cooperative banks are further divided into two categories - urban and rural.

- Rural cooperative Banks are either short-term or long-term.
- Short-term cooperative banks can be subdivided into State Co-operative Banks, District Central Co-operative Banks, Primary Agricultural Credit Societies.
- Long-term banks are either State Cooperative Agriculture or Rural Development Banks (SCARDBs) or Primary Cooperative

Agriculture and Rural Development Banks (PCARDBs).

- Urban Co-operative Banks (UCBs) refer to primary cooperative banks located in urban and semi-urban areas.

Development Banks

Financial institutions that provide long-term credit in order to support capital-intensive investments spread over a long period and yielding low rates of return with considerable social benefits are known as Development Banks. The major development banks in India are; Industrial Finance Corporation of India (IFCI Ltd), 1948, Industrial Development Bank of India' (IDBI) 1964, Export-Import Banks of India (EXIM) 1982, Small Industries Development Bank Of India (SIDBI) 1989, National Bank for Agriculture and Rural Development (NABARD) 1982.

The banking system of a country has the capability to heavily influence the development of a country's economy. It is also instrumental in the development of rural and suburban regions of a country as it provides capital for small businesses and helps them to grow their business.

The organized financial system comprises Commercial Banks, Regional Rural Banks (RRBs), Urban Co-operative Banks (UCBs), Primary Agricultural Credit Societies (PACS) etc. caters to the financial service requirement of the people. The initiatives taken by the Reserve Bank and the Government of India in order to promote financial inclusion have considerably improved the access to the formal financial institutions. Thus, the banking system of a country is very significant not only for economic growth but also for promoting economic equality.

4.4. Recent development in Indian Banking System

In the recent year, the banking Industry has been undergoing rapid changes which is reflecting in banking reforms. Telecommunication and Information technology are the most significant areas which have changed rapidly. It has accelerated the broadcasting of financial information which lowering the costs of many financial activities.

In the last few year banking sector has introduce new products: Credit Cards, ATM, Tele-Banking, Electronic Fund Transfer (EFT), Internet Banking, Mobile Banking etc. These new products increase the efficiency of banks by reducing transactions cost. Some of the important areas which developed recently are discussing here.

Retail Banking Concept:

One of the major development in the banking sector is the introduction of retail banking in the country. At present, banks are focusing more on

retail banking by proving various loan facilities to depositors. The banking sector is facing increased competition from non-banking institution. The Retail Banking encompasses various financial products (different type of deposit accounts, home loan, auto loan, credit cards, demate facilities, Insurance mutual funds, credit and debit cards, ATM, Stock broking, payment of utility bills) catering to diverse customer groups, offering a host of financial services, mostly to individuals. Simply speaking, it takes care of the diverse banking needs of an individual. (Kaur, Bhandri and Gupt, 2009). Now a days, banks are focusing more on individual needs through retail banking which increased the other income of the banks significantly.

Information Technology:

Information technology (IT) has transformed the functioning of businesses, the world over. With the innovation in the IT, Indian banking sector has benefited a lot by offering new products and services. Information technology has helped the banking sector by opening newer delivery channels to customers – ATMs networking in the form of shared payment networks, internet banking, implementation of core Banking solutions, mobile banking etc. 13 The RBI has played a proactive role in the implementation of IT in the banking sector. According to RBI the two major advantages of technological adoptions.

a. Reduction in banks operational cost.
b. Facilitating more efficient transactions among customers with in the same network.

Over the year RBI has increase the role of technology in the day to day operation of banks. The IT Vision Document, 2011-17 of the Reserve Banks sets out the roadmap for implementation of key IT applications in banking with special emphasis on seamless delivery of banking services through effective implementation of Business Continuity Management (BCM). Information Security policy, and Business process Re-engineering (BPR). Public sector banks accounting for more than 60% of the total number of ATMs as at end March 2012, while close to one third of the total ATMs were attribute to the new private sector banks.

On Comparing the number of off-site and on-site ATM installed, it has been noted that new private sector banks have largest number of off-site ATMs in 2011-12, while Public sector banks have largest number of on-site ATMs. Further, foreign banks have more offsite ATMs than on-site ATMs in all the financial area.

Consolidation through Mergers:

To archive a higher level of efficiency and taking benefits of economics

of scale, mergers and acquisition are increasing in the banking sector. The RBI has been encouraging the consideration process wherever possible, given the inability of small banks to complete with large banks which enjoy enormous economies of scale and scope. It is observe that most of the mergers and acquisitions are voluntary and market driven between the healthy and financially sound and based on profitability motive.

Banking Structure in India:

Indian banking system consists of "nonscheduled banks" and "scheduled banks". Nonscheduled banks refer to those that are not included in the second schedule of the Banking Regulation Act of 1965 and thus do not satisfy the conditions laid down by that schedule. Schedule banks refer to those that are included in the Second Schedule of Banking Regulation Act of 1965 and thus satisfy the following conditions: a bank must (1) have paid up capital and reserve of not less than Rs. 5 lakh and (2) satisfy the Reserve Bank of India (RBI) that its affairs are not conducted in a manner detrimental to the interest of its deposits. Scheduled banks consists of "scheduled commercial banks" and scheduled cooperative banks.

The former are further divided into four categories: (1) public sector banks (that are further classified as "Nationalized Banks and the "State Bank of India (SBI) banks"); (2) private sector banks (that are further classified as "Old Private Sector Banks" and "New Private Sector Banks" that emerged after 1991); (3) foreign banks in India, and (4) regional rural banks (that operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers, agricultural workers and small entrepreneurs). These scheduled commercial banks except foreign banks are registered in India under the Companies Act. 15 The SBI banks consist of SBI and five independently capitalized banking subsidiaries.

The SBI is the largest commercial bank in India in terms of profits, assets, deposits, branches and employees and has 13 head offices governed each by a board of directors under the supervision of a central board. It was originally established in 1806 when the bank of Calcutta (latter called the Bank of Bengal) was established, and then amalgamated as the Imperial Bank of India after the merger with the bank of Madras and the Bank of Bombay.

The Imperial Bank of India was Nationalized and named SBI in 1955. Nationalized banks refer to private sector banks that were nationalized (14 banks in 1969 and 6 in 1980) by the central government compared with the SBI banks, nationalized banks are centrally governed by their

respective head offices. In 1993, Punjab National Bank merged another nationalized bank, New Bank of India, leading to a decline in total number of nationalized banks from 20 to 19.

Regional rural banks account for only 4% of total assets of scheduled commercial banks. As at the end of March 2001, the number of scheduled banks is a follows: 19 nationalized banks, 8 SBI banks, 23 old private sector banks, 8 new private sector banks, 42 foreign banks, 196 regional rural banks and 67 cooperative banks. But number of scheduled commercial banks in India as on 31 October, 2012 as follows: 26 public sector banks 20 private sector banks.

Let Us Sum Up

The Indian banking system consists of 12 public sector banks, 22 private sector banks, 46 foreign banks, 56 regional rural banks, 1485 urban cooperative banks and 96,000 rural cooperative banks in addition to cooperative credit institutions.

Check Your Progress

1. ________is the central bank of the country and regulates the banking system of India
2. The institutions that accept deposits from the general public and advance loans with the purpose of earning profits are known as ________
3. The________ of a country has the capability to heavily influence the development of a country's economy

Glossary

Deposits: A deposit is a financial term that means money held at a bank

Scheduled banks: It is a banking corporation whose minimum paid up capital is Rs. 5 lakhs and does not harm the interest of the depositors.

Non-scheduled banks: These are the banks which do not comply with the rules specified by the Reserve Bank of India, or say the banks which do not come under the category of scheduled banks.

Answers to Check Your Progress

1. Reserve Bank of India
2. Commercial Banks
3. banking system

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Block-2: Introduction

Block-2: Banking and Financial System has been divided in to four Units.

Unit-5: Financial System deals with Introduction, Financial System-Meaning, Components of Financial System, Functions of Financial System and Importance of Financial System.

Unit-6: Types of Banks Structure explains about Introduction, Banking Meaning and Definition, Central Bank, Cooperative Bank, Commercial Banks, Regional Rural Banks, Local Area Banks, Specialized Banks, Small Finance Banks and Payment Banks.

Unit-7: RBI's Regulations and Functions of Commercial Banks discuss with Introduction, RBI's Regulations, Functions of Commercial Banks and Credit Creation.

Unit-8: Modern Functions of Banks describes about the Introduction, Key aspects of banks, Traditional Functions of Banks, Modern Functions of Banks.

In all the units of Block -2 **Banking and Financial System**, the Check your progress, Glossary, Answers to check your progress and Suggested Reading has been provided and the Learners are expected to attempt all the Check your progress as part of study.

Unit-5

Financial System

STRUCTURE

Overview

Objectives

5.1. Introduction

5.2. Financial System- Meaning

5.3. Components of Financial System

5.4. Functions of Financial System

5.5. Importance of Financial System

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of financial system has been clearly explained. Study about the financial system is a set of institutions, such as banks, insurance companies, and stock exchanges that permit the exchange of funds. Financial systems exist on firm, regional, and global levels.

Objectives

After reading this unit, student should be able to:

- Know the Financial System Functions and its importance
- Understand the Financial System Exist on Firm

5.1. Introduction

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges that permit the exchange of funds. Financial systems exist on firm, regional, and global levels.

A financial system is a network of financial institutions – such as insurance companies, stock exchanges, and investment banks – that work together to exchange and transfer capital from one place to another.

Through the financial system, investors receive capital to fund projects and receive a return on their investments.

5.2. Financial System- Meaning

A financial system consists of institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment, and providing facilities, including payment systems, for the financing of commercial activity. A financial system is an economic arrangement wherein financial institutions facilitate the transfer of funds and assets between borrowers, lenders, and investors. Its goal is to efficiently distribute economic resources to promote economic growth and generate a return on investment (ROI) for market participants.

The market participants may include investment banks, stock exchanges, insurance companies, individual investors, and other institutions. It functions at corporate, national, and international levels and is governed by various rules dictating the eligibility of participants and the use of funds for different purposes. Aside from financial institutions, financial markets, financial assets, and financial services are the components of the financial system.

5.3. Components of Financial System

The financial system is composed of many components depending on the level. From a company's perspective, its financial system includes procedures that follow its financial activities. It would include aspects such as finances, accounting, revenue, expenses, wages, and more. From a regional standpoint, the financial system, as mentioned above, facilitates the exchange of funds between borrowers and lenders. Players on a regional level would include banks and other financial institutions such as clearinghouses. On a global scale, the financial system includes the interactions between financial institutions, investors, central banks, government authorities, the World Bank, and more. This course serves as an introduction to the financial system. It breaks down the financial system into its six elements:

- Lenders & borrowers
- Financial intermediaries
- Financial instruments
- Financial markets
- Money creation
- Price discovery.

There are several financial system components to ensure a smooth transition of funds between lenders, borrowers, and investors.

- Financial Institutions
- Financial Markets
- Tradable or Financial Instruments
- Financial Services
- Currency (Money)

1) **Financial Institutions:** Financial institutions act as intermediaries between the lender and the borrower when providing financial services. These include:
   - Banks (Central, Retail, and Commercial)
   - Insurance Companies
   - Investment Companies
   - Brokerage Firms
2) **Financial Markets:** These are places where the exchange of assets occurs with borrowers and lenders, such as stocks, bonds, derivatives, and commodities. Financial markets help businesses to grow and expand by allowing investors to contribute capital. Investors invest in company stock with the expectation of it producing a return in the future. As the business makes a profit, it can then pass on the surplus to the investors.
3) **Financial Instruments:** Tradable or financial instruments enable individuals to trade within the financial markets. These can include cash, shares of stock (representing ownership), bonds, options, and futures.
4) **Financial Services:** Financial services provide investors a way of managing assets and offer protection against systemic risk. These also ensure individuals have the appropriate amount of capital in the most efficient investments to promote growth. Banks, insurance companies, and investment services would be considered financial services.
5) **Currency (Money):** A currency is a form of payment to exchange products, services, and investments and holds value to society.

Examples

Financial systems are an essential part of an economy, and without them, the flow of funds would cease to exist. It keeps evolving considering the regional or global economic situations. An example of this is the G20's virtual summit held in March 2020, discussing the role

and significance of the global approach to the financial crisis caused by the coronavirus pandemic. The center of discussion was the ability of the global financial system to operate effectively and efficiently. Financial markets have mitigated systemic risk due to the improved financial market infrastructures, systemically important financial market utilities, risk management standards, and centralized clearing houses. Here is another example to understand its importance in everyday life.

Business Loans

- When a business requires capital to fund new projects or develop new technology, it applies for a business loan. There are several options to get it done, such as getting a line of credit or an installment loan.
- To qualify for the loan, the lender looks at several business components like its credit score or balance sheet to determine the systemic risk of giving out the loan.
- The financial institution (bank) then allocates the necessary funds to the business. The business can use the money to fund a future project to generate additional income.
- The bank then requires the business to make payments towards the loan, including interests for its time value. .

5.4. Functions of Financial System

A financial system allows its participants to prosper and reap the benefits. It also helps in borrowing and lending when needed. In simpler words, it will circulate the funds to different parts of an economy. Here are some of the financial system functions:

1. **Payment System –** An efficient payment system allows businesses and merchants to collect money in exchange for their products or services. Payments can be made with cash, checks, credit cards, and even crypto currency in certain instances.
2. **Savings –** Public savings allow individuals and businesses to invest in a range of investments and see them grow over time. Borrowers can use them to fund new projects and increase future cash flow, and investors get a return on investment in return.
3. **Liquidity –** The financial markets give investors the ability to reduce the systemic risk by providing liquidity. It thus allows for easy buying and selling of assets when needed.
4. **Risk Management –** It protects investors from various financial risks through insurances and other types of contracts.

5. **Government Policy –** Governments attempt to stabilize or regulate an economy by implementing specific policies to deal with inflation, unemployment, and interest rates.

5.5. Importance of Financial System

1) **Links savers and borrower:** The financial system serves as an important source for bringing together the savers and borrowers. It bridges the gap in between the one who has excess of funds lying idle with them and one who are in need of them. The financial system enables in pooling of funds from one person to another person across the economy.

2) **Provide payment mechanism:** It enables people in successfully doing financial transactions by providing various convenient mode of payments. Financial system support payment mechanism which facilitates smooth flow of funds in economy. Buyers and sellers are easily able to complete transactions for sale and purchase of goods using payment methods like cheque, UPI, debit cards, credit cards etc.

3) **Improve liquidity:** Financial system plays an efficient role in enhancing overall liquidity in market. It serves as a mediator for facilitating the free movement of funds among people. Households are provided with different investment avenues for deploying their funds that have better liquidity rates i.e. can be easily converted into cash. It motivates the lenders in doing investments that ensure regular availability of appropriate funds in the market.

4) **Risk allocation:** Risk diversification is one of the important feature of financial system. Investors are provided with wide range of investment securities in financial market to choose from as per their choice. Financial system enables allocation of people's funds among various sources due to which risk is minimized.

5) **Promote capital formation:** Financial system accelerates the rate of capital formation in a country. It assists business in acquiring funds from banks, financial institutions and general public for financing their activities. Availability of funds at right time enables business in maintaining their continuity and attaining growth. Government also require funds for financing its different infrastructural development and social-welfare activities. Financial system by supplying right amount of funds support the capital formation in nation.

6) **Employment growth:** An efficient financial system of country is capable of generating large employment opportunities for people. It

supplies the required amount of funds to business and large organizations for carrying out their activities and expanding their size. With the growth in business and industrial sector, it will consequently generate more employment opportunities for both organized as well as unorganized sector.

7) **Attracts foreign capital:** Financial system enables in attracting sufficient amount of foreign capital in an economy. Capital market constitutes an important part of country's financial system. If this market is properly developed and promoted, then it is capable of attracting funds not only form domestic market but also form foreign market. When there is sufficient capital available, investment will widen that will result in speeding up the economic development of nation.

8) **Balanced regional development:** It has a significant role in achieving balanced regional development in a country. Financial system enables in overall development of rural and backward areas by offering concessions and sops. Balance development mitigate political and several other dispute in nation. It also controls the migration of rural peoples toward urban areas.

Let Us Sum Up

In this unit you have learned about the following:

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges that permit the exchange of funds. Financial systems exist on firm, regional, and global levels. Although banks do many things, their primary role is to take in funds called deposits from those with money, pool them, and lend them to those who need funds. Banks are intermediaries between depositors (who lend money to the bank) and borrowers (to whom the bank lends money). A financial system can be perceived on a company, regional, or global scale, which facilitates the practice of exchanging funds between one entities to another. It involves various players such as insurance companies, stock exchanges, investment banks, and more. Financial systems are regulated, as their processes influence and contribute to the growth of many assets.

The financial system refers to the network of institutions, markets, and instruments that facilitate the transfer of funds between savers and borrowers. It plays a crucial role in the allocation of resources within an economy by channeling funds from those who have excess capital (savers) to those who need it (borrowers) for investment, consumption, or other purposes.

Check Your Progress

1. Through the ________, investors receive capital to fund projects and receive a return on their investments
2. ________help businesses to grow and expand by allowing investors to contribute capital.
3. A ________ is a form of payment to exchange products, services, and investments and holds value to society

Glossary

Deposits: A deposit is a financial term that means money held at a bank

Scheduled banks: It is a banking corporation whose minimum paid up capital is Rs. 5 lakhs and does not harm the interest of the depositors.

Non-scheduled banks: These are the banks which do not comply with the rules specified by the Reserve Bank of India, or say the banks which do not come under the category of scheduled banks.

Answers to Check Your Progress

1. Financial System
2. Financial markets
3. Currency

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-6

Types of Banks Structure

STRUCTURE

Overview

Objectives

6.1. Introduction

6.2. Banking Meaning and Definition

6.3. Central Bank

6.4. Cooperative Bank

6.5. Commercial Banks

6.6. Regional Rural Banks

6.7. Local Area Banks

6.8. Specialized Banks

6.9. Small Finance Banks

6.10. Payment Banks

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Bank structure has been clearly explained. There are two broad categories under which banks are classified in India- scheduled and non- scheduled banks. The scheduled banks include commercial banks and cooperative banks. The commercial banks include regional rural banks, small finance bank, foreign banks, private sector banks, and public sector banks.

Objectives

After reading this unit, student should be able to:

- Know the different types of Banks.
- Understand the Central Bank and Commercial Bank Functions

6.1. Introduction

Banking is the business of protecting money for others. Banks lend this money, generating interest that creates profits for the bank and its customers. It is a business activity of accepting and safeguarding

money owned by other individuals and entities, and then lending out this money in order to conduct economic activities such as making profit or simply covering operating expenses.

6.2. Banking: Meaning and Definition

. A bank is a financial institution licensed to accept deposits and make loans. But they may also perform other financial services.

The term “bank” can refer to many different types of financial institutions including bank and trust companies, savings and loan associations, credit unions or any other type of institution that accepts deposits.

It is defined as “Accepting of deposits of money from public for the purpose of Lending or Investment, repayable on demand or otherwise and withdrawable by cheque, draft, or otherwise”

Modern banking in India originated in the mid of 18th century. Among the first banks were the Bank of Hindustan, which was established in 1770 and liquidated in 1829–32; and the General Bank of India, established in 1786 but failed in 1791.

Types of Banks:

A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. The following are the various types of bank.

1. Central Bank
2. Cooperative Bank
3. Commercial Banks
4. Regional Rural Banks
5. Local Area Banks
6. Specialized Banks
7. Small Finance Banks
8. Payment Banks

6.3. Central Bank

A central bank is a public institution that manages the currency of a country or group of countries and controls the money supply literally, the amount of money in circulation. The main objective of many central banks is price stability. The Reserve Bank of India is the central bank of the country.

Functions of Central Bank:

The functions of a central bank can be discussed as follows:

1. Currency regulator or bank of issue
2. Bank to the government
3. Custodian of Cash reserves
4. Custodian of International currency
5. Lender of last resort
6. Clearing house for transfer and settlement
7. Controller of credit
8. Protecting depositor's interests

The above mentioned functions will be discussed in detail in the following lines.

Currency regulator or bank of issue:

Central banks possess the exclusive right to manufacture notes in an economy. All the central banks across the world are involved in issuing notes to the economy. This is one of the most important functions of the central bank in an economy and due to this the central bank is also known as the bank of issue. Earlier all the banks were allowed to publish their own notes which resulted in a disorganized economy. To avoid this situation the government around the world authorized the central banks to function as the issuer of currency, which resulted in uniformity in circulation and balanced supply of money in the economy.

Bank to the government:

One of the important functions of the central bank is to act as the bank to the government. The central bank accepts deposits and issues funds to the government. It is also involved in making and receiving payments for the government. Central banks also offer short term loans to the government in order to recover from bad phases in the economy.

In addition to being the bank to the government, it acts as an advisor and agent of the government by providing advice to the government in areas of economic policy, capital market, money market and loans from the government. In addition to that, the central bank is instrumental in formulation of monetary and fiscal policies that help in regulation of money in the market and controlling inflation.

Custodian of Cash reserves:

It is a practice of the commercial banks of a country to keep a part of their cash balances in the form of deposits with the central bank. The

commercial banks can draw that balance when the requirement for cash is high and pay back the same when there is less requirement of cash. It is for this reason that the central bank is regarded as the banker's bank. Central bank also plays an important role in the credit creation policy of commercial banks.

Custodian of International currency:

An important function of the central bank is to maintain a minimum balance of foreign currency. The purpose of maintaining such a balance is to manage sudden or emergency requirements of foreign reserves and also to overcome any adverse deficits of balance of payments.

Lender of last resort:

The central bank acts as a lender of last resort by providing money to its member banks in times of cash crunch. It performs this function by providing loans against securities, treasury bills and also by rediscounting bills. This is regarded as one of the most crucial functions of the central bank wherein it helps in protecting the financial structure of the economy from collapsing.

Clearing house for transfer and settlement:

Central bank acts as a clearing house of the commercial banks and helps in settling of mutual indebtedness of the commercial banks. In a clearing house, the representatives of different banks meet and settle the interbank payments.

Controller of credit:

Central banks also function as the controller of credit in the economy. It happens that commercial banks create a lot of credit in the economy that increases the inflation. The central bank controls the way credit creation by commercial banks is done by engaging in open market operations or bringing about a change in the CRR to control the process of credit creation by commercial banks.

Protecting depositor's interests:

Central bank also needs to keep an eye on the functioning of the commercial banks in order to protect the interests of depositors.

6.4. Cooperative Bank

Co-operative banks are financial entities established on a co-operative basis and belonging to their members. This means that the customers of a co-operative bank are also its owners. These banks provide a wide range of regular banking and financial services.

Functions of Cooperative Banks

- It provides financial assistance to people with small means and protects them from the latches of money lenders providing loans and other services at a higher rate at the expense of the needy.
- It supervises and guides affiliated societies.
- Rural financing- It provides financing to rural sectors like cattle farming, crop farming, hatching, etc. at comparatively lower rates.
- Urban financing- it provides financing for small scale industries, personal finance, home finance, etc.
- It mobilizes funds from its members and provides interest on the invested capital.

Objectives of Cooperative Banks

- To provide rural financing and micro-financing.
- To remove the dominance of money lenders and middleman.
- To provide credit services to agriculturalists and weaker sections of the society at comparatively lower rates.
- To provide financial support and personal financial services to small scale industries, housing financial assistance, etc.
- To provide basic banking services to its members.
- To promote the overall development of rural areas.

6.5. Commercial Banks

Commercial banks are financial institutions that offer a wide range of banking services to individuals, businesses, and governments. They are the most common type of banks and play a central role in the financial system. Here are some key features of commercial banks:

1. **Accepting Deposits:** One of the primary functions of commercial banks is to accept deposits from customers. These deposits can take various forms, including savings accounts, current accounts, fixed deposits, and recurring deposits.
2. **Providing Loans and Credit:** Commercial banks lend out a significant portion of the deposits they receive to individuals, businesses, and governments. They offer various types of loans and credit facilities, including personal loans, home loans, car loans, business loans, and lines of credit.
3. **Issuing Credit Cards:** Commercial banks issue credit cards to eligible customers, allowing them to make purchases on credit

and repay the amount later, often with interest. Credit cards offer convenience and flexibility in making payments, both online and offline.

4. **Facilitating Payments and Transfers:** Commercial banks provide payment and transfer services to facilitate the movement of funds between individuals, businesses, and organizations. These services include electronic fund transfers, wire transfers, checks, and online banking.
5. **Managing Investments:** Commercial banks offer investment products and services to help customers grow their wealth and achieve their financial goals. These may include mutual funds, brokerage services, wealth management, and advisory services.
6. **Foreign Exchange Services:** Commercial banks facilitate foreign exchange transactions, allowing customers to buy, sell, and exchange currencies for international trade, travel, investment, and remittances.
7. **Safekeeping of Valuables:** Some commercial banks offer safe deposit boxes or vaults for customers to securely store valuable items such as jewelry, documents, and important records.
8. **Corporate Banking Services:** Commercial banks provide specialized banking services to corporations and large businesses, including cash management, trade finance, corporate lending, treasury services, and investment banking.
9. **Retail Banking Services:** Commercial banks offer retail banking services to individual customers, including savings accounts, checking accounts, personal loans, mortgages, and other consumer banking products.

Commercial banks play a crucial role in the economy by intermediating between savers and borrowers, mobilizing funds, facilitating economic transactions, and supporting economic growth and development. They are regulated by banking authorities and must comply with regulatory requirements to ensure stability and safety in the financial system.

6.6. Regional Rural Banks

Regional Rural Banks (RRB) are Indian Scheduled Commercial Banks (Government Banks) operating at regional level in different states of India. They have been created with a view of serving primarily the rural areas of India with basic banking and financial services.

Functions of Regional Rural Banks

Since a Regional Rural Bank is a Scheduled Commercial Bank, its

primary functions are to accept deposits and to disburse loans. The important functions of Regional Rural Banks are discussed below.

1. Accept Deposits

- RRBs accept deposits from their members who hold an account in the bank.
- Deposits can be made in current or savings accounts.
- Depositors can also be made in fixed or recurring forms.

2. Loan Extension

- The RRB Act of 1975 states that the RRB can extend loans and credit services to the **Priority Sector (PS)**. The loans to this sector are classified under **PSL or Priority Sector Lending**. The RBI announced the coverage of RBBs in PSL from FY 1997.
- The priority sector comprises of small and marginal farmers, craftsmen and artisans, local traders, medium and small scale businesses, education, housing, renewable energy, etc. which needs development and financial investment.
- 75% of the total Bank Credit has to be provided to the Priority Lending Sector. Out of this total credit, 10% has to be given to the economically weaker sections.
- Hence, short- term loans on a low rate of interest are extended by these banks to the priority sector. RRBs cannot, however, extend large or long- term loans to its customers.

3. **Wage disbursement**

- The Regional Rural Banks in India perform the important function of *distribution of wages* under the MGNREGA (Mahatma Gandhi National Rural Employment Guarantee Act), the Pradhan Mantri Gram Sadak Yojana (PMGSY).
- The *pensions* provided under the poverty alleviation schemes and pension schemes of India are also distributed through these banks.

4. Secondary functions of RRBs

- Similar to commercial banks, the secondary functions of the Regional Rural Banks in India are providing agency services and general utility services to their customers.
- Agency services like foreign exchange, bill payments, money wire transfer, etc. are performed by RRBs.
- Utility services like ATM, UPI, issuance of debit cards, locker

facilities, etc. are also provided by RRBs in India.

6.7. Local Area Banks

Local Area Banks (LABs) are a specific type of banking institution established in India. They are small, geographically focused banks that cater primarily to the banking needs of local communities in specified regions or districts. LABs were introduced in India as a part of the government's efforts to promote financial inclusion and reach underserved areas.

Key features of Local Area Banks (LABs) in India include:

1. Geographical Focus: LABs operate within a limited geographical area, typically covering one or a few districts or regions. This localized focus allows them to better understand the needs of the local community and tailor their banking services accordingly.
2. Priority Sector Lending: LABs are mandated to allocate a significant portion of their lending to priority sectors such as agriculture, small-scale industries, microenterprises, and other sectors that contribute to the development of rural and semi-urban areas.
3. Financial Inclusion: LABs play a crucial role in promoting financial inclusion by providing banking services to unbanked and underbanked populations in remote and rural areas. They often offer basic banking products and services tailored to the needs of low-income individuals and small businesses.
4. Regulatory Framework: LABs in India are regulated by the Reserve Bank of India (RBI) under the Banking Regulation Act, 1949. They are subject to the same regulatory requirements and prudential norms as other commercial banks, ensuring stability and soundness in the banking system.
5. Ownership Structure: LABs may have different ownership structures, including public, private, or cooperative ownership. However, they are typically promoted by local stakeholders such as cooperatives, non-governmental organizations (NGOs), or community-based organizations.

Overall, Local Area Banks (LABs) play a vital role in promoting financial inclusion, stimulating economic development, and improving access to banking services in rural and underserved areas of India.

6.8. Specialized Banks

Specialized banks are financial institutions that focus on providing specific types of banking services or catering to particular customer

segments. These banks may operate alongside traditional commercial banks or as standalone entities. They play a crucial role in meeting the specialized financial needs of individuals, businesses, and organizations. Some common types of specialized banks include:

1. **Development Banks:** Development banks specialize in providing long-term financing for projects that promote economic development, infrastructure development, and poverty reduction. They typically target sectors such as agriculture, industry, energy, transportation, and housing.

2. **Export-Import Banks (EXIM Banks):** These banks specialize in facilitating international trade by providing financing, insurance, and other services to support exports and imports. They play a crucial role in promoting trade and economic growth by mitigating the risks associated with cross-border transactions.

3. **Industrial Banks:** Industrial banks focus on providing financial services to industrial enterprises, including manufacturers, producers, and suppliers of industrial goods and services. They may offer specialized lending products, equipment financing, and advisory services tailored to the needs of industrial clients.

4. **Housing Finance Companies (HFCs):** HFCs specialize in providing loans and financing for housing-related purposes, including home purchase, construction, renovation, and improvement. They play a critical role in promoting affordable housing and homeownership by offering specialized mortgage products and services.

5. **Microfinance Institutions (MFIs):** Microfinance institutions specialize in providing financial services to low-income individuals, microenterprises, and small businesses that typically lack access to traditional banking services. They offer small loans, savings accounts, insurance, and other financial products tailored to the needs of underserved populations.

6. **Islamic Banks:** Islamic banks operate in accordance with Islamic principles and Sharia law, which prohibit the payment or receipt of interest (riba) and the involvement in transactions considered unethical or exploitative. Instead, they use profit-sharing arrangements, asset-backed financing, and other Sharia-compliant mechanisms to provide banking services to customers.

7. **Postal Savings Banks:** Postal savings banks leverage postal networks to offer basic banking services, including savings accounts, remittances, and small loans, to customers who may have limited access to traditional banking services. They play a

vital role in promoting financial inclusion, particularly in rural and remote areas.

These are just a few examples of specialized banks, but there are many other types catering to specific sectors, industries, or customer segments. Each type of specialized bank serves a unique purpose and plays a crucial role in meeting the diverse financial needs of individuals, businesses, and communities.

6.9. Small Finance Banks

Small Finance Banks (SFBs) are a category of banks in India that focus on providing financial services to underserved and unserved segments of the population, including small businesses, micro and small enterprises, farmers, and low-income households. They were introduced by the Reserve Bank of India (RBI) with the objective of promoting financial inclusion and expanding access to banking services in rural and semi-urban areas.

Key characteristics of Small Finance Banks include:

1. **Focus on Financial Inclusion:** SFBs are mandated to primarily serve the banking needs of unbanked and underbanked populations, including those in remote and rural areas. They are expected to offer basic banking services such as deposits, loans, remittances, and payment services to individuals and small businesses.
2. **Target Customer Segments:** SFBs target segments such as small and marginal farmers, micro and small enterprises (MSEs), low-income households, and other economically weaker sections of society. They aim to provide tailored financial products and services to meet the specific needs of these customers.
3. **Prudential Norms:** Like other banks, SFBs are subject to prudential norms and regulatory requirements prescribed by the RBI. They must maintain adequate capital adequacy, adhere to asset classification and provisioning norms, and comply with anti-money laundering and Know-Your-Customer (KYC) guidelines.
4. **Priority Sector Lending:** SFBs are required to allocate a significant portion of their lending to priority sectors such as agriculture, micro and small enterprises, affordable housing, education, and other sectors identified by the RBI. This ensures that they contribute to the development of targeted sectors and segments.
5. **Branch Network:** SFBs are expected to establish a wide network of branches and banking outlets, particularly in rural and

semi-urban areas where banking services are limited. They may leverage technology and innovative delivery channels such as mobile banking, agent banking, and digital platforms to reach customers efficiently.

6. **Financial Inclusion Initiatives:** SFBs often undertake various initiatives to promote financial literacy and awareness among their customers. They may offer financial education programs, conduct outreach activities, and collaborate with local communities and organizations to foster a savings and credit culture.

Overall, Small Finance Banks play a crucial role in expanding access to banking services, promoting financial inclusion, and supporting economic development, especially in rural and underserved areas of India.

6.10. Payment Banks

Payment Banks are a specific category of banks introduced by the Reserve Bank of India (RBI) in India to further financial inclusion and promote digital payments. These banks are licensed under the Payment and Settlement Systems Act, 2007, and are allowed to provide a limited range of banking services, primarily focused on payments and remittance-related activities. However, they are not permitted to undertake lending activities like traditional commercial banks.

Here are key features of Payment Banks:

1. **Focus on Digital Payments:** Payment Banks primarily focus on facilitating digital payments and remittance services. They leverage technology and digital infrastructure to offer convenient and cost-effective payment solutions to individuals and businesses.
2. **Customer Segments:** Payment Banks target segments such as low-income households, migrant workers, small businesses, and unbanked populations who may not have access to traditional banking services. They aim to provide affordable and accessible payment solutions to these underserved segments.
3. **Services Offered:** Payment Banks are permitted to offer a limited range of services, including:
   - Accepting deposits: Payment Banks can accept deposits from individuals and small businesses, subject to certain restrictions.

- Providing payment services: They can issue prepaid payment instruments (PPIs) such as prepaid wallets, prepaid cards, and mobile wallets. These instruments can be used for making payments, remittances, and other transactions.
- Facilitating fund transfers: Payment Banks can enable fund transfers, including domestic remittances and money transfers, through electronic channels such as mobile banking, internet banking, and ATMs.
- Selling third-party financial products: They can distribute mutual funds, insurance products, and other third-party financial products to their customers.

4. **Regulatory Framework:** Payment Banks are regulated by the Reserve Bank of India (RBI) and are subject to the same regulatory requirements as other banks, albeit with certain restrictions on their activities. They must comply with regulations related to customer protection, anti-money laundering (AML), know-your-customer (KYC), and data security.
5. **Partnerships and Collaboration:** Payment Banks often collaborate with other financial institutions, technology companies, and government agencies to expand their reach and enhance their service offerings. They may partner with traditional banks, fintech firms, mobile network operators, and government agencies to leverage their existing infrastructure and customer base.

Overall, Payment Banks play a vital role in advancing financial inclusion, promoting digital payments, and enhancing access to banking services for underserved populations in India. They contribute to the growth of the digital economy and help reduce the reliance on cash transactions.

Let Us Sum Up

In this unit you have learned about the following:

There are two broad categories under which banks are classified in India- scheduled and non- scheduled banks. The scheduled banks include commercial banks and cooperative banks. The commercial banks include regional rural banks, small finance bank, foreign banks, private sector banks, and public sector banks.

Check Your Progress

1. The ____________ acts as a lender of last resort by providing money to its member banks in times of cash crunch.
2. ____________ is a banking segment created by RBI under the

guidance of Indian Government.

3. A ____________ is like any other bank, but operating on a smaller scale without involving any credit risk

Glossary

Deposits: A deposit is a financial term that means money held at a bank

Scheduled banks: It is a banking corporation whose minimum paid up capital is Rs. 5 lakhs and does not harm the interest of the depositors.

Non-scheduled banks: These are the banks which do not comply with the rules specified by the Reserve Bank of India, or say the banks which do not come under the category of scheduled banks.

Answers to Check Your Progress

1. Central Bank
2. Small Finance Bank
3. Payment Bank

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-7

RBI's Regulations and Functions of Commercial Banks

STRUCTURE

Overview

Objectives

7.1. Introduction

7.2. RBI's Regulations

7.3. Functions of Commercial Banks

7.4. Credit Creation

Check your Progress

Let Us Sum Up

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the RBI's Regulations and the functions of Commercial Banks has been explained. The Credit creation separates a bank from other financial institutions. In simple terms, credit creation is the expansion of deposits. And, banks can expand their demand deposits as a multiple of their cash reserves because demand deposits serve as the principal medium of exchange.

Objectives

After reading this unit, student should be able to:

- Know the RBI's Regulations
- Understand the Commercial Bank and Credit Creation

7.1. Introduction

The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank was initially established in Kolkata but was permanently moved to Mumbai in 1937

7.2. RBI's Regulations

The Reserve Bank of India (RBI) regulates various aspects of banking and financial activities in India to ensure the stability, integrity, and

efficiency of the financial system. Here are some key areas of regulation by the RBI:

1. **Banking Regulation:** The RBI regulates banks and financial institutions under the Banking Regulation Act, 1949. This includes issuing licenses for new banks, setting capital requirements, regulating ownership and governance structures, and overseeing mergers and acquisitions in the banking sector.
2. **Monetary Policy:** The RBI formulates and implements monetary policy to achieve price stability and promote economic growth. It sets interest rates, such as the repo rate, reverse repo rate, and marginal standing facility rate, to control inflation and manage liquidity in the financial system.
3. **Prudential Norms:** The RBI sets prudential norms and guidelines to ensure the soundness and stability of banks. These norms cover areas such as asset classification, provisioning, capital adequacy, risk management, exposure limits, and corporate governance practices.
4. **Foreign Exchange Management:** The RBI regulates foreign exchange transactions and manages the country's foreign exchange reserves. It formulates policies to maintain exchange rate stability, facilitate cross-border transactions, regulate capital flows, and prevent money laundering and financial crimes.
5. **Payment Systems:** The RBI regulates payment and settlement systems in India to ensure efficiency, safety, and reliability. It oversees various payment instruments and systems, such as RTGS (Real-Time Gross Settlement), NEFT (National Electronic Funds Transfer), IMPS (Immediate Payment Service), UPI (Unified Payments Interface), and card payments.
6. **Financial Markets:** The RBI regulates financial markets, including money markets, bond markets, and foreign exchange markets, to maintain orderly and fair trading conditions. It monitors market participants, sets prudential norms for market intermediaries, and implements measures to prevent market abuse and manipulation.
7. **Financial Inclusion:** The RBI promotes financial inclusion by encouraging banks to expand access to banking services, especially in underserved areas. It sets targets for priority sector lending, directs banks to open branches in rural and remote areas, and supports initiatives to enhance financial literacy and awareness.

8. **Consumer Protection:** The RBI regulates banks and financial institutions to protect the interests of consumers. It issues guidelines on fair practices, transparency, disclosure requirements, grievance redressal mechanisms, and customer education programs to ensure that customers are treated fairly and provided with adequate information and recourse.

These are some of the key areas of regulation by the Reserve Bank of India to maintain stability, integrity, and efficiency in the banking and financial system and promote the broader objectives of economic growth, financial inclusion, and consumer protection.

7.3. Functions of Commercial Banks

The main functions of commercial banks are accepting deposits from the public and advancing them loans. The following points highlight the top six functions of commercial banks. The functions are:

1. Accepting of Deposits
2. Advancing Loans
3. Credit Creation
4. Financing Foreign Trade
5. Agency Services
6. Miscellaneous Services to Customers.

1. Accepting of Deposits:

Generally, the banks accept four types of deposits from the public which are as follows:

(a) Current Account or Demand Deposit: Under this account the depositor can withdraw the money whenever he requires it. Normally no interest is paid by the bank because the bank cannot utilize this money in earning and he must keep himself ready to meet the demand of the customer. He must keep cent per cent reserve against the deposit.

(b).In this account the depositor has to maintain minimum balance. Occasionally a small interest is paid to the people who keep large balances. Under this account the depositor is not free to withdraw any amount like current account. He can withdraw only a specified sum of money in a week. Here the depositor gets less interest in comparison to Fixed Account.

(c) Fixed or Time Deposit Account: Under this account deposits are accepted for a fixed period say one, two, four or five years or above. The money deposited in this account cannot be normally withdrawn

before the expiry of the agreed period. The rate of interest on this account is higher than on other accounts.

(d) Home Safe Account: Under this account a safe is provided by the bank to the customers. Safe is locked and the bank keeps the key with him. Customers put their small savings in the safe and after two to three months the customers take the safe to the bank where the banker unlocks it before the customer and makes credit in the customer's account. A nominal rate of interest is allowed to the customer.

2. Advancing Loans:

A bank lends a certain percentage of cash lying in deposits on higher interest rate than it pays to the depositors. This is how it earns profits and carries on its business. The bank advances loan in the following manner:

(a) Cash Credit: This type of loan is granted to businessmen against certain specified securities. To a new customer, a loan account has to be opened from where the money is withdrawn by cheque but he pays interest on the full amount.

(b) Call Loans/Money at Call and Short Notice: They are very short-term loans and are mostly given to bill brokers for 15 days. They are advanced against first class securities. This can be recalled at a very short-notice.

(c) Overdraft: 31 Overdraft is the facility extended by the banker to draw a sum greater than the balance lying in his current account. The businessman is charged interest only on that amount by which his current account is actually withdrawn and not by the full amount of the overdraft sanctioned.

(d) Discounting Bills of Exchange: If a creditor wants money immediately and has a bill of exchange, the bank gives his money by discounting the bill of exchange. The banker deposits the amount of the bill in the current account of bill-holder after deducting the rate of interest for the period of the loan which is normally not more than 90 days. When the bill matures the bank gets payment from the banker.

3. Credit Creation:

Credit creation is one of the most important functions of the commercial banks. In order to earn profit the bank accept deposits and advance loans by keeping a small cash in reserve to meet the day to day needs of the customers. When a bank gives loan, it opens an account in the name of the loan taker and does not pay him in cash but allows him to draw the money according to his

requirements. By granting a loan, the bank creates credit or deposit.

4. **Financing Foreign Trade:**

   A commercial bank helps in foreign trade by financing his customers and by accepting foreign bills of exchange. The bank encourages the documents like D/A (Documents against acceptance) and D/P (Documents against payments) in foreign payments. Further, it transact foreign exchange business and buys and sells foreign currency.

5. **Agency Service:**

   A bank discharges agency services on behalf of its customers which are as follows: (i). The bank collects payments of bills of exchange, cheques dividends etc. on behalf of his customers. (ii). It buys and sells shares, securities, debentures etc. for its customers. (iii). The bank remits money to different places by bank drafts on telegraphic transfer (T/T) on behalf of its customers. (iv). It discharges the functions of marketing, work as a trustee, administrator or executor for its customers.31 (v). It gives proper advice to the customers in the matter of correspondence and other matters of business.

6. **Miscellaneous Services**:

   Besides the above mentioned services the commercial bank performs a number of other services the important of them are as follows: (i). It provides lockers facility to the customers where the customers can keep the valuable documents and ornaments etc. (ii). It underwrites the company debentures and shares. (iii). It provides information’s about the customers. (iv).It issues travelers cheques, letter of credit etc. to the customers and it accepts bills on behalf of the customers.

7.4. Credit Creation

Demand deposits are an important constituent of money supply and the expansion of demand deposits means the expansion of money supply. The entire structure of banking is based on credit.

Credit basically means getting the purchasing power now and promising to pay at some time in the future. Bank credit means bank loans and advances.

A bank keeps a certain part of its deposits as a minimum reserve to meet the demands of its depositors and lends out the remaining to earn income. The loan is credited to the account of the borrower. Every bank loan creates an equivalent deposit in the bank. Therefore, credit creation means expansion of bank deposits.

The two most important aspects of credit creation are:

1. **Liquidity** – The bank must pay cash to its depositors when they exercise their right to demand cash against their deposits.
2. **Profitability** – Banks are profit-driven enterprises. Therefore, a bank must grant loans in a manner which earns higher interest than what it pays on its deposits.

The bank's credit creation process is based on the assumption that during any time interval, only a fraction of its customers genuinely need cash. Also, the bank assumes that all its customers would not turn up demanding cash against their deposits at one point in time.

Basic Concepts of Credit Creation

- **Bank as a business institution**– Bank is a business institution which tries to maximize profits through loans and advances from the deposits.
- **Bank Deposits** – Bank deposits form the basis for credit creation and are of two types:
- **Primary Deposits** – A bank accepts cash from the customer and opens a deposit in his name. This is a primary deposit. This does not mean credit creation. These deposits simply convert currency money into deposit money. However, these deposits form the basis for the creation of credit.
- **Secondary or Derivative Deposits** – A bank grants loans and advances and instead of giving cash to the borrower, opens a deposit account in his name. This is the secondary or derivative deposit. Every loan crates a deposit. The creation of a derivative deposit means the creation of credit.
- **Cash Reserve Ratio (CRR)** – Banks know that all depositors will not withdraw all deposits at the same time. Therefore, they keep a fraction of the total deposits for meeting the cash demand of the depositors and lend the remaining excess deposits. CRR is the percentage of total deposits which the banks must hold in cash reserves for meeting the depositors' demand for cash.
- **Excess Reserves** – The reserves over and above the cash reserves are the excess reserves. These reserves are used for loans and credit creation.
- **Credit Multiplier** – Given a certain amount of cash, a bank can create multiple times credit. In the process of multiple credit creation, the total amount of derivative deposits that a bank creates is a multiple of the initial cash reserves.

Credit creation Process:

There are two ways of analyzing the credit creation process:

a. Credit creation by a single bank

b. Credit creation by the banking system as a whole

In a single bank system, one bank operates all the cash deposits and cheques. The process of creating credit is explained with the hypothetical example below:

Table 7.1 Credit Creation by Single Bank

Rounds	Primary Deposits	Cash Reserves (r= 20%)	Credit Creation or Derivative Deposits (ΔD)
1. (Person A)	Rs. 1000 (Initial primary deposits)	Rs. 200	Rs. 800 (Initial excess reserves ΔR)
2. (Person B)	800	160	640
3. (Person C)	640	128	512
4. (Person D)	512	102	410
-	-	-	-
-	-	-	-
Total	5000	1000	4000

Let's assume that the bank requires to maintain a CRR of 20 percent.

- If a person (person A) deposits 1,000 rupees with the bank, then the bank keeps only 200 rupees in the cash reserve and lends the remaining 800 to another person (person B). They open a credit account in the borrower's name for the same.
- Similarly, the bank keeps 20 percent of Rs. 800 (i.e. Rs. 160) and advances the remaining Rs. 640 to person C.
- Further, the bank keeps 20 percent of Rs. 640 (i.e. Rs. 128) and advances the remaining Rs. 512 to person D.

This process continues until the initial primary deposit of Rs. 1,000 and the initial additional reserves of Rs. 800 lead to additional or derivative deposits of Rs. 4,000 (800+640+512+….). Adding the initial deposits, we get total deposits of Rs. 5,000. In this case, the credit multiplier is 5 (reciprocal of the CRR) and the credit creation is five times the initial excess reserves of Rs. 800.

Multiple Credit Creation by the Banking System

The banking system has many banks in it and it cannot grant loans in excess of the cash it creates. When a bank creates a derivative deposit, it loses cash to other banks. The loss of deposit of one bank is the gain of deposit for some other bank. This transfer of cash within the banking system creates primary deposits and increases the possibility for further

creation of derivative deposits. Here is an illustration to explain this process better:

Table 7.2 Multiple credit creation by Banking System

Rounds	Primary Deposits	Cash Reserves (r= 20%)	Credit Creation or Derivative Deposits (ΔD)
A	Rs. 1000 (Initial primary deposits)	Rs. 200	Rs. 800 (Initial excess reserves ΔR)
B	800	160	640
C	640	128	512
D	512	102	410
-	-	-	-
-	-	-	-
Total	5000	1000	4000

As explained above, the initial deposit of Rs. 1,000 with bank A leads to a creation of total deposits of Rs. 5,000.

Limitations of Credit Creation

While banks would prefer an unlimited capacity for creating credit to increase profits, there are many limitations. These limitations make the process of creating credit non-profitable. Therefore, a bank continues to create additional credit as long as:

- There is a negligible chance of the loans turning into bad debts
- The interest rate that banks charge on loans and advances is greater than the interest that the bank gives to depositors for the money deposited in the bank.

Let Us Sum Up

In this unit you have learned about the following:

Credit creation separates a bank from other financial institutions. In simple terms, credit creation is the expansion of deposits. And, banks can expand their demand deposits as a multiple of their cash reserves because demand deposits serve as the principal medium of exchange.

Check Your Progress

1. ____________ is one of the most important functions of the commercial banks.
2. A commercial bank helps in foreign trade by financing his customers and by accepting ____________
3. The loan is ____________ to the account of the borrower

Glossary

Demand Deposit: It is a bank account from which deposited funds can be withdrawn at any time, without advance notice

Bill of exchange: A written order to a person requiring them to make a specified payment to the signatory or to a named payee; a promissory note.

Answers to Check Your Progress

1. Credit Creation
2. Foreign bills of exchange
3. Credited

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-8

Modern Functions of Banks

STRUCTURE

Overview

Objectives

8.1. Introduction

8.2. Key aspects of Banks

8.3. Traditional Functions of Banks

8.4. Modern Functions of Banks

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of modern banks has been explained. Study about the bank is a lawful organization that accepts deposits that can be withdrawn on demand. Banks are institutions that help the public in the management of their finances, public deposit their savings in banks with the assurance to withdraw money from the deposits whenever required.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Bank
- Understand the Modern Function of Banks

8.1. Introduction

Banking is defined as the business activity of accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to conduct economic activities such as making profit or simply covering operating expenses.

Banks are financial institutions that provide a wide range of financial services to individuals, businesses, and governments.

They play a central role in the economy by facilitating the flow of funds between savers and borrowers, managing risks, and supporting economic growth and development.

8.2. Key aspects of Banks

1. **Deposit-Taking:** One of the primary functions of banks is to accept deposits from customers. Deposits can be in the form of savings accounts, current accounts, fixed deposits, recurring deposits, and other types of accounts. Banks pay interest on certain types of deposits to attract customers' funds.
2. **Lending:** Banks lend out a significant portion of the deposits they receive to borrowers in the form of loans and credit. They provide various types of loans, including personal loans, home loans, car loans, business loans, and agricultural loans. Lending is a crucial function that supports consumption, investment, and economic activities.
3. **Payments and Transfers:** Banks facilitate payments and transfers between individuals, businesses, and organizations. They provide payment services such as check processing, Electronic Fund Transfers (EFT), wire transfers, Automated Clearing House (ACH) transactions, and card-based payments (debit cards, credit cards).
4. **Investment Services:** Banks offer investment products and services to help customers grow their wealth and achieve their financial goals. These may include mutual funds, brokerage services, retirement planning, insurance products, wealth management, and advisory services.
5. **Foreign Exchange Services:** Banks facilitate foreign exchange transactions, allowing customers to buy, sell, and exchange currencies for international trade, travel, investment, and remittances. They provide foreign exchange services through foreign currency accounts, currency exchange desks, and online platforms.
6. **Risk Management:** Banks play a crucial role in managing various types of risks, including credit risk, market risk, liquidity risk, operational risk, and compliance risk. They employ risk management techniques such as risk assessment, risk mitigation, risk monitoring, and regulatory compliance to safeguard their financial stability and protect stakeholders' interests.
7. **Corporate Banking Services:** Banks provide specialized banking services to corporate clients, including cash management, treasury services, working capital financing, trade finance, project finance, and corporate advisory services. They

support businesses in managing their finances, optimizing liquidity, and expanding their operations.

8. **Financial Advisory:** Banks offer financial advisory services to help customers make informed decisions about their finances. This includes advice on investments, insurance, retirement planning, tax planning, estate planning, and other financial matters.

These are some of the key functions of banks, which collectively contribute to the functioning of the financial system and the broader economy. Banks play a critical role in mobilizing savings, allocating capital, facilitating transactions, managing risks, and promoting economic growth and development.

8.3. Traditional functions of Banks

Traditional functions of banks refer to the fundamental services that banks have historically provided throughout their existence. These functions form the core activities of banks and include:

1. **Accepting Deposits:** One of the primary functions of banks is to accept deposits from individuals, businesses, and other entities. Deposits can take various forms, including savings accounts, current accounts, fixed deposits, and recurring deposits.
2. **Providing Loans:** Banks lend out a significant portion of the deposits they receive to borrowers in the form of loans and credit. These loans can be for various purposes, such as personal loans, home loans, car loans, business loans, and agricultural loans.
3. **Issuing Credit:** Banks issue credit to eligible customers in the form of credit cards and overdraft facilities. Credit cards allow customers to make purchases on credit and repay the amount later, often with interest, while overdraft facilities provide short-term credit against the customer's account balance.
4. **Facilitating Payments:** Banks facilitate payments and transfers between individuals, businesses, and organizations. This includes processing checks, electronic fund transfers (EFT), wire transfers, and other payment instruments to settle transactions.
5. **Providing Safekeeping Services:** Banks offer safekeeping services for valuable items such as jewelry, documents, and important records. They provide safe deposit boxes or vaults where customers can securely store their valuables.

6. **Issuing Certificates of Deposit (CDs):** Banks issue Certificates of Deposit (CDs) to customers who want to earn a fixed interest rate on their deposits for a specified period. CDs are time deposits that cannot be withdrawn before the maturity date without incurring a penalty.
7. **Foreign Exchange Services:** Banks facilitate foreign exchange transactions, allowing customers to buy, sell, and exchange currencies for international trade, travel, investment, and remittances. They provide foreign exchange services through foreign currency accounts, currency exchange desks, and online platforms.
8. **Trade Finance:** Banks provide trade finance services to facilitate international trade transactions. This includes issuing letters of credit, trade finance loans, export financing, import financing, and documentary collections to help businesses mitigate the risks associated with cross-border trade.
9. **Advisory Services:** Banks offer financial advisory services to help customers manage their finances, achieve their financial goals, and make informed decisions about investments, insurance, retirement planning, and wealth management.
10. **Corporate Banking Services:** Banks provide specialized banking services to corporate clients, including cash management, treasury services, working capital financing, trade finance, project finance, and corporate advisory services.

These traditional functions form the core activities of banks and are essential for the functioning of the financial system and the economy. While banks have expanded their range of services over time, these traditional functions remain central to their operations.

8.4. Modern functions of Banks

Modern banks perform a wide range of functions beyond traditional deposit-taking and lending activities. Here are some modern functions of banks:

1. **Digital Banking Services:** Banks have embraced technology to offer a variety of digital banking services, including online banking, mobile banking, and banking apps. Customers can perform transactions, check account balances, transfer funds, pay bills, and manage their finances conveniently through digital channels.
2. **Electronic Payments:** Banks facilitate electronic payments through various channels such as debit cards, credit cards,

prepaid cards, and digital wallets. They enable customers to make purchases, pay bills, and transfer money electronically, reducing the reliance on cash transactions.

3. **Investment Services:** Banks provide investment services to help customers grow their wealth and achieve their financial goals. These services may include brokerage services, investment advisory, mutual funds, insurance products, retirement planning, and wealth management solutions.
4. **Asset Management:** Banks offer asset management services to institutional and individual investors. They manage investment portfolios, provide investment advice, and offer discretionary and non-discretionary portfolio management services to maximize returns while managing risks.
5. **Risk Management:** Banks play a crucial role in managing various types of risks, including credit risk, market risk, liquidity risk, operational risk, and compliance risk. They employ risk management techniques such as risk assessment, risk mitigation, risk monitoring, and regulatory compliance to safeguard their financial stability and protect stakeholders' interests.
6. **Trade Finance:** Banks facilitate international trade by offering trade finance services such as letters of credit, trade finance loans, export financing, import financing, and documentary collections. They help businesses mitigate the risks associated with cross-border transactions and facilitate the smooth flow of goods and services.
7. **Corporate Banking:** Banks provide specialized banking services to corporate clients, including cash management, treasury services, working capital financing, trade finance, project finance, and corporate advisory services. They support businesses in managing their finances, optimizing liquidity, and expanding their operations.
8. **Sustainable Finance:** Banks are increasingly focusing on sustainable finance initiatives to support Environmental, Social, and Governance (ESG) objectives. They offer green financing, social impact investing, sustainability-linked loans, and other products to promote sustainable development and address climate change and social challenges.
9. **Fintech Partnerships:** Banks collaborate with fintech companies and startups to innovate and enhance their products and services. They leverage technology solutions such as artificial

intelligence, blockchain, machine learning, and big data analytics to improve customer experience, streamline operations, and offer new financial products.

10. **Financial Inclusion:** Banks play a vital role in promoting financial inclusion by extending banking services to underserved and unbanked populations. They establish branches and banking outlets in rural and remote areas, offer low-cost banking products, and leverage technology to reach customers who have limited access to traditional banking services.

These are some of the modern functions of banks, reflecting the evolving nature of the banking industry in response to technological advancements, changing customer preferences, and regulatory requirements.

Let Us Sum Up

In this unit, you have learned about the following:

A bank is a lawful organization that accepts deposits that can be withdrawn on demand. Banks are institutions that help the public in the management of their finances, public deposit their savings in banks with the assurance to withdraw money from the deposits whenever required money market is played by the commercial banks.

Check Your Progress

1. The ________ of the industries are met by short-term loans provided by banks
2. ________ is benefited by commercial banks as they not only invest directly in various companies' shares
3. ________ provides working capital and a major role in the Indian

Glossary

Financial intermediary: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund

Primary market: The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market.

Secondary market: The secondary market is where investors buy and sell securities they already own. It is what most people typically think of as the "stock market," though stocks are also sold on the primary market when they are first issued.

Answers to Check Your Progress

1. Working capital requirements
2. Capital market
3. Money Market

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Block-3: Introduction

Block-3: Capital Market has been divided in to four Units.

Unit-9: Introduction to Capital Market deals with Introduction, Meaning and Definition of Capital Market, Features of Capital Market, and Key aspects of Capital Market, Structures of Capital Market, Types of Capital Market and the Function of Capital Market.

Unit-10: SEBI and its Regulations explains about Introduction, Meaning of SEBI, Objectives of SEBI, Structure of SEBI, Functions of SEBI, Role of SEBI, Authority and Power of SEBI, Mutual Funds and SEBI and the Regulations of SEBI.

Unit-11: Non-Banking Financial Institutions in India describes about Introduction, Meaning of Non-Banking Financial Institutions, Types of Non-Banking Financial Institutions, The role of Non-Banking Financial Institutions in the Wider Industry and the Non-Banking Financial Institutions in India.

Unit-12: Stock Exchange discuss with Introduction, Meaning of Stock Exchange, Features of Stock Exchange, Functions of Stock Exchange, Trading and Settlement Procedures, Benefits of Listing with Stock Exchange, Investment Methods and the Major Stock Exchange in India.

In all the units of Block -3 **Capital Market**, the Check your progress, Glossary, Answers to Check your progress and Suggested Reading has been provided and the Learners are expected to attempt all the Check your progress as part of study.

Unit-9
Capital Market

STRUCTURE

Overview
Objectives
9.1. Introduction
9.2. Meaning and Definition of Capital Market
9.3. Features of Capital Market
9.4. Key aspects of Capital Market
9.5. Structures of Capital Market
9.6. Types of Capital Market
9.7. Function of Capital Market
Let Us Sum Up
Check Your Progress
Glossary
Answers to Check Your Progress
Suggested Readings

Overview

In this unit the concept of Capital Markets has been explained. Study about the Capital markets are financial markets that bring buyers and sellers together to trade stocks, bonds, currencies, and other financial assets. Capital markets include the stock market and the bond market. They help people with ideas become entrepreneurs and help small businesses grow into big companies.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Capital Market
- Understand the Function of Capital Market

9.1. Introduction

A capital market is a market for medium and long term funds. It includes all organizations, institutions and instruments that provide long term and medium term funds. It does not include the instruments or institutions which provides finance for short period (up to one year). Capital markets are where savings and investments are channeled between suppliers—people or institutions with capital to lend or invest—and those in need. Suppliers typically include banks and investors while those who seek

capital are businesses, governments, and individuals. Capital markets are composed of primary and secondary markets. The most common capital markets are the stock market and the bond market. Capital markets seek to improve transactional efficiencies. These markets bring suppliers together with those seeking capital and provide a place where they can exchange securities.

The capital market is a segment of the financial market where long-term securities such as stocks, bonds, and other financial instruments are bought and sold. It is a vital component of the financial system as it facilitates the allocation of capital from investors to businesses and governments seeking financing for long-term investment projects.

9.2. Meaning and Definition of Capital Market

Capital market is a place where buyers and sellers indulge in trade (buying/selling) of financial securities like bonds, stocks, etc. The trading is undertaken by participants such as individuals and institutions. Capital market trades mostly in long-term securities.

9.3. Features of Capital Market

- Link between Savers and Investment Opportunities: Capital market is a crucial link between saving and investment process.
- Deals in Long Term Investment: Capital market provides funds for long and medium term.
- Utilizes Intermediaries.
- Determinant of Capital Formation.
- Government Rules and Regulations.

1. **Link between savers and investors:** The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called “Surplus units” and the investors/borrowers are known as “deficit units”. The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to deficit units.
2. **Deals in Long Term fund:** Capital market provides funds for long and medium term. It does not deal with channelizing saving for less than one year.
3. **Utilizes Intermediaries:** Capital market makes use of different intermediaries such as brokers, underwriters, depositories etc.

These intermediaries act as working organs of capital market and are very important elements of capital market.

4. **Capital formation:** The capital market prides incentives to savers in the form of interest or dividend to transfer their surplus fund into the deficit units who will invest it in different businesses. The transfer of funds by the surplus units to the deficit units leads to capital formation.

5. **Government Rules and Regulations:** The capital market operates freely but under the guidance of government policies. These markets function within the framework of government rules and regulations, e.g., stock exchange works under the regulations of SEBI which is a government body. An ideal capital market is one:

    - Where finance is available at reasonable cost.
    - Which facilitates economic growth.
    - Where market operations are free, fair, competitive and transparent.
    - Must provide sufficient information to investors.
    - Must allocate capital productively.

9.4. Key aspects of Capital Market

1. **Primary Market:** In the primary market, newly issued securities are sold to investors for the first time. This process, known as an Initial Public Offering (IPO) for stocks or a bond issuance for bonds, allows companies and governments to raise capital to fund their expansion, infrastructure projects, or other long-term investment needs.
2. **Secondary Market:** Once securities have been issued in the primary market, they are traded among investors in the secondary market. The secondary market provides liquidity to investors by allowing them to buy and sell securities after the initial issuance. Stock exchanges and Over-The-Counter (OTC) markets are the primary platforms for secondary market trading.
3. **Stock Market:** The stock market is a type of capital market where shares of publicly traded companies are bought and sold. Investors can purchase shares of stock in companies, becoming partial owners and potentially benefiting from capital appreciation and dividends.
4. **Bond Market:** The bond market, also known as the debt market, is where bonds and other debt securities are bought and sold. Bonds represent loans made by investors to corporations, governments, or

other entities in exchange for periodic interest payments and the return of the principal amount at maturity.

5. **Derivatives Market:** The derivatives market is a subset of the capital market where financial instruments derived from underlying assets such as stocks, bonds, currencies, commodities, or indices are traded. Derivatives include options, futures, forwards, and swaps, which are used for hedging, speculation, and risk management purposes.
6. **Investment Banking:** Investment banks play a significant role in the capital market by underwriting securities offerings, facilitating mergers and acquisitions, providing financial advisory services, and assisting companies in raising capital through debt and equity issuances.
7. **Regulation:** Capital markets are subject to regulation by government agencies and financial regulatory bodies to ensure transparency, fairness, and stability. Regulatory oversight aims to protect investors, maintain market integrity, prevent fraud and manipulation, and promote efficient capital allocation.
8. **Market Participants:** Various participants operate in the capital market, including investors, issuers, financial intermediaries, securities exchanges, regulatory authorities, and other market infrastructure providers. These participants play different roles in the capital-raising process and contribute to the functioning of the market.

Overall, the capital market serves as a critical avenue for businesses and governments to access funding for long-term investment projects, while also providing opportunities for investors to allocate capital and generate returns. It plays a crucial role in fostering economic growth, promoting innovation, and facilitating wealth creation.

9.5. Structure of Capital Market

The structure of the capital market refers to its organization and components, including the institutions, participants, and instruments that facilitate the buying and selling of long-term securities such as stocks, bonds, and derivatives. Here is an overview of the structure of the capital market:

1. **Primary Market:**
    - **Issuers:** Companies, governments, and other entities seeking to raise capital issue new securities in the primary market through Initial Public Offerings (IPOs) or bond issuances.

- **Underwriters:** Investment banks and financial institutions underwrite new securities offerings, facilitating the sale of securities to investors. They may purchase the securities from the issuer and resell them to investors or help with the pricing and distribution of the securities.
- **Regulatory Authorities:** Government agencies and regulatory bodies oversee the primary market to ensure compliance with securities laws and regulations. They approve prospectuses, monitor disclosures, and supervise the issuance process to protect investors' interests.

2. **Secondary Market:**
    - **Exchanges:** Stock exchanges and bond exchanges provide organized platforms for the trading of securities in the secondary market. Examples include the New York Stock Exchange (NYSE), NASDAQ, London Stock Exchange (LSE), and Bombay Stock Exchange (BSE).
    - **Over-the-Counter (OTC) Market:** The OTC market consists of decentralized trading platforms where securities are bought and sold directly between parties without a centralized exchange. OTC markets include electronic communication networks (ECNs), broker-dealer networks, and dealer-to-dealer trading platforms.
    - **Brokerage Firms:** Brokerage firms act as intermediaries between buyers and sellers in the secondary market. They execute trades on behalf of clients and provide trading platforms, research, and investment advice to investors.
    - **Market Makers:** Market makers are specialized firms or individuals that provide liquidity to the secondary market by quoting bid and ask prices for securities. They buy and sell securities from their own inventory to facilitate trading and maintain orderly markets.

3. **Investment Banks:** Investment banks play a crucial role in the capital market by providing a wide range of financial services, including underwriting securities offerings, advising on mergers and acquisitions, providing capital raising and restructuring services, and facilitating institutional trading.
    - **Regulatory Authorities:** Regulatory authorities such as the Securities and Exchange Commission (SEC) in the United States, the Financial Conduct Authority (FCA) in the United Kingdom, and the Securities and Exchange Board of India (SEBI)

in India oversee and regulate the capital market to ensure transparency, fairness, and stability. They enforce securities laws, conduct inspections, and impose sanctions on violators to maintain market integrity.

4. **Investors:** Various types of investors participate in the capital market, including institutional investors (such as mutual funds, pension funds, and hedge funds), individual investors, corporations, and governments. They buy and sell securities to achieve investment objectives, manage risks, and generate returns on their investments.
5. **Financial Instruments:** Financial instruments traded in the capital market include stocks, bonds, derivatives (such as options, futures, and swaps), Exchange-Traded Funds (ETFs), and structured products. These instruments represent ownership interests, debt obligations, or rights to underlying assets and are traded for investment or speculative purposes.

Overall, the structure of the capital market is complex and diverse, encompassing a wide range of institutions, participants, and instruments that facilitate the allocation of capital and the trading of securities to support economic growth and development.

9.6. Types of Capital Market

The capital market can be categorized into various types based on different criteria, including the nature of securities traded, the maturity of the securities, and the methods of trading. Here are some common types of capital markets:

1. **Primary Market:** In the primary market, newly issued securities are sold to investors for the first time. This market facilitates the raising of capital by companies, governments, and other entities through Initial Public Offerings (IPOs) and bond issuances. The primary market helps issuers raise funds for long-term investment projects, expansion plans, and other capital needs.
2. **Secondary Market:** The secondary market is where existing securities are bought and sold among investors. This market provides liquidity to investors by enabling them to trade securities after the initial issuance. Stock exchanges, bond markets, and Over-the-Counter (OTC) markets are examples of secondary markets where investors can buy and sell stocks, bonds, and other financial instruments.
3. **Equity Market:** The equity market, also known as the stock market, is a type of capital market where shares of publicly

traded companies are bought and sold. Investors can purchase shares of stock in companies, becoming partial owners and potentially benefiting from capital appreciation and dividends. The equity market provides companies with a means to raise equity capital to finance their operations and growth.

4. **Debt Market:** The debt market, also known as the bond market or fixed-income market, is where bonds and other debt securities are bought and sold. Bonds represent loans made by investors to issuers, including corporations, governments, and municipalities, in exchange for periodic interest payments and the return of the principal amount at maturity. The debt market provides issuers with a source of long-term financing, and investors with fixed-income securities for income generation and portfolio diversification.
5. **Money Market:** The money market is a segment of the capital market where short-term debt securities with maturities of one year or less are traded. Money market instruments include Treasury bills, commercial paper, certificates of deposit (CDs), repurchase agreements (repos), and short-term government securities. The money market provides liquidity to financial institutions and corporations for their short-term funding needs and serves as a venue for managing liquidity and interest rate risk.
6. **Foreign Exchange Market:** The foreign exchange (forex) market is a global decentralized market where currencies are bought and sold. It is the largest and most liquid financial market in the world, with trading taking place 24 hours a day across different time zones. The forex market facilitates international trade and investment by enabling the conversion of one currency into another for transactions, hedging, and speculation.
7. **Derivatives Market:** The derivatives market is a segment of the capital market where financial instruments derived from underlying assets such as stocks, bonds, currencies, commodities, or indices are traded. Derivatives include options, futures, forwards, and swaps, which are used for hedging, speculation, and risk management purposes. The derivatives market allows investors to gain exposure to asset classes and manage various types of risks, including price fluctuations, interest rate movements, and currency fluctuations.

These are some common types of capital markets, each serving specific purposes and providing opportunities for investors and issuers to raise capital, manage risks, and participate in financial markets.

9.7. Function of Capital Market

The capital market plays an important role in mobilizing saving and channel them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country.

1. **Link between savers and investors:** The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the investors/borrowers are known as "deficit units". The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to deficit units.
2. **Basis for industrialization:** Capital market generates long term funds, which are essential for the establishment of industries. Thus, capital market acts as a basis for industrialization.
3. **Accelerating the pace of growth:** Easy and smooth availability of funds for medium and long period encourages the entrepreneurs to take profitable ventures/businesses in the field of trade, industry, commerce and even agriculture. It results in the all-round economic growth and accelerates the pace of economic development.
4. **Generating liquidity:** Liquidity means convertibility into cash. Shares of the public companies are transferable i.e., in case of financial requirements these shares can be sold in the stock market and the cash can be obtained. This is how capital market generates liquidity.
5. **Increase the national income:** Funds flow into the capital market from individuals and financial intermediaries which are absorbed by commerce, industry and government. It thus facilitates the movement of stream of capital to be used more productively and profitability to increase the national income.
6. **Capital formation:** The capital market prides incentives to savers in the form of interest or dividend to transfer their surplus fund into the deficit units who will invest it in different businesses. The transfer of funds by the surplus units to the deficit units leads to capital formation.

7. **Productive investment:** The capital market provides a mechanism for those who have savings transfer their savings to those who need funds for productive investments. It diverts resources from wasteful and unproductive channels such as gold, jewelry, conspicuous consumption, etc. to productive investments.

8. **Stabilization of the value of securities:** A well-developed capital market comprising expert banking andnon-banking intermediaries brings stability in the value of stocks and securities. It does so by providing capital to the needy at reasonable interest rates and helps in minimizing speculative activities.

9. **Encourages economic growth:** The capital market encourages economic growth. The various institutions which operate in the capital market give quantities and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets into productive physical assets. This leads to the development of commerce and industry through the private and public sector, thereby encouraging/inducing economic growth.

Let Us Sum Up

In this unit, you have learned the following:

Capital markets are financial markets that bring buyers and sellers together to trade stocks, bonds, currencies, and other financial assets. Capital markets include the stock market and the bond market. They help people with ideas become entrepreneurs and help small businesses grow into big companies. Capital markets refer to the venues where funds are exchanged between suppliers of capital and those who demand capital for use. Primary capital markets are where new securities are issued and sold. The secondary market is where previously issued securities are traded between investors. The best-known capital markets include the stock market and the bond markets

Check Your Progress

1. A ________ is a market for medium and long term funds.
2. It provides a place for purchase and sale of existing securities and is often termed as ________.
3. The capital market acts as an important link between savers and ________.

Glossary

Financial intermediary: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund

Primary market: The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market

Secondary market: The secondary market is where investors buy and sell securities they already own. It is what most people typically think of as the "stock market," though stocks are also sold on the primary market when they are first issued

Answers to Check Your Progress

1. Capital Market
2. Stock Market
3. Investors

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-10

SEBI and its Regulations

STRUCTURE

Overview

Objectives

10.1. Introduction

10.2. Meaning of SEBI

10.3. Objectives of SEBI

10.4. Structure of SEBI

10.5. Functions of SEBI

10.6. Role of SEBI

10.7. Authority and Power of SEBI

10.8. Mutual Funds and SEBI

10.9. Regulations of SEBI

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit, Study about the SEBI and It plays an important role in regulating all the players operating in the Indian capital market. It attempts to protect the interest of investors and aims at developing the capital markets by enforcing various rules and regulations.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of SEBI
- Understand the Function of SEBI

10.1. Introduction

The listed companies or public limited companies issuing right shares by 31st July 2020 and intending to send notices to the shareholders, may do so in any other mode other than registered post, speed post or courier and is not considered a violation of SEBI circular. It plays an important role in regulating all the players operating in the Indian capital market. It attempts to protect the interest of investors and aims at

developing the capital markets by enforcing various rules and regulations.

10.2. Meaning of SEBI

SEBI stands for the Securities and Exchange Board of India. It is the regulatory body for the securities market in India. SEBI was established in 1988 and was given statutory powers on April 12, 1992, through the SEBI Act, 1992. Its role is to protect the interests of investors in securities, promote the development of the securities market, and regulate the securities market and its participants. SEBI's functions include regulating stock exchanges, registering and regulating brokers and other intermediaries, promoting fair practices and code of conduct in the securities market, and regulating mergers and acquisitions of companies. It plays a crucial role in ensuring transparency and integrity in the Indian financial markets.

It monitors and regulates the Indian capital and securities market while ensuring to protect the interests of the investors, formulating regulations and guidelines. The head office of SEBI is at Bandra Kurla Complex, Mumbai.

10.3. Objectives of SEBI

The primary objective of SEBI is to ensure that the Indian stock market works systematically. Also, it safeguards the interest of traders and investors by giving them healthy in securities. SEBI even works on the development of equity markets and ensures that people adhere to the guidelines. As mentioned above, one of the objectives of its establishment is to assure that no malpractices are followed in the Indian Capital Market. Here is a list of the significant objectives of SEBI:

- Monitors important acquisition of shares and takeover of companies
- Protect the interest of investors
- Promoting the development of securities market and regulating the business
- It is also involved in research & development so that the stock market is efficient and updated with the advanced techniques.
- It offers a platform for sub-brokers, registrars, stockbrokers, portfolio managers, investment advisers, bankers, merchant bankers, share transfer agents, trustees of trust deeds, underwriters, and other associated people to register and regulate work.

- They also check that the investors are educated about the intermediaries of the securities market
- They also keep a close check that no fraudulent or unfair practices are done related to the securities market.
- It also controls the operations of participants, credit rating agencies, and custodians of securities, depositories and foreign portfolio investors.

Purpose of SEBI:

The Securities and Exchange Board of India (SEBI) serves several purposes in the Indian financial market:

1. **Investor Protection**: SEBI aims to safeguard the interests of investors by ensuring fair and transparent dealings in securities markets. It regulates various entities such as stock exchanges, brokers, and other market intermediaries to maintain market integrity and protect investors from fraudulent practices.
2. **Development of the Securities Market**: SEBI plays a crucial role in fostering the development of the securities market in India. It introduces reforms and regulations to promote efficiency, transparency, and liquidity in the market. SEBI's initiatives include facilitating the introduction of new financial products, encouraging participation from various investor categories, and promoting technological advancements in trading and settlement systems.
3. **Regulation of Intermediaries**: SEBI regulates various intermediaries involved in the securities market, including stockbrokers, merchant bankers, mutual funds, portfolio managers, and credit rating agencies. It sets standards and guidelines for their conduct, registration, and compliance to ensure the smooth functioning of the market and protect investor interests.
4. **Monitoring and Enforcement**: SEBI monitors the activities of market participants to detect any violations of securities laws and regulations. It conducts investigations, inspections, and audits to enforce compliance with its regulations and take appropriate actions against offenders. SEBI has the authority to impose penalties, suspend licenses, and prosecute individuals or entities found guilty of market manipulation, insider trading, or other fraudulent activities.
5. **Promotion of Fair Practices**: SEBI promotes fair and ethical practices in the securities market through the enforcement of

codes of conduct and corporate governance norms. It encourages transparency, disclosure, and accountability among listed companies to enhance investor confidence and market credibility.

Overall, SEBI plays a pivotal role in maintaining the integrity, efficiency, and stability of the Indian securities market while ensuring investor protection and promoting market development.

10.4. Structure of SEBI

SEBI has a corporate framework comprising of various departments each managed by a department head. There are about 20 departments under SEBI. Some of these departments are corporation finance, economic and policy analysis, debt and hybrid securities, enforcement, human resources, investment management, commodity derivatives market regulation, legal affairs, and more. SEBI board comprises nine members. The Board consists of the following members.

1. One Chairman of the board who is appointed by the Central Government of India
2. One Board member who is appointed by the Central Bank, that is, the RBI
3. Two Board members who are hailing from the Union Ministry of Finance
4. Five Board members who are elected by the Central Government of India

As of now, 17 exchanges are operating in India, and the guidelines of SEBI regulate all the trades, including NSE and BSE. The current Chairman of SEBI is Ajay Tyagi; he was appointed on 10th January 2017. He took over the charge from U.K Sinha on 1st March 2017. Just like other corporate forms, SEBI has a hierarchical structure which comprises of various departments that are headed by their department heads. It has one Chairman, 7 boards of members and around 20 departments. Here is the list of a few departments of SEBI:

- Corporate Finance
- Human Resources Department
- Economic & Policy Analysis
- Foreign Portfolio Investors & Custodians
- Debt & Hybrid Securities
- Information Technology

- Enforcement
- Investment Management Department
- Legal Affairs
- Office of International Affairs
- Commodity Derivatives market regulation
- National Institute of Securities Market and more

Their respective heads head all of the departments. The senior management consists of a board of directors with the following structure.

- Union Government of India nominates the Chairman.
- Two members from the Union Finance Ministry
- One member from Reserve Bank of India
- Union Government of India nominates the rest five members.

It is paramount for you to know that SEBI is responsive to 3 groups that make the market which is the investors, market intermediaries and issuer of securities.

10.5. Functions of SEBI

The Securities and Exchange Board of India (SEBI) performs a range of functions to regulate and supervise various participants and activities in the Indian securities market. Some of the key functions of SEBI include:

1. **Regulating Securities Market**: SEBI regulates the securities market in India to ensure fair, transparent, and efficient functioning. It oversees stock exchanges, stockbrokers, depositories, and other intermediaries to maintain market integrity.
2. **Protecting Investor Interests**: SEBI aims to protect the interests of investors by promoting fair practices, preventing fraud, and ensuring adequate disclosure of information by listed companies. It regulates takeovers, mergers, and acquisitions to safeguard shareholder interests.
3. **Registration and Regulation of Intermediaries**: SEBI registers and regulates various market intermediaries such as stockbrokers, merchant bankers, portfolio managers, and investment advisors. It sets eligibility criteria, issues licenses, and monitors their conduct to maintain market integrity.
4. **Promoting Market Development**: SEBI facilitates the development of the securities market by introducing reforms, encouraging innovation, and promoting investor education and

awareness. It introduces new products, trading mechanisms, and technology initiatives to enhance market efficiency and liquidity.

5. **Enforcing Securities Laws and Regulations**: SEBI enforces securities laws and regulations to prevent market abuse, insider trading, and other fraudulent activities. It conducts investigations, inspections, and audits to detect violations and takes enforcement actions against offenders.
6. **Monitoring Listed Companies**: SEBI regulates listed companies by imposing disclosure requirements, corporate governance norms, and listing obligations to ensure transparency, accountability, and investor protection.
7. **Supervising Market Infrastructure Institutions**: SEBI supervises market infrastructure institutions such as stock exchanges, depositories, and clearing corporations to ensure the smooth functioning of trading, clearing, and settlement processes.
8. **Conducting Research and Education**: SEBI conducts research, publishes reports, and organizes educational programs to promote investor awareness, market research, and best practices in the securities market.
9. **International Cooperation**: SEBI collaborates with international regulatory bodies and organizations to exchange information, share best practices, and enhance regulatory cooperation in cross-border securities market activities.

Overall, SEBI plays a crucial role in regulating, supervising, and developing the Indian securities market to protect investor interests, maintain market integrity, and foster market growth.

10.6. Role of SEBI

The role of the Securities and Exchange Board of India (SEBI) is multifaceted and central to the functioning of the Indian securities market. Some of the key roles of SEBI include:

1. **Regulatory Oversight**: SEBI acts as the primary regulatory authority for the securities market in India. It formulates and enforces regulations to ensure fair, transparent, and efficient functioning of the market. This includes regulating various entities such as stock exchanges, brokers, depositories, and other intermediaries.
2. **Investor Protection**: SEBI's foremost role is to protect the interests of investors. It implements measures to prevent fraud,

manipulation, and insider trading. SEBI ensures that investors receive accurate and timely information about securities, companies, and market developments to make informed investment decisions.

3. **Market Development**: SEBI plays a crucial role in developing and nurturing the securities market in India. It introduces reforms, policies, and initiatives to promote market growth, liquidity, and investor participation. SEBI encourages innovation, introduces new financial products, and facilitates the adoption of advanced technologies to enhance market efficiency.
4. **Enforcement of Regulations**: SEBI has the authority to enforce securities laws and regulations. It conducts investigations, inspections, and audits to detect violations and takes enforcement actions against individuals or entities found guilty of non-compliance. SEBI imposes penalties, suspends licenses, and initiates legal proceedings to maintain market integrity.
5. **Monitoring Corporate Governance**: SEBI regulates listed companies to ensure compliance with corporate governance norms and disclosure requirements. It promotes transparency, accountability, and integrity in corporate practices to protect shareholder interests and enhance investor confidence.
6. **Market Surveillance and Supervision**: SEBI conducts market surveillance to monitor trading activities, detect market abuse, and maintain market integrity. It supervises market infrastructure institutions such as stock exchanges, depositories, and clearing corporations to ensure smooth functioning of trading, clearing, and settlement processes.
7. **Education and Awareness**: SEBI promotes investor education and awareness through various initiatives, programs, and publications. It aims to empower investors with knowledge and information to make informed decisions and protect themselves from financial frauds and scams.
8. **International Cooperation**: SEBI collaborates with international regulatory bodies and organizations to exchange information, share best practices, and enhance regulatory cooperation in cross-border securities market activities. SEBI participates in global forums and initiatives to contribute to the development of international regulatory standards.

Overall, SEBI plays a pivotal role in safeguarding investor interests, maintaining market integrity, and fostering the growth and development of the Indian securities market.

9.7. Authority and Power of SEBI

The Securities and Exchange Board of India (SEBI) is vested with significant authority and powers to regulate and supervise the securities market in India. Some of the key authorities and powers of SEBI include:

1. **Legislative Mandate**: SEBI operates under the Securities and Exchange Board of India Act, 1992, which empowers it to regulate securities markets, protect investor interests, and promote the development and regulation of the securities market in India.
2. **Rulemaking and Regulations**: SEBI has the authority to formulate rules, regulations, and guidelines for various participants and activities in the securities market. It issues regulations governing securities issuance, trading, disclosure, corporate governance, and other market-related activities.
3. **Registration and Licensing**: SEBI has the authority to register and regulate various entities operating in the securities market, including stock exchanges, stockbrokers, depositories, mutual funds, portfolio managers, investment advisors, and other intermediaries. SEBI sets eligibility criteria, issues licenses, and monitors compliance with regulatory requirements.
4. **Market Surveillance and Enforcement**: SEBI conducts surveillance of the securities market to monitor trading activities, detect market abuse, insider trading, and other violations of securities laws and regulations. It has the power to investigate, inspect, and audit market participants to ensure compliance with regulatory requirements. SEBI can impose penalties, suspend licenses, and initiate legal proceedings against offenders.
5. **Corporate Governance Oversight**: SEBI regulates listed companies and imposes corporate governance norms, disclosure requirements, and listing obligations to ensure transparency, accountability, and investor protection. SEBI has the authority to review corporate actions, such as mergers, acquisitions, and corporate restructuring, to safeguard shareholder interests.
6. **Market Infrastructure Supervision**: SEBI supervises market infrastructure institutions such as stock exchanges, depositories, and clearing corporations to ensure the smooth functioning of trading, clearing, and settlement processes. SEBI sets standards and guidelines for market infrastructure institutions and monitors their compliance with regulatory requirements.

7. **Investor Protection Measures**: SEBI implements measures to protect investor interests, such as requiring companies to provide accurate and timely disclosure of information, regulating collective investment schemes, and promoting investor education and awareness.
8. **International Cooperation**: SEBI collaborates with international regulatory bodies and organizations to exchange information, share best practices, and enhance regulatory cooperation in cross-border securities market activities.

Overall, SEBI's authority and powers are extensive, enabling it to effectively regulate, supervise, and develop the securities market in India while safeguarding investor interests and maintaining market integrity

9.8. Mutual Funds and SEBI

Asset Management companies run mutual funds, and that needs to be passed by SEBI. A watchdog that is listed with SEBI holds the securities of varied schemes of the fund. The performance of mutual funds is monitored by the trustees of AMC to make sure that they work as per the SEBI guidelines. A firm needs to be established as a separate AMC if it wants to offer mutual funds. Also, the firm should have a net worth of Rs.50,00,000/-. In case the mutual funds are exquisitely dealing with the money market, then it is a mandate for them to be registered with RBI. All the additional funds can be filed with SEBI. A couple of year’s back a new self-regulation agency for mutual funds has been set up that is called Association of Mutual Funds of India. It aims to enhance operational standards and to ensure that it works with complete professional and ethical qualities.

Method for registering a mutual fund with SEBI

As per the guidelines by SEBI, any appellant who wishes to apply for listing should be done through the Form A which has been laid under Schedule I of SEBI Regulations 1996. A person who has more than or equal to 40% of the Net Worth of the Assets of the company should be presumed as a Sponsor, and only he should apply in Form A.

These are the few things that a person should have to apply for it:

- While filling the Form A, it is mandatory to submit a non-refundable fee of Rs.5 lakh.
- After doing this, SEBI would examine the application as per the eligibility criteria.

- If you meet the criteria, after that, you would have to complete other formalities like executing the trust deed, incorporating the asset management company, setting up a trustee company, etc.
- Once the sponsor meets all the conditions after that SEBI would provide a registration certificate after that, you have to pay a registration fee of Rs.25 lakh.

SEBI guidelines on Mutual Funds Reclassification

- SEBI has suggested 6 classifications for hybrid, 10 classifications for equity funds, 16 for debt funds and 2 for index funds.
- Debt fund classification is recommended based on the duration of fund and asset quality mix
- It has also taken over large, mid and small-cap based on the market-related rankings
- Funds should be names as per the core intent of the fund and asset mix. Ensure that it should state the risk associated clearly

Mutual Funds Regulation by SEBI

- Shareholders do not have authority to hold more than 10% of the shareholding directly or indirectly in the AMC of a mutual fund
- The increasing weight of the top three constituents of the index should not be more than 65%
- It is a mandate that every new fund should submit their compliance status to SEBI before launch
- Any investor of the liquid scheme who exits within seven days would have to pay a penalty
- Liquid schemes should hold a minimum of 20% in liquid assets like treasury bills, government securities, cash and rep on government securities.

9.9. Regulations of SEBI

The Securities and Exchange Board of India (SEBI) enforces various regulations to govern the functioning of the securities market and ensure fair, transparent, and efficient operations. Some of the key regulations enforced by SEBI include:

1. **SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015**: These regulations prescribe listing requirements and disclosure norms for companies listed on stock exchanges. They mandate periodic disclosure of financial results, shareholding patterns, corporate governance practices, and

other material information to ensure transparency and investor protection.

2. **SEBI (Prohibition of Insider Trading) Regulations, 2015**: These regulations prohibit insider trading and prescribe norms for prevention, detection, and reporting of insider trading activities. They define the duties of insiders, restrict trading by insiders based on unpublished price-sensitive information, and establish mechanisms for monitoring and enforcement.
3. **SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011**: These regulations govern the acquisition of shares and takeovers of listed companies. They regulate the acquisition of substantial shareholding, mandatory open offers, disclosure requirements, and takeover procedures to protect the interests of minority shareholders.
4. **SEBI (Buyback of Securities) Regulations, 2018**: These regulations govern the buyback of securities by listed companies. They prescribe conditions, procedures, and disclosures for conducting buyback offers, including the maximum buyback size, pricing, and timing requirements.
5. **SEBI (Mutual Funds) Regulations, 1996**: These regulations govern the establishment, operation, and management of mutual funds in India. They prescribe norms for fund mobilization, investment objectives, asset allocation, valuation, disclosure, and investor protection.
6. **SEBI (Foreign Portfolio Investors) Regulations, 2019**: These regulations govern the registration and operations of foreign portfolio investors (FPIs) in India. They prescribe eligibility criteria, investment limits, compliance requirements, and reporting obligations for FPIs investing in Indian securities markets.
7. **SEBI (Depositories and Participants) Regulations, 2018**: These regulations govern the functioning of depositories and depository participants (DPs) in India. They prescribe registration requirements, operational norms, risk management practices, and investor protection measures for depositories and DPs.
8. **SEBI (Credit Rating Agencies) Regulations, 1999**: These regulations govern the registration and operations of credit rating agencies in India. They prescribe eligibility criteria, disclosure norms, rating methodologies, and compliance requirements for credit rating agencies to ensure the integrity and reliability of credit ratings.

These are just a few examples of the regulations enforced by SEBI. The regulatory framework is comprehensive and covers various aspects of securities issuance, trading, intermediation, and investor protection to maintain market integrity and promote investor confidence. SEBI periodically reviews and updates its regulations to adapt to changing market dynamics and enhance regulatory effectiveness.

Let Us Sum Up

In this unit, you have learned the following:

SEBI is a statutory regulatory body established on the 12th of April, 1992. It monitors and regulates the Indian capital and securities market while ensuring to protect the interests of the investors, formulating regulations and guidelines. It plays an important role in regulating all the players operating in the Indian capital market. It attempts to protect the interest of investors and aims at developing the capital markets by enforcing various rules and regulations.

Check Your Progress

1. ________ plays an important role in regulating all the players operating in the Indian capital market.
2. The primary objective of SEBI is to ensure that the ________ works systematically.
3. The chairman of SEBI is nominated by the ________ Government of India.

Glossary

Securities: Securities are fungible and tradable financial instruments used to raise capital in public and private markets. There are primarily three types of securities: equity-which provides ownership rights to holders; debt-essentially loans repaid with periodic payments; and hybrids-which combine aspects of debt and equity.

Derivatives: A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset (like a security) or set of assets (like an index). Common underlying instruments include bonds, commodities, currencies, interest rates, market Indexes, and stocks

Answers to Check Your Progress

1. SEBI
2. Indian Stock Market
3. Union

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-11

Non-Banking Financial Institutions in India

STRUCTURE

Overview

Objectives

11.1. Introduction

11.2. Meaning of Non-Banking Financial Institutions

11.3. Types of Non-Banking Financial Institutions

11.4. The role of Non-Banking Financial Institutions in the Wider Industry

11.5. Non-Banking Financial Institutions in India

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Non-Banking Financial Institutions has been clearly explained. Study about the non-bank financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups. A Non-Banking Financial Institution (NBFI) or Non-Bank Financial Company (NBFC) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Non-Banking Financial Institutions
- Understand the role of Non-Banking Financial in India

11.1. Introduction

A Non-Banking Financial Institution (NBFI) or Non-Bank Financial Company (NBFC) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. Non-banking financial institutions are entities that neither acquire a valid banking license nor do they allow customers to deposit amounts. However, these entities can offer alternative financial facilities to customers, including investment, consultation, brokerage, transmission, and risk pooling services.

11.2. Meaning of Non-Banking Financial Institutions

Non-Banking Financial Institutions (NBFIs) are financial institutions that provide banking services without meeting the legal definition of a bank. They play a vital role in the financial system by offering a variety of financial services and products to individuals, businesses, and other entities. Unlike traditional banks, NBFIs do not hold banking licenses and are not subject to the same regulations and restrictions as banks. However, they are regulated by financial authorities such as central banks, securities regulators, or specialized regulatory bodies depending on the jurisdiction.

NBFIs encompass a wide range of entities, including:

1. **Finance Companies**: These companies provide loans and credit facilities to consumers and businesses. They may specialize in various types of financing such as consumer finance, auto loans, or equipment leasing.
2. **Leasing Companies**: Leasing companies offer equipment leasing and leasing solutions to businesses. They allow businesses to acquire equipment and machinery without the need for large upfront capital investments.
3. **Insurance Companies**: While insurance companies primarily provide insurance products, they also engage in various financial activities such as investment management, asset accumulation, and risk transfer.
4. **Mutual Funds**: Mutual funds pool money from investors and invest in a diversified portfolio of securities such as stocks, bonds, and money market instruments. They offer investors an opportunity to access professional portfolio management and diversification.
5. **Asset Management Companies (AMCs)**: AMCs manage investment portfolios on behalf of clients such as mutual funds, pension funds, and high-net-worth individuals. They make investment decisions, conduct research, and execute trades to achieve investment objectives.
6. **Venture Capital and Private Equity Firms**: These firms provide funding to startups, early-stage companies, and established businesses in exchange for equity ownership. They play a crucial role in funding innovation, entrepreneurship, and business growth.

7. **Housing Finance Companies**: Housing finance companies specialize in providing loans and financing solutions for the purchase, construction, and renovation of residential properties. They cater to individuals and families seeking home loans.
8. **Microfinance Institutions (MFIs)**: MFIs provide small loans and financial services to low-income individuals, entrepreneurs, and small businesses in underserved or unbanked areas. They aim to promote financial inclusion and alleviate poverty by providing access to credit.

Overall, NBFIs complement traditional banking services by offering specialized financial products, catering to specific market segments, and promoting financial inclusion. However, they also pose unique regulatory challenges due to their diverse activities and potential systemic risks. Regulatory authorities closely monitor NBFIs to ensure financial stability, consumer protection, and market integrity.

11.3. Types of Non-Banking Financial Institutions

Mutual Funds

1. Mediators between people and stock exchange
2. Money collected from people by selling their units is called the corpus
3. Oldest Mutual Fund company in India is UTI (Unit Trust of India)
4. Mutual Funds nearly provides all the considerations

Insurance Companies

1. Collect money from the public through the sale of insurance policies
2. There are two types of Insurance – Life Insurance and General Insurance

- General Insurance includes Loss of property, car, house etc.
- It also includes Health Insurance

IRDA Act, 1999

As per the Insurance Regulatory and Development Authority Act, Insurance companies were opened up for private companies. The objective was to promote competition FDI was allowed up to 26% (Recently increased to 49%) IRDA was established as the regulator of the insurance sector

1. LIC – Life Insurance Corporation

- Set up in 1956 by the government by nationalizing all the existing private sector life insurance companies

- This was done due to large scale defaults

2. GIC – General Insurance Corporation

- It was established in 1973
- Subsidiaries of GIC are:-

NICL – National Insurance Company of India Limited

- United India Insurance Company Limited
- Oriental Insurance Company of India Limited
- New India Insurance Company of India Limited

ULIP – Unit Linked Insurance Plans

- A mixture of Insurance and Mutual Funds

Aspirants can go through the List of Insurance Companies in India on the linked page.

Hedge Funds

1. These are mutual funds for rich investors
2. Funds are raised through the sale of their unit to High net worth Individuals and Institutional Investors
3. Units of these are usually sold in chunks/groups
4. There is a lock-in period for Hedge funds before which funds cannot be withdrawn
5. Corpus is an investment in risky instruments with a long term perspective

Venture Capital Firms/ Companies

1. They provide finance and technical assistance to firms which undertake a business project based on innovative ventures
2. They provide finance for the commercial application of new technology

Merchant banks (Investment Banks)

1. Merchant banks provide financial consultancy services
2. They advise firms on fundraising, manage IPO of firms, underwrite new issues and facilitate demat trading.

Finance Companies (Loan Companies)

1. Financial Institutions raise funds from the public for lending purposee.g. – Muthoot Finance, Cholamandalam

Micro Finance Institutions (MFI)

1. Raise funds from the public for lending to weaker sections
2. In India, they mainly raise funds from bankse.g. – Basix, Bandhan, SKS Micro Finance.

Vulture Funds

1. These funds buy stocks of companies which are nearing bankruptcy at a very low price.
2. After purchasing such stocks, they initiate the recovery process to increase the price of shares and sell it at a later point of time.

Islamic Banks

1. These banks provide loans on the basis of Islamic laws called Sharia.
2. In the law of Sharia Interest cannot be charged on the loans

Leasing Companies

1. They purchase equipment and machinery and provide the same to companies on a lease.
2. These companies charge rent on these machineries which is similar to EMI

11.4. The Roles of Non-Banking Financial Institutions in the Wider Industry

For most people, the bank is the first port of call when seeking out financial aid or advice. However, many people also find that the services offered by the bank don't adequately meet their requirements, leaving them at a loss for what to do next. While banks tend to offer a set of financial services as part of a clear packaged deal, NBFIs unbundle these offers and tailor their services to meet the needs of the specific client. Therefore, many people who can't find help at the bank can find it with an NBFI. The role of NBFIs is generally to allocate surplus resources to individuals and companies with financial deficits, allowing them to supplement banks. By unbundling financial services, targeting them and specializing in the needs of the individual, NBFIs work to enhance competition in the financial sector. NBFIs offer most kinds of banking services, often including:

- Loans
- Credit facilities
- Retirement planning
- Education funding

- Underwriting stocks and shares
- Money market trading
- TFCs (Term Finance Certificates)
- Wealth management
- Portfolio of stocks and shares management
- Discounting services

NBFIs, explained

The number of non-bank financial institutions has increased greatly in recent years, as retail companies, industrial companies and venture capital companies have entered the lending business. NBFIs frequently specialize in the support of property investments, preparing feasibility, market or industry studies for companies. The kinds of services offered by non-bank financial institutions generally fall in one of three categories, which we have outlined in further detail below.

Risk Pooling Institutions

These are organizations such as insurance companies which underwrite economic risks associated with a series of factors, including illness, death, damage and risk of loss. In return for collecting an insurance premium, these organizations provide a promise of economic protection in case of loss. There are two key kinds of insurance companies: general insurance and life insurance. The former tends to be a short term agreement, while life insurance can be agreed on a much longer term basis.

Institutional Investors

This category refers to organizations such as pension funds and mutual funds. These are the institutions which trade securities in volumes that qualify for lower commissions. These are also known as contractual savings institutions. Mutual funds can be either open ended or closed ended.

Other Non-Bank Financial Institutions

These are other forms of NBFI which provide financial services such as the leasing of assets, company management, financial advice, security brokering and market makers, who provided liquidity. It may also refer to specialized sectorial financiers who provide a limited range of services to a targeted sector, such as real estate financers or payday lending companies

11.5. Non-Banking Financial Institutions in India

As of January 31, 2021, there were 9,507 Non-Banking Financial Companies (NBFCs) registered with the Reserve Bank of India. The role of NBFIs is generally to allocate surplus resources to individuals and companies with financial deficits, allowing them to supplement banks. By unbundling financial services, targeting them and specializing in the needs of the individual, NBFIs work to enhance competition in the financial sector.

Let Us Sum Up

In this unit, you have learned the following:

These non-bank financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups. A Non-Banking Financial Institution (NBFI) or Non-Bank Financial Company (NBFC) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFC facilitate bank- related financial services, such as investment, risk pooling, contractual savings, and market brokering. Examples of these include insurance firms, pawnshops, cashier's, check issuers, check cashing locations, payday lending, currency exchanges, and microloan organizations.Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment which act as backup facilities should the primary form of intermediation fail."

The term non-bank likely started as non-deposit taking banking institution. However, due to financial regulations adopted from English speaking countries, non-English speaking countries took "non-bank" as a single word. This is probably because in English speaking countries the term 'bank' is generally accepted as equivalent to 'financial institution' but outside English speaking countries, especially developing countries, see the term bank as deposit taking institutions only, and every other financial service providers as something that must not be termed a bank.

This is possibly due to language differences. But also importantly, this is likely due to developing countries in the past having adopted the western banking system much later than the West. As developing countries adopted, or learned the financial system from English speaking countries, there was a higher focus in regulatory terms such as bank and non-bank, while not understanding that non-bank is actually a shortened version of non-deposit taking bank. This is in contrast to English speaking countries as in English speaking countries the general

public, as well as regulatory institutions, refer to financial institutions as simply a "bank" in many instances. Operations of non-bank financial institutions are not covered under a country's banking regulations.

Check Your Progress

1. ________ are entities that neither acquire a valid banking license nor do they allow customers to deposit amounts
2. ________are incorporated legal entities that largely produce goods and services for the market
3. .General Insurance Corporation it was established in ________

Glossary

Financial intermediary: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investmentbank, mutual fund, or pension fund

Primary market: The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market

Secondary market: The secondary market is where investors buy and sell securities they already own. It is what most people typically think of as the "stock market," though stock are also sold on the primary market when they are first issued.

Answers to Check Your Progress

1. Non-Banking Financial Institutions
2. Non-Financial Corporations
3. 1973

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-12
Stock Exchange

STRUCTURE

Overview

Objectives

12.1. Introduction

12.2. Meaning of Stock Exchange

12.3. Features of Stock Exchange

12.4. Functions of Stock Exchange

12.5. Trading and Settlement Procedures

12.6. Benefits of Listing with Stock Exchange

12.7. Investment Methods

12.8. Major Stock Exchange in India

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Stock Exchange has been explained. Study about the stock exchange, also called stock market or in continental Europe bourse, organized market for the sale and purchase of securities such as shares, stocks, and bonds. In most countries the stock exchange has two important functions. As a ready market for securities, it ensures their liquidity and thus encourages people to channel savings into corporate investment

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Stock Exchange
- Understand the Role of Stock Exchange in India

12.1. Introduction

It is a place where shares of pubic listed companies are traded. The primary market is where companies float shares to the general public in an Initial Public Offering (IPO) to raise capital. Stock exchange, also called stock market or in continental Europe bourse, organized market for the sale and purchase of securities such as shares, stocks, and

bonds. In most countries the stock exchange has two important functions. As a ready market for securities, it ensures their liquidity and thus encourages people to channel savings into corporate investment. As a pricing mechanism, it allocates capital among firms by determining prices that reflect the true investment value of a company's stock. (Ideally, this price represents the present value of the stream of expected income per share.)

Membership requirements of stock exchanges vary among countries, mainly with respect to the number of members, the degree of bank participation, the rigour of the eligibility requirements, and the level of government involvement. Trading is done in various ways: it may occur on a continuous auction basis, involve brokers buying from and selling to dealers in certain types of stock, or be conducted through specialists in a particular stock.

Technological developments have greatly influenced the nature of trading. By the 21st century, increased access to the Internet and the proliferation of Electronic Communications Networks (ECNs) had allowed electronic trading, or e-trading, to alter the investment world. These computerized ECNs made it possible to match the orders of buyers and sellers of securities without the intervention of specialists or market makers. In a traditional full-service or discount brokerage, a customer places an order with a broker member of a stock exchange, who in turn passes it on to a specialist on the floor of the exchange who actually concludes the transaction.

The traditional specialist makes a market for a stock on the exchange by matching buy and sell orders in his exclusive "book" and establishing a price for the trade. In the over-the-counter market, market makers establish prices by setting "bid" and "asked" spreads with a commitment to complete trades in a given security. In e-trading the customer enters an order directly online, and specialized software automatically matches orders to achieve the best price available. In effect, the ECN is a stock exchange for off-the-floor trading. As a result, the operations of some stock exchanges, such as NASDAQ, need not be centralized in one location but can be coordinated electronically from a number of locations.

12.2. Meaning of Stock Exchange

A stock exchange, securities exchange, or bourse, is an exchange where stockbrokers and traders can buy and sell securities, such as shares of stock, bonds, and other financial instruments. The stock exchange in India serves as a market where financial instruments like stocks, bonds and commodities are traded.

It is a platform where buyers and sellers come together to trade financial tools during specific hours of any business day while adhering to SEBI's well-defined guidelines. However, only those companies who are listed in a stock exchange are allowed to trade in it.

Stocks which are not listed on a reputed stock exchange can still be traded in an 'Over the Counter Market'. But such shares would not be held high in esteem in the stock exchange market.

How does it work?

Mostly, a stock exchange in India works independently as no 'market makers' or 'specialists' are present in them. The entire process of trading in stock exchange in India is order-driven and is conducted over an electronic limit order book. In such a set-up, orders are automatically matched with the help of the trading computer. It functions to match investors' market orders with the most suitable limit orders. The major benefit of such an order-driven market is that it facilitates transparency in transactions by displaying all market orders publicly. Brokers play a vital role in the trading system of the stock exchange market, as all orders are placed through them. Both institutional investors and retail customers can avail the benefits associated with direct market access or DMA. By using the trading terminals provided by stock exchange market brokers, investors can place their orders directly into the trading system.

12.3. Features of Stock Exchange

A stock exchange is a regulated marketplace where securities such as stocks, bonds, derivatives, and other financial instruments are bought and sold. These exchanges provide a platform for investors, traders, and companies to trade securities in a transparent, fair, and efficient manner. Some key features and functions of stock exchanges include:

1. **Listing of Securities**: Companies that wish to raise capital by issuing stocks or bonds can list their securities on a stock exchange. Listing requirements vary by exchange but typically include meeting certain financial, governance, and disclosure standards.

2. **Trading Platform**: Stock exchanges provide an electronic trading platform where buyers and sellers can execute trades. These platforms match buy and sell orders, ensuring liquidity and price discovery for traded securities.

3. **Market Regulation**: Stock exchanges enforce rules and regulations to maintain fair and orderly trading. They monitor

trading activities, detect market manipulation and insider trading, and impose penalties for violations of exchange rules.

4. **Price Discovery**: Stock exchanges facilitate price discovery by bringing together buyers and sellers and allowing them to transact at prices determined by market forces. The continuous trading of securities on exchanges helps establish fair market prices.
5. **Market Indices**: Stock exchanges often calculate and publish market indices, which track the performance of a basket of stocks representing the overall market or specific sectors. These indices serve as benchmarks for evaluating market performance and investment returns.
6. **Market Surveillance**: Stock exchanges conduct market surveillance to monitor trading activities, detect irregularities, and maintain market integrity. Surveillance systems use sophisticated algorithms to identify potential market abuses and ensure compliance with exchange rules.
7. **Listing Requirements**: Companies seeking to list their securities on a stock exchange must meet specific listing requirements, which may include minimum capitalization, corporate governance standards, financial reporting obligations, and regulatory compliance.
8. **Market Data and Information**: Stock exchanges provide market data, trading statistics, and other information to investors, traders, and market participants. This data includes real-time prices, trading volumes, bid-ask spreads, and corporate announcements.
9. **Market Liquidity**: Stock exchanges enhance market liquidity by providing a centralized marketplace where buyers and sellers can easily transact securities. Liquidity ensures that investors can buy or sell securities quickly and at competitive prices.

Some examples of well-known stock exchanges include the New York Stock Exchange (NYSE) and the NASDAQ in the United States, the London Stock Exchange (LSE) in the United Kingdom, the Tokyo Stock Exchange (TSE) in Japan, and the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) in India. These exchanges play a crucial role in the global financial system by facilitating capital formation, investment, and risk management.

12.4. Functions of Stock Exchange

Liquidity and Marketability: One of the main drawing factors of the stock exchange is that it enables high liquidity. The securities can be sold at a moment's notice and be converted to cash. It is a continuous market and the investors can divest and reinvest with ease as per their wishes.

Price Determination: In a secondary market, the only way to determine the price of securities in via the rules of supply and demand. A stock exchange enables this process via constant valuation of all the securities. Such prices of shares of various companies can be tracked via the index we call the Sensex.

Safety: The government strictly governs and regulates the stock exchanges. In the case of the BSE, the Securities Board of India is the governing body. All transactions occur within the legal framework. This provides the investor with assurances and a safe place to transact in securities.

Contribution to the Economy: As we know the stock exchange deals in already-issued securities. But these securities are continuously sold and resold and so on. This allows the funds to be mobilized and channelized instead of sitting idle. This boosts the economy.

Spreading of Equity: The stock exchange ensures wider ownership of securities. It actually educates the public about the safety and the benefits of investing in the stock market. It ensures a better quality of transactions and smooth functioning. The idea is to get more public investors and spread the ownership of securities for the benefit of everyone.

Speculation: One often hears that the stock exchange is a speculative market. And while this is true, the speculation is kept within the legal framework. For the stake of liquidity and price determination, a healthy dose of speculative trading is necessary, and the stock exchange provides us with such a platform.

Role of an Economic Barometer: Stock exchange serves as an economic barometer that is indicative of the state of the economy. It records all the major and minor changes in the share prices. It is rightly said to be the pulse of the economy, which reflects the state of the economy.

Valuation of Securities: Stock market helps in the valuation of securities based on the factors of supply and demand. The securities offered by companies that are profitable and growth-oriented tend to be

valued higher. Valuation of securities helps creditors, investors and government in performing their respective functions.

Transactional Safety: Transactional safety is ensured as the securities that are traded in the stock exchange are listed, and the listing of securities is done after verifying the company's position. All companies listed have to adhere to the rules and regulations as laid out by the governing body.

Contributor to Economic Growth: Stock exchange offers a platform for trading of securities of the various companies. This process of trading involves continuous disinvestment and reinvestment, which offers opportunities for capital formation and subsequently, growth of the economy.

Making the public aware of equity investment: Stock exchange helps in providing information about investing in equity markets and by rolling out new issues to encourage people to invest in securities.

Offers scope for speculation: By permitting healthy speculation of the traded securities, the stock exchange ensures demand and supply of securities and liquidity.

Facilitates liquidity: The most important role of the stock exchange is in ensuring a ready platform for the sale and purchase of securities. This gives investors the confidence that the existing investments can be converted into cash, or in other words, stock exchange offers liquidity in terms of investment.

Better Capital Allocation: Profit-making companies will have their shares traded actively, and so such companies are able to raise fresh capital from the equity market. Stock market helps in better allocation of capital for the investors so that maximum profit can be earned.

Encourages investment and savings: Stock market serves as an important source of investment in various securities which offer greater returns. Investing in the stock market makes for a better investment option than gold and silver.

12.5. Trading and Settlement Procedures

1. Selecting a Broker or Sub-broker

When a person wishes to trade in the stock market, it cannot do so in his/her individual capacity. The transactions can only occur through a broker or a sub-broker. So according to one's requirement, a broker must be appointed. Now such a broker can be an individual or a partnership or a company or a financial institution (like banks). They

must be registered under SEBI. Once such a broker is appointed you can buy/sell shares on the stock exchange.

2. Opening a Demat Account

Since the reforms, all securities are now in electronic format. There are no issues of physical shares/securities anymore. So an investor must open a dematerialized account, i.e. a Demat account to hold and trade in such electronic securities. So you or your broker will open a Demat account with the depository participant. Currently, in India, there are two depository participants, namely Central Depository Services Ltd. (CDSL) and National Depository Services Ltd. (NDSL).

3. Placing Orders:

And then the investor will actually place an order to buy or sell shares. The order will be placed with his broker, or the individual can transact online if the broker provides such services. One thing of essential importance is that the order /instructions should be very clear. Example: Buy 100 shares of XYZ Co. for a price of Rs. 140/- or less. Then the broker will act according to your transactions and place an order for the shares at the price mentioned or an even better price if available. The broker will issue an order confirmation slip to the investor.

4. Execution of the Order

Once the broker receives the order from the investor, he executes it. Within 24 hours of this, the broker must issue a Contract Note. This document contains all the information about the transactions, like the number of shares transacted, the price, date and time of the transaction, brokerage amount, etc. Contract Note is an important document. In the case of a legal dispute, it is evidence of the transaction. It also contains the Unique Order Code assigned to it by the stock exchange.

5. Settlement

Here the actual securities are transferred from the buyer to the seller. And the funds will also be transferred. Here too the broker will deal with the transfer. There are two types of settlements,

On the Spot settlement: Here we exchange the funds immediately and the settlement follows the T+2 pattern. So a transaction occurring on Monday will be settled by Wednesday (by the second working day)

Forward Settlement: Simply means both parties have decided the settlement will take place on some future date. It can be T+% or T+9 etc

12.6. Benefit of Listing with Stock Exchange

Listing with a stock exchange extends special privileges to company securities. For instance, only listed company shares are quoted on

a stock exchange. Being listed on a reputed stock exchange is deemed beneficial for companies, investors and the public in general and they tend to benefit in these following ways:

Increased Value

Only stocks listed with a reputable stock exchange are considered to be higher in value. Companies can cash in on their market reputation in the stock exchange market by increasing their number of shareholders. Issuing shares in the market for shareholders to acquire is a potent way of increasing shareholder base and base, which in turn increases their credibility.

Accessing capital

One of the most effective ways of availing cheap capital for a company is by issuing company shares in the stock exchange market for shareholders to acquire. Listed companies can generate comparatively more capital through share issuance owing to their repute in a stock exchange market and use it to keep their company afloat and its operations running.

Collateral value

Almost all lenders accept listed securities as collateral and extend credit facilities against them. A listed company is more likely to avail a faster approval for their credit request; as they are deemed more credible in the stock exchange market.

Liquidity

Listing helps shareholder avail the advantage of liquidity better than other counterparts and offers them ready marketability. It allows shareholders to estimate the value of investment owned by them. Additionally, it permits share transactions with a company and helps them to even out the associated risks. It also helps shareholders to improve their earnings from even the slightest increase in overall organizational value.

Fair price

The quoted price also tends to represent the real value of a particular security in a stock exchange in India. The fact that the prices of listed securities are set as per the forces of demand and supply and are disclosed publicly, investors are assured to acquire them at a fair price.

12.7. Investment Methods

Investing in the stock exchange involves various methods and strategies tailored to individual preferences, risk tolerance, and investment goals.

Here are some common investment methods used in the stock exchange:

1. **Buy and Hold**: This is a long-term investment strategy where investors purchase stocks with the intention of holding them for an extended period, typically several years or more. Buy-and-hold investors focus on the fundamentals of the companies they invest in, such as earnings growth, market share, and competitive advantages. They aim to benefit from the appreciation of stock prices over time and may reinvest dividends to compound their returns.
2. **Value Investing**: Value investors seek out undervalued stocks trading below their intrinsic value based on fundamental analysis. They look for companies with strong financials, solid management, and favorable growth prospects that are trading at a discount relative to their intrinsic worth. Value investors believe that the market sometimes misprices stocks, presenting opportunities to buy quality assets at a bargain.
3. **Growth Investing**: Growth investors target companies with strong growth potential in terms of revenue, earnings, and market share. They focus on high-growth sectors or industries and prioritize companies with innovative products, expanding markets, and scalable business models. Growth investors are willing to pay premium valuations for stocks with the expectation of future growth and capital appreciation.
4. **Dividend Investing**: Dividend investors focus on stocks that pay regular dividends to shareholders. They prioritize companies with a history of stable or increasing dividend payouts, strong cash flows, and sustainable dividend yields. Dividend investing aims to generate passive income from dividends while benefiting from potential capital appreciation over time.
5. **Income Investing**: Income investors prioritize generating regular income from their investments, often focusing on fixed-income securities such as bonds, preferred stocks, or dividend-paying stocks. They seek out assets with attractive yields and low volatility to generate consistent cash flow to meet their income needs.
6. **Sector Rotation**: Sector rotation involves shifting investments among different sectors or industries based on macroeconomic trends, business cycles, or market conditions. Investors may rotate into sectors poised for growth and out of sectors facing headwinds or overvaluation. Sector rotation strategies aim to

capitalize on sector-specific opportunities and diversify risk exposure.

7. **Market Timing**: Market timing involves attempting to predict short-term fluctuations in stock prices or market trends to buy low and sell high. Investors use technical analysis, chart patterns, and market indicators to identify entry and exit points in the market. Market timing strategies carry higher risks and may lead to underperformance if mistimed.
8. **Index Investing**: Index investors seek to replicate the performance of a specific market index, such as the S&P 500 or the Nifty 50, by investing in index funds or Exchange-Traded Funds (ETFs). These passive investment vehicles hold a diversified portfolio of stocks that mirror the composition of the underlying index. Index investing offers broad market exposure, low costs, and simplicity.
9. **Dollar-Cost Averaging (DCA)**: DCA involves investing a fixed amount of money at regular intervals, regardless of market conditions. By spreading investments over time, DCA helps smooth out market volatility and reduces the impact of market fluctuations on overall investment returns. This strategy allows investors to buy more shares when prices are low and fewer shares when prices are high, potentially improving long-term returns.
10. **Options Trading**: Options trading involves buying and selling options contracts based on the price movements of underlying stocks or indices. Options provide investors with leverage, flexibility, and the ability to profit from directional movements in the market or hedge against downside risk. Options strategies include buying calls or puts, selling covered calls, or employing more complex strategies like straddles or spreads.

These are just some of the many investment methods and strategies used in the stock exchange. Each approach has its own benefits, risks, and suitability depending on individual circumstances and investment objectives. It's essential for investors to conduct thorough research, diversify their portfolios, and consider seeking professional advice before making investment decisions in the stock market.

12.8. Major Stock Exchange in India

There are two major types of Stock Exchanges in India, namely the –

Bombay Stock Exchange (BSE): This particular stock exchange was established in 1875 in Mumbai at Dalal Street. It renowned as the oldest

stock exchange not just in Asia and is the 'World's 10th largest Stock Exchange'. The estimated market capitalization of Bombay Stock Exchange as of April stands at $ 4.9 Trillion and has around 6000 companies publicly listed under it. The performance of BSE is measured by the Sensex, and it reached its all-time high in June in 2019, when it touched 40312.07.

National Stock Exchange (NSE): The NSE was established in 1992 in Mumbai and is accredited as the pioneer among the demutualized electronic stock exchange markets in India. This stock exchange market was established with the objective to eliminate the monopolistic impact of the Bombay Stock exchange in the Indian stock market. The estimated market capitalization of National Stock Exchange as of March 2016 was US$ 4.1 trillion and was acclaimed as the 12th largest stock exchange in the world. NIFTY 50 is NSE's index, and it is extensively used by investors across the globe to gauge the performance of the Indian capital market.

- Here is a list of stock exchanges in India
- The Bombay Stock Exchange Ltd
- India International Exchange or India INX
- Metropolitan Stock Exchange of India Ltd (was valid up to September 15th, 2019)
- National Stock Exchange of India Ltd.
- NSE IFSC Ltd.

Being a vital part of the Indian stock market, a stock exchange in India tends to influence the country's financial sector to a great extent. Their collective performances happen to be a deciding factor of economic growth.

Also, all major types of stock exchanges are closely integrated with each other; if one major stock exchange falls, it will have a ripple effect on all other major exchanges across the globe.

For example, if the index of Bombay Stock Exchange falls, its effect will be felt across stock exchanges like New York Stock Exchange, Tokyo Stock Exchange, Shanghai Stock Exchange, etc. as well.

Let Us Sum Up

In this unit, you have learned the following:

Stock exchange, also called stock market or in continental Europe bourse, organized market for the sale and purchase of securities such as shares, stocks, and bonds. In most countries

the stock exchange has two important functions. As a ready market for securities, it ensures their liquidity and thus encourages people to channel savings into corporate investment. As a pricing mechanism, it allocates capital among firms by determining prices that reflect the true investment value of a company's stock. (Ideally, this price represents the present value of the stream of expected income per share.)

Membership requirements of stock exchanges vary among countries, mainly with respect to the number of members, the degree of bank participation, the rigour of the eligibility requirements, and the level of government involvement. Trading is done in various ways: it may occur on a continuous auction basis, involve brokers buying from and selling to dealers in certain types of stock, or be conducted through specialists in a particular stock.

Technological developments have greatly influenced the nature of trading. By the 21st century, increased access to the Internet and the proliferation of Electronic Communications Networks (ECNs) had allowed electronic trading, or e-trading, to alter the investment world. These computerized ECNs made it possible to match the orders of buyers and sellers of securities without the intervention of specialists or market makers. In a traditional full-service or discount brokerage, a customer places an order with a broker member of a stock exchange, who in turn passes it on to a specialist on the floor of the exchange who actually concludes the transaction.

The traditional specialist makes a market for a stock on the exchange by matching buy and sell orders in his exclusive "book" and establishing a price for the trade. In the over-the-counter market, market makers establish prices by setting "bid" and "asked" spreads with a commitment to complete trades in a given security. In e-trading the customer enters an order directly online, and specialized software automatically matches orders to achieve the best price available. In effect, the ECN is a stock exchange for off-the-floor trading. As a result, the operations of some stock exchanges, such as NASDAQ, need not be centralized in one location but can be coordinated electronically from a number of locations.

Check Your Progress

1. The________ serves as a market where financial instruments like stocks, bonds and commodities are traded.
2. Bombay Stock Exchange was established in ________
3. National Stock Exchange was established in ________

Glossary

Financial intermediary: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund

Primary market: The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market

Secondary market: The secondary market is where investors buy and sell securities they already own. It is what most people typically think of as the "stock market," though stocks are also sold on the primary market when they are first issued.

Answers to Check Your Progress

1. Stock Exchange in India
2. 1875
3. 1992

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Block-4: Introduction

Block-4: Share Market has been divided in to four Units.

Unit-13: Share Market deals with Introduction, Meaning of Share Market, Trade on Share Market, Types of Share Market, Function and Purpose, Scope of Stock Exchange and the Difference between Share Market and Stock Market.

Unit-14: Types of Equities and Bonds explains about Introduction, Meaning of Equities, Types of Equities, Meaning of Bond, Types of Bonds and the Role of Bond and Equities.

Unit-15: Types of Investments describes about Introduction, Meaning and Definition of Investment, Purpose of Investment, Types of Investments and the Benefits of Investments.

Unit-16: Share Market Indices presents about the Introduction, Meaning, Types of Stock Market Indices, Stock market indices create and developed, Formation of an Index, Importance of Stock Market Indices.

In all the units of Block -4 **Share Market**, the Check your progress, Glossary, Answers to Check your progress and Suggested Reading has been provided and the Learners are expected to attempt all the Check your progress as part of study.

Unit-13
Share Market

STRUCTURE

Overview

Objectives

13.1. Introduction

13.2. Meaning of Share Market

13.3. Trade on Share Market

13.4. Types of Share Market

13.5. Function and Purpose

13.6. Scope of Stock Exchange

13.7. Difference between Share Market and Stock Market

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Share Market has been explained. Study about the share market or a stock market is essentially a market where various kinds of bonds and securities are traded. The price of a company's stock depends on the demand and the supply of that stock. Investing in shares can prove to be a great source of long-term wealth generation for any individual investor

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Share Market
- Understand the Features of Primary and Secondary Share Market

13.1. Introduction

The share market is a platform where buyers and sellers come together to trade on publicly listed shares during specific hours of the day. People often use the terms ‘share market’ and ‘stock market’ interchangeably. However, the key difference between the two lies in the fact that while the former is used to trade only shares, the latter allows you to trade various financial securities such as bonds,

derivatives, forex etc. The principal stock exchanges in India are the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE). Individual and institutional investors come together on stock exchanges to buy and sell shares in a public venue. Share prices are set by supply and demand as buyers and sellers place orders. Order flow and bid-ask spreads are often maintained by specialists or market makers to ensure an orderly and fair market.

13.2. Meaning of Share Market

Stock markets are venues where buyers and sellers meet to exchange equity shares of public corporations. Stock markets are vital components of a free-market economy because they enable democratized access to trading and exchange of capital for investors of all kinds.

13.3. Trade on Share Market

There are four categories of financial instruments that are traded on the stock exchange. These include:

Shares

A share represents a unit of equity ownership in a company. Shareholders are entitled to any profits that the company may earn in the form of dividends. They are also the bearers of any losses that the company may face.

Bonds

To undertake long term and profitable projects, a company requires substantial capital. One way to raise capital is to issue bonds to the public. These bonds represent a “loan” taken by the company. The bondholders become the creditors of the company and receive timely interest payments in the form of coupons. From the perspective of the bondholders, these bonds act as fixed income instruments, where they receive interest on their investment as well as their invested amount at the end of the prescribed period.

Mutual Funds

Mutual funds are professionally managed funds that pool the money of numerous investors and invest the collective capital into various financial securities. You can find mutual funds for a variety of financial instruments like equity, debt, or hybrid funds, to name a few.

Each mutual fund scheme issues units that are of a certain value similar to a share. When you invest in such funds, you become a unit-holder in that mutual fund scheme. When instruments that are part of that mutual fund scheme earn revenue over time, the unit-holder receives that

revenue reflected as the net asset value of the fund or in the form of dividend payouts.

Derivatives

A derivative is a security that derives its value from an underlying security. This can have a wide variety such as shares, bonds, currency, commodities and more! The buyers and sellers of derivatives have opposing expectations of the price of an asset, and hence, enter into a "betting contract" with regards to its future price.

13.4. Types of Share Markets

Stock markets can be classified into two parts: primary markets and secondary markets.

1. Primary Share Markets
2. Secondary Market

1) Primary Share Markets:

- **Definition**: The primary share market, also known as the primary market or new issue market, is where newly issued securities are bought and sold for the first time. This is the market where companies raise capital by issuing shares to investors through processes like Initial Public Offerings (IPOs) or rights issues.
- **Purpose**: The primary market facilitates the capital-raising process for companies. Through IPOs, companies can raise funds for various purposes, such as business expansion, investment in new projects, debt repayment, or working capital needs.
- **Participants**: The main participants in the primary market include the issuing company (the issuer), investment banks or underwriters responsible for managing the offering, institutional investors, and retail investors who subscribe to the new securities.
- **Price Determination**: The price of newly issued securities in the primary market is determined through processes like book-building or fixed-price offerings. The issuing company, along with underwriters, decides on the issue price based on factors such as market demand, company fundamentals, and investor appetite.
- **Regulation**: The primary market is regulated by securities regulators such as the Securities and Exchange Board of India (SEBI) in India. Regulators oversee the IPO process, ensure

compliance with disclosure requirements, and protect the interests of investors.

2) **Secondary Market:**

- **Definition**: The secondary share market, also known as the secondary market or stock exchange, is where previously issued securities are bought and sold among investors. This is the market where investors trade shares of publicly listed companies after the initial issuance.
- **Purpose**: The primary function of the secondary market is to provide liquidity to investors by allowing them to buy and sell shares at prevailing market prices. It also facilitates price discovery, reflects investor sentiment, and supports efficient capital allocation.
- **Participants**: The secondary market involves a broad range of participants, including individual investors, institutional investors, traders, market makers, and stockbrokers. These participants engage in buying and selling shares on stock exchanges.
- **Price Determination**: In the secondary market, prices of shares are determined by supply and demand dynamics, investor sentiment, company performance, economic factors, and market conditions. Market forces dictate the prevailing market price, which fluctuates based on trading activity.
- **Regulation**: Stock exchanges where secondary market transactions occur are regulated by securities regulators to ensure fair, orderly, and transparent trading. Regulators oversee market operations, monitor trading activities, enforce compliance with exchange rules, and protect investor interests.

Overall, the primary market facilitates the issuance of new securities by companies to raise capital, while the secondary market provides a platform for trading existing securities among investors, thereby supporting liquidity and price discovery in the stock market. Both markets are essential components of the broader capital market ecosystem.

Shares can be further categorized into two types. These are:

- Equity shares
- Preference shares

They vary based on their profitability, voting rights and treatment in the event of liquidation.

i) **Equity Shares Meaning:** These are also known as ordinary shares and comprise the bulk of the shares being issued by a particular company. Equity shares are transferable and are traded actively by investors in stock markets. As an equity shareholder, you are not only entitled to voting rights on company issues but also have the right to receive dividends. These dividends, however, are not fixed. Equity shareholders also partake in any losses faced by the company, limited to the amount they had invested. Equity shares can be further divided based on:

- Share capital
- Definition
- Returns

Classification of Equity Shares based on Share Capital

Here is a look at the classification of equity shares based on share capital:

- **Authorized Share Capital:** Every company, in its Memorandum of Associations, requires to prescribe the maximum amount of capital that can be raised by issuing equity shares. The limit, however, can be increased by paying additional fees and after the completion of certain legal procedures.
- **Issued Share Capital:** This implies the specified portion of the company's capital, which has been offered to investors through the issuance of equity shares. For example, if the nominal value of one stock is Rs. 200/- and the company issues 20,000 equity shares, the issued share capital will be Rs. 40 lakh.
- **Subscribed Share Capital:** The portion of the issued capital, which has been subscribed by investors is known as subscribed share capital.
- **Paid-Up Capital:** The amount of money paid by investors for holding the company's stocks is known as paid-up capital. As investors pay the entire amount at once, subscribed and paid-up capital refer to the same amount.

Classification of Equity Shares based on Definition

Here is a look at the equity share classification based on the definition:

- **Bonus Shares:** Bonus share definition implies those additional stocks which are issued to existing shareholders free-of-cost, or as a bonus.

- **Rights Shares:** Right shares meaning is that a company can provide new shares to its existing shareholders - at a particular price and within a specific period - before being offered for trading in stock markets.
- **Sweat Equity Shares:** If as an employee of the company, you have made a significant contribution, the company can reward you by issuing sweat equity shares.
- **Voting and Non-Voting Shares**: Although the majority of shares carry voting rights, the company can make an exception and issue differential or zero voting rights to shareholders.

Classification of Equity Shares based on Returns

Based on returns, here is a look at the types of shares:

- **Dividend Shares:** A company can choose to pay dividends in the form of issuing new shares, on a pro-rata basis.
- **Growth Shares:** These types of shares are associated with companies that have extraordinary growth rates. While such companies might not provide dividends, the value of their stocks increases rapidly, thereby providing capital gains to investors.
- **Value Shares:** These types of shares are traded in stock markets at prices lower than their intrinsic value. Investors can expect the prices to appreciate over some time, thus providing them with a better share price.

ii) Preference Shares: Preferential shareholders receive preference in receiving profits of a company as compared to ordinary shareholders. Also, in the event of liquidation of a particular company, the preferential shareholders are paid off before ordinary shareholders. Here are the different types of shares in this category:

- **Cumulative and Non-Cumulative Preference Shares:** In the case of cumulative preference shares, if a particular company doesn't declare an annual dividend, the benefit is carried forward to the next financial year. Non-cumulative preference shares don't provide for receiving outstanding dividends benefits.
- **Participating / Non - Participating Preference Share:** Participating preference shares allow shareholders to receive surplus profits, after payment of dividends by the company. This is over and above the receipt of dividends. Non-participating preference shares carry no such benefits, apart from the regular receipt of dividends.

- **Convertible/Non-Convertible Preference Shares:** Convertible preference shares can be converted into equity shares, after meeting the requisite stipulations by the company's Article of Association (AoA), while non-convertible preference shares carry no such benefits.
- **Redeemable/Irredeemable Preference Share:** A company can repurchase or claim redeemable preference share at a fixed price and time. These types of shares are sans any maturity date. Irredeemable preference shares, on the other hand, have no such conditions.

13.5. Function and Purposes

The stock market is one of the most important ways for companies to raise money, along with debt markets which are generally more imposing but do not trade publicly. This allows businesses to be publicly traded, and raise additional financial capital for expansion by selling shares of ownership of the company in a public market. The liquidity that an exchange affords the investors enables their holders to quickly and easily sell securities. This is an attractive feature of investing in stocks, compared to other less liquid investments such as property and other immoveable assets.

History has shown that the price of stocks and other assets is an important part of the dynamics of economic activity, and can influence or be an indicator of social mood. An economy where the stock market is on the rise is considered to be an up-and-coming economy. The stock market is often considered the primary indicator of a country's economic strength and development.

Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions. Financial stability is the raison d'être of central banks.

Exchanges also act as the clearinghouse for each transaction, meaning that they collect and deliver the shares, and guarantee payment to the seller of a security. This eliminates the risk to an individual buyer or seller that the counterparty could default on the transaction.

The smooth functioning of all these activities facilitates economic growth in that lower costs and enterprise risks promote the production of goods and services as well as possibly employment. In this way the financial system is assumed to contribute to increased prosperity, although some

controversy exists as to whether the optimal financial system is bank-based or market-based. Recent events such as the Global Financial Crisis have prompted a heightened degree of scrutiny of the impact of the structure of stock markets (called market microstructure), in particular to the stability of the financial system and the transmission of systemic risk.

13.6. Scope of Stock Exchange

The scope of a stock exchange encompasses various aspects related to the functioning and impact of the exchange on the financial system, economy, and stakeholders involved. Some key aspects of the scope of a stock exchange include:

1. **Capital Formation**: Stock exchanges provide a platform for companies to raise capital by issuing stocks and bonds to investors. This process of initial public offerings (IPOs) and subsequent secondary offerings facilitates capital formation, which companies utilize for business expansion, investment in projects, and other growth opportunities.
2. **Investment Opportunities**: Stock exchanges offer investors a wide range of investment opportunities in equities, bonds, derivatives, and other financial instruments. Investors can diversify their investment portfolios, earn returns through capital appreciation and dividends, and hedge against risks through trading on the exchange.
3. **Price Discovery**: Stock exchanges facilitate price discovery by bringing together buyers and sellers in a centralized marketplace. The continuous trading of securities on the exchange helps establish fair market prices based on supply and demand dynamics, investor sentiment, and other factors.
4. **Market Liquidity**: Stock exchanges enhance market liquidity by providing a platform for buying and selling securities. Liquidity ensures that investors can easily transact securities at competitive prices and minimizes the impact of large orders on market prices.
5. **Risk Management**: Stock exchanges offer risk management tools such as derivatives (e.g., futures and options) that enable investors to hedge against price fluctuations, manage exposure to market risks, and protect their investment portfolios.
6. **Benchmark Indices**: Stock exchanges calculate and maintain benchmark indices that track the performance of a basket of stocks representing the overall market or specific sectors. These

indices serve as benchmarks for evaluating market performance, benchmarking investment returns, and developing investment products such as index funds and Exchange-Traded Funds (ETFs).

7. **Corporate Governance**: Stock exchanges enforce listing requirements and corporate governance standards for listed companies to ensure transparency, accountability, and investor protection. Listed companies are required to adhere to disclosure norms, financial reporting standards, and regulatory compliance to maintain their listing status on the exchange.
8. **Economic Indicators**: Stock exchanges play a role as economic indicators, reflecting investor sentiment, market confidence, and the overall health of the economy. Movements in stock prices, trading volumes, and market indices can provide insights into economic trends, business cycles, and investor behavior.
9. **Job Creation and Economic Growth**: Stock exchanges contribute to job creation and economic growth by facilitating capital formation, promoting entrepreneurship, and fostering investment in productive activities. A vibrant stock market attracts domestic and foreign investment, stimulates economic activity, and supports sustainable development.

Overall, the scope of a stock exchange extends beyond the trading of securities to encompass broader aspects of capital markets, financial intermediation, risk management, and economic development. A well-functioning stock exchange plays a critical role in mobilizing savings, allocating capital efficiently, and fostering economic prosperity

13.7. Difference between Share Market and Stock Market

Generally, people enter the financial market to enjoy a bit more income. Thus, they lack knowledge of the money market terms. It is difficult for a newbie to understand terms such as ‘share’, ‘stock’, and ‘equity’. But not having a clear understanding can be a problem. An investor should be familiar with these terms well before they start investing. Being aware of their meanings helps you invest wisely. In this article, we will talk about stock market vs.share market and see what their differences are. A new investor may not always know the difference between stock market and share market. As a result, their vision gets blurry.

Let’s break the terms into parts and see their meanings first. Even though these terms are used interchangeably, they differ in their modes of operation. A share market or a stock market is essentially a market where various kinds of bonds and securities are traded. The price of a

company’s stock depends on the demand and the supply of that stock. A company can issue shares directly, but it cannot issue stocks in such a manner. When a number of shares are put together, it is called stocks. Also, keep in mind that shares can have a small value, while stocks will always have a significant amount of value. These are the major differences between stock market and share market. Now that you know the how the stock market is similar to and different from the share market, trading is even easier.

Share market

The term ‘share’ is associated with investment options like mutual funds and limited partnership. But both markets are based on the same thing-trading.

- Shares are units of the total valuation of a company. For instance, if you invest in a company, you will receive a certain number of shares, depending on the money you invest.
- The share market is a market where a company offers its shares to raise funds and continue the growth of its business. It is a place where an investor can buy part ownership in any company.
- It is a platform to buy and sell shares.
- In general, shares refer to stock ownership of a particular company.
- When you buy the shares of a company, you become a ‘shareholder’ of that company. For example, when someone claims to own shares in a company, it means they have invested in a specific firm and is a shareholder of such a firm.
- An investor also enjoys a part of profits earned by the company through dividends.
- If the business does not perform well, the investor also needs to bear the loss.

Stock market

The stock market, also known as the stock exchange, is a place where stocks, equities, and other securities and bonds are actively traded.

- The term ‘stock’ is used to mean the ownership certificate of any company.
- A stock market provides the infrastructure to trade in a secure and controlled manner. The stock market brings the stock seller and buyer together.

- The Securities and Exchange Board of India (SEBI) regulates the stock exchanges in India. Hence, fair pricing and transparency of transactions are assured.
- A stock cannot be bought or sold if it is not listed with a stock exchange. In the stock market, stockbrokers trade companies' stocks, securities, and bonds.
- India's two principle stock exchanges are the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).
- The market tracks demand and supply of stocks and sets its price accordingly.

Even though these terms are used interchangeably, they differ in their modes of operation. A share market or a stock market is essentially a market where various kinds of bonds and securities are traded. The price of a company's stock depends on the demand and the supply of that stock. A company can issue shares directly, but it cannot issue stocks in such a manner. When a number of shares are put together, it is called stocks. Also, keep in mind that shares can have a small value, while stocks will always have a significant amount of value. These are the major differences between stock market and share market. Now that you know the how the stock market is similar to and different from the share market, trading is even easier.

Let Us Sum Up

In this unit, you have learned the following:

There are some differences between share market and stock market. A share market or a stock market is essentially a market where various kinds of bonds and securities are traded. The price of a company's stock depends on the demand and the supply of that stock. Investing in shares can prove to be a great source of long-term wealth generation for any individual investor. Stocks provide you with a variety of sectors and industries to choose from, helping you diversify your portfolio and mitigate your risks. Always remember to narrow down on trusted and reliable financial partners to open your Demand account and trading account, like IIFL.

Check Your Progress

1. The________ is a platform where buyers and sellers come together to trade on publicly listed shares during specific hours of the day
2. ________ are professionally managed funds that pool the money of numerous investors and invest the collective capital into various financial securities

3. ________ are transferable and are traded actively by investors in stock markets

Glossary

Derivatives: A derivative is a contract between two or more partieswhose value is based on an agreed-upon underlyingfinancial asset (like a security) or set of assets (like an Index). Common underlying instruments includeBonds, commodities, currencies, interest rates, Market indexes, and stocks.

Mutual fund: A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to Invest in securities like stocks, bonds, money market Instruments, and other assets.

Bond: A bond represents a promise by a borrower to pay a Lender their principal and usually interest on a Loan. Bonds are issued by governments, municipalities.

Share: Shares are units of equity ownership in a corporation

Answers to Check Your Progress

1. share market
2. Mutual funds
3. Equity shares

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition,McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-14

Types of Equities and Bonds

STRUCTURE

Overview

Objectives

14.1. Introduction

14.2. Meaning of Equities

14.3. Types of Equities

14.4. Meaning of Bond

14.5. Types of Bonds

14.6. Role of Bond and Equities

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Equities and Bonds has been explained. Study about the Bonds investment provides an income stream that is easily predictable and in many cases, bonds pay the interest twice in a year. If the bondholder holds the bond till the day of maturity, the investor gets the entire principal amount and hence, these are considered as an ideal way to preserve one's capital. Bonds can also provide the offset exposure to the extreme volatile shareholdings one might have. By investing in bonds, one can expect a steady stream of income even before the maturity in the form of interests.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Equities and Bond
- Understand the Role of Bond and Equities

14.1. Introduction

There are several types of equity accounts that combine to make up total shareholders' equity. These accounts include common stock, preferred stock, contributed surplus, additional paid-in capital, retained earnings, other comprehensive earnings, and treasury stock.

Equity is the amount funded by the owners or shareholders of a

company for the initial start-up and continuous operation of a business. Total equity also represents the residual value left in assets after all liabilities have been paid off, and is recorded on the company's balance sheet. To calculate total equity, simply deduct total liabilities from total assets

14.2. Meaning of Equities

Equities refer to ownership interests or shares in a company that entitle the holder to a proportionate claim on the company's assets and earnings. When individuals or institutional investors purchase equities, they become shareholders or owners of the company, and they typically have voting rights in company matters such as electing the board of directors.

14.3. Types of Equities

1. **Common Stock**: Common stock represents the basic form of ownership in a company. Common shareholders have voting rights and may receive dividends if the company declares them, although dividends are not guaranteed. In the event of liquidation, common shareholders are entitled to the residual assets of the company after all debts and obligations have been paid.
2. **Preferred Stock**: Preferred stock is a class of equity that typically pays a fixed dividend to shareholders before any dividends are paid to common shareholders. Preferred shareholders generally do not have voting rights, or if they do, they may have limited voting rights compared to common shareholders. In the event of liquidation, preferred shareholders have priority over common shareholders in receiving assets.
3. **Convertible Securities**: Convertible securities, such as convertible preferred stock or convertible bonds, are hybrid instruments that can be converted into a specified number of common shares at the option of the holder. Convertible securities offer the potential for capital appreciation if the company's stock price rises, while also providing downside protection through the fixed-income component.
4. **Warrants**: Warrants are options issued by a company that give the holder the right, but not the obligation, to purchase common stock at a predetermined price within a specified period. Warrants are often issued as part of a financing arrangement or as an incentive for investors to participate in a securities offering.

5. **Rights**: Rights are similar to warrants but are typically issued to existing shareholders as a preemptive right to purchase additional shares of common stock before they are offered to the public in a rights offering. Rights offerings allow companies to raise capital from existing shareholders without diluting their ownership stakes.
6. **Depositary Receipts**: Depositary receipts, such as American Depositary Receipts (ADRs) or Global Depositary Receipts (GDRs), represent ownership interests in foreign companies traded on stock exchanges outside their home country. Depositary receipts allow investors to invest in foreign companies without the need to directly purchase shares on foreign exchanges.

These are some of the main types of equities available to investors. Each type has its own characteristics, risks, and potential rewards, and investors should carefully consider their investment objectives, risk tolerance, and time horizon before investing in equities.

14.4. Meaning of Bond

Bonds are debt instruments issued by governments, municipalities, corporations, or other entities to raise capital. When an investor purchases a bond, they are essentially lending money to the issuer in exchange for periodic interest payments (coupon payments) and the return of the principal amount (face value or par value) at maturity.

Bonds are issued by organizations generally for a period of more than one year to raise money by borrowing. Organizations in order to raise capital issue bond to investors which is nothing but a financial contract, where the organization promises to pay the principal amount and interest (in the form of coupons) to the holder of the bond after a certain date. (Also called maturity date). Some Bonds do not pay interest to the investors, however it is mandatory for the issuers to pay the principal amount to the investors.

What is a Maturity Date?

Maturity date refers to the final date for the payment of any financial product when the principal along with the interest needs to be paid to the investor by the issuer.

Characteristics of a Bond

- **Coupon Rate**: The coupon rate is the annual interest rate paid by the issuer to the bondholder, expressed as a percentage of the bond's face value. Coupon payments are typically made

semi-annually, although they can be paid annually, quarterly, or monthly.

- **Maturity Date**: The maturity date is the date on which the issuer repays the principal amount of the bond to the bondholder. Bonds can have short-term maturities (less than one year), medium-term maturities (one to ten years), or long-term maturities (more than ten years).
- **Face Value**: The face value, also known as the par value or principal amount, is the amount that the issuer agrees to repay to the bondholder at maturity. It is typically expressed in denominations of $1,000 or multiples thereof.
- **Yield**: The yield of a bond is the effective annual return on the bond, taking into account the coupon payments, the purchase price, and the time to maturity. Yield can be calculated as the coupon rate divided by the bond's current market price, or it can be calculated as the internal rate of return (IRR) on the bond's cash flows.
- **Credit Rating**: Bonds are assigned credit ratings by credit rating agencies based on the issuer's creditworthiness and the risk of default. Higher-rated bonds (such as AAA or AA) are considered lower risk and typically offer lower yields, while lower-rated bonds (such as BB or B) are considered higher risk and typically offer higher yields to compensate investors for the increased risk.

14.5. Types of Bonds

1. **Government Bonds**: Government bonds are issued by national governments to finance government spending and manage debt. They are considered low-risk investments because they are backed by the full faith and credit of the government. Examples include U.S. Treasury bonds, UK Gilts, and German Bunds.
2. **Corporate Bonds**: Corporate bonds are issued by corporations to raise capital for business operations, expansion, or acquisitions. They offer higher yields than government bonds to compensate investors for the additional credit risk associated with corporate issuers. Corporate bonds can be classified as investment-grade (high credit quality) or high-yield (speculative or junk bonds).
3. **Municipal Bonds**: Municipal bonds, also known as munis, are issued by state and local governments to finance public projects such as schools, highways, and utilities. They are exempt from

federal income tax and may also be exempt from state and local taxes, making them attractive to investors in high tax brackets.

4. **Convertible Bonds**: Convertible bonds are hybrid securities that allow bondholders to convert their bonds into a specified number of common shares of the issuing company at a predetermined conversion price. Convertible bonds offer investors the potential for capital appreciation if the issuer's stock price rises, while also providing downside protection through the fixed-income component.
5. **Zero-Coupon Bonds**: Zero-coupon bonds do not pay periodic interest payments like traditional bonds. Instead, they are sold at a discount to their face value and redeemed at face value at maturity. The difference between the purchase price and the face value represents the investor's return on the bond.
6. **Floating Rate Bonds**: Floating rate bonds have variable interest rates that adjust periodically based on changes in a reference interest rate, such as LIBOR or the prime rate. Floating rate bonds offer investors protection against rising interest rates because their coupon payments increase when interest rates rise.

These are some of the main types of bonds available to investors, each with its own risk-return profile, tax treatment, and investment characteristics. Investors should carefully consider their investment objectives, risk tolerance, and income needs before investing in bonds.

14.6. Role of Bond and Equities

It's time to invest your money. So how exactly are you going to allocate that money? After all, a well- diversified portfolio strategy is recommended before you start to buy assets such as stocks and bonds. Indeed, stocks and bonds are two of the most traded types of assets—each available for sale on several different platforms or through a variety of markets or brokers. And there are important, primary differences between stocks and bonds.

The Bond Market

The bond market is where investors go to trade (buy and sell) debt securities, prominently bonds, which may be issued by corporations or governments. The bond market is also known as the debt or the credit market. Securities sold on the bond market are all various forms of debt. By buying a bond, credit, or debt security, you are lending money for a set period and charging interest—the same way a bank does to its debtors. The bond market provides investors with a steady, albeit

nominal, source of regular income. In some cases, such as Treasury bonds issued by the federal government, investors receive biannual interest payments. Many investors choose to hold bonds in their portfolios as a way to save for retirement, for their children's education, or other long-term needs.

Where Bonds Are Traded?

The bond market does not have a centralized location to trade, meaning bonds mainly sell over the counter (OTC). As such, individual investors do not typically participate in the bond market. Those who do, include large institutional investors like pension funds foundations, and endowments, as well as investment banks, hedge funds, and asset management firms. Individual investors who wish to invest in bonds may do so through a bond fund managed by an asset manager.

Many brokerages now also allow individual investors direct access to corporate bond issues, Treasuries, munis, and CDs. New securities are put up for sale on the primary market, and any subsequent trading takes place on the secondary market, where investors buy and sell securities they already own. These fixed-income securities range from bonds to bills to notes. By providing these securities on the bond market, issuers can get the funding they need for projects or other expenses needed.

Who Participates in the Bond Market?

The three main groups involved in the bond market include:

- **Issuers**: These are the entities that develop, register, and sell instruments on the bond market, whether they're corporations or different levels of government. For example, the U.S. Treasury issues Treasury bonds, which are long-term securities that provide bi-annual interest payments for investors and mature after 10 years. Investing in certain sectors of the bond market, such as U.S. Treasury securities, is said to be less risky than investing in stock markets, which are prone to greater volatility.
- **Underwriters**: Underwriters usually evaluate risks in the financial world. In the bond market, an underwriter buys securities from the issuers and resells them for a profit.
- **Participants**: These entities buy and sell bonds and other related securities. By buying bonds, the participant issues a loan for the length of the security and receives interest in return. Once it matures, the face value of the bond is paid back to the participant.

The Stock Market

A stock market is a place where investors go to trade equity securities, such as common stocks, and derivatives—including options and futures.

Stocks are traded on stock exchanges. Buying equity securities, or stocks, means you are buying a very small ownership stake in a company. While bondholders lend money with interest, equity holders purchase small stakes in companies on the belief that the company performs well and the value of the shares purchased will increase.

The primary function of the stock market is to bring buyers and sellers together into a fair, regulated, and controlled environment where they can execute their trades. This gives those involved the confidence that trading is done with transparency, and that pricing is fair and honest. This regulation not only helps investors, but also the corporations whose securities are being traded. The economy thrives when the stock market maintains its robustness and overall health.

Just like the bond market, there are two components to the stock market. The primary market is reserved for first-run equities: initial public offerings (IPOs) will be issued on this market. This market is facilitated by underwriters, who set the initial price for securities. Equities are then opened up on the secondary market, which is where the most trading activity takes place.

Key Differences

One major difference between the bond and stock markets is that the stock market has central places or exchanges where stocks are bought and sold. The other key difference between the stock and bond market is the risk involved in investing in each. When it comes to stocks, investors may be exposed to risks such as country or geopolitical risk (based on where a company does business or is based), currency risk, liquidity risk, or even interest rate risks, which can affect a company's debt, the cash it has on hand, and its bottom line.

Bonds, on the other hand, are more susceptible to risks such as inflation and interest rates. When interest rates rise, bond prices tend to fall. If interest rates are high and you need to sell your bond before it matures, you may end up getting less than the purchase price. If you buy a bond from a company that isn't financially sound, you're opening yourself up to credit risk. In a case like this, the bond issuer isn't able to make the interest payments, leaving itself open to default. Stock market performance can broadly be gauged using indexes such as the S&P 500 or Dow Jones Industrial Average. Similarly, bond indices like the Barclays Capital Aggregate Bond Index can help investors track the performance of bond portfolios.

Let Us Sum Up

In this unit, you have learned the following:

Bonds investment provides an income stream that is easily predictable and in many cases, bonds pay the interest twice in a year. If the bondholder holds the bond till the day of maturity, the investor gets the entire principal amount and hence, these are considered as an ideal way to preserve one's capital. Bonds can also provide the offset exposure to the extreme volatile shareholdings one might have. By investing in bonds, one can expect a steady stream of income even before the maturity in the form of interests

Check Your Progress

1. ________is the amount of capital invested or owned by the owner of a company
2. ________are issued by organizations generally for a period of more than one year to raise money by borrowing.
3. The ________ is where investors go to trade (buy and sell) debt securities, prominently bonds, which may be issued by corporations or governments

Glossary

Stock: A stock is a general term used to describe the ownership certificates of any company

Bond: Bonds are investment securities where an investor lends money to a company or a government for a set period of time, in exchange for regular interest payments. Once the bond reaches maturity, the bond issuer returns the investor's money.

Equity: Equity represents the value that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debts were paid off.

Answers to Check Your Progress

1. Equity
2. Bond
3. Bond Market

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-15

Types of Investments

STRUCTURE

Overview

Objectives

15.1. Introduction

15.2. Meaning and Definition of Investment

15.3. Purpose of Investment

15.4. Types of Investments

15.5. Benefits of Investments

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit various types of Investment has been explained. Study about investment is an asset or item accrued with the goal of generating income or recognition. In an economic outlook, an investment is the purchase of goods that are not consumed today but are used in the future to generate wealth.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Investment
- Understand the Purpose and Benefits of Investment

15.1. Introduction

Investment refers to the allocation of money or resources with the expectation of generating returns or income in the future. The purpose of investment is to grow wealth, preserve purchasing power, meet financial goals, and achieve financial security over the long term. Investments can take various forms, including stocks, bonds, real estate, mutual funds, and other financial instruments.

One can make money through investments in three ways: one, they can lend money to someone (be it the government or a business) on interest; second, they can become a part-owner of a business, like purchasing shares in a particular company; and lastly, by buying assets

that tend to increase in value over time, such as real estate or bullion. The investment universe boils down to these three components, namely fixed income (bonds), equities (stocks), gold, and cash and cash equivalents or money market instruments.

15.2. Meaning and Definition of Investment

Investment involves committing resources, such as money or capital, with the expectation of generating returns or profits over time.Investors seek to deploy their funds in assets or opportunities that offer the potential for capital appreciation, income generation, or both.

An investment is essentially an asset that is created with the intention of allowing money to grow. The wealth created can be used for a variety of objectives such as meeting shortages in income, saving up for retirement, or fulfilling certain specific obligations such as repayment of loans, payment of tuition fees, or purchase of other assets.

Understanding the investment definition is crucial as sometimes, it can be difficult to choose the right instruments to fulfill your financial goals. Knowing the investment meaning in your particular financial situation will allow you to make the right choices.

Investment may generate income for you in two ways. One, if you invest in a saleable asset, you may earn income by way of profit. Second, if Investment is made in a return generating plan, then you will earn an income via accumulation of gains. In this sense, 'what is investment' can be understood by saying that investments are all about putting your savings into assets or objects that become worth more than their initial worth or those that will help produce an income with time.

15.3. Purpose of Investment

Financially speaking, an investment definition is an asset that is obtained with the intention of allowing it to appreciate in value over time. Generally, investments fall in any one of basic categories, as explained below.

1) **To Keep Money Safe :** Capital preservation is one of the primary objectives of investment for people. Some investments help keep hard-earned money safe from being eroded with time. By parking your funds in these instruments or schemes, you can ensure that you do not outlive your savings. Fixed deposits, government bonds, and even an ordinary savings account can help keep your money safe. Although the return on investment may be lower here, the objective of capital preservation is easily met.

2) **To Help Money Grow :** Another one of the common objectives of investing money is to ensure that it grows into a sizable corpus over

time. Capital appreciation is generally a long-term goal that helps people secure their financial future. To make the money you earn grow into wealth, you need to consider investment objectives and options that offer a significant return on the initial amount invested. Some of the best investments to achieve growth include real estate, mutual funds, commodities, and equity. The risk associated with these options may be high, but the return is also generally significant.

3) **To Earn a Steady Stream of Income:** Investments can also help you earn a steady source of secondary (or primary) income. Examples of such investments include fixed deposits that pay out regular interest or stocks of companies that pay investors dividends consistently. Income-generating investments can help you pay for your everyday expenses after you have retired. Alternatively, they can also act as excellent sources of supplementary income during your working years by providing you with additional money to meet outlays like college expenses or EMIs.

4) **To Minimize the Burden of Tax:** Aside from capital growth or preservation, investors also have other compelling objectives for investment. This motivation comes in the form of tax benefits offered by the Income Tax Act, 1961. Investing in options such as Unit Linked Insurance Plans (ULIPs), Public Provident Fund (PPF), and Equity Linked Savings Schemes (ELSS) can be deducted from your total income. This has the effect of reducing your taxable income, thereby bringing down your tax liability.

5) **To Save up for Retirement :** Saving up for retirement is a necessity. It is essential to have a retirement fund you can fall back on in your golden years, because you may not be able to continue working forever. By investing the money you earn during your working years in the right investment options, you can allow your funds to grow enough to sustain you after you've retired.

6) **To Meet your Financial Goals :** Investing can also help you achieve your short-term and long-term financial goals without too much stress or trouble. Some investment options, for instance, come with short lock-in periods and high liquidity. These investments are ideal instruments to park your funds in if you wish to save up for short-term targets like funding home improvements or creating an emergency fund. Other investment options that come with a longer lock-in period are perfect for saving up for long-term goals.

15.4. Types of Investment

Investments generally fall under two broad umbrellas – growth-oriented investments and fixed-income investments. A growth-oriented investment option aims at increasing the value of the capital over time, whereas a fixed-income investment option aims at providing a steady (and sometimes rising) stream of income that can either be paid to the investors or re-invested while seeking to maintain the original value of the investment. Let's understand the different types of investments under these two investment styles:

Mutual fund Investment

Mutual funds are financial instruments that pool the money from various investors to invest in securities such as stocks (equities), bonds, money market instruments, etc. Returns on mutual fund investments are based on the market performance of the fund's underlying assets. Investors can invest in mutual funds either via SIP (Systematic Investment Plan) or the lump sum mode.

According to the risk profile, investment horizon, and financial goals, an investor can choose from different types of mutual funds available to them. Largely there are six types of mutual funds, namely growth or equity funds, liquid or money market funds, fixed-income or debt funds, hybrid or balanced funds, index funds, and tax-saving funds. Mutual funds help investors in achieving their financial goals, be it short-term or long-term. The Indian markets' watchdog SEBI (Securities and Exchange Board of India) has clearly defined each of these mutual fund categories to enable investors to make informed decisions.

Stocks

Also known as shares or equities, stocks are among the most popular growth-oriented investments. When you purchase a share, you become part-owner of a publicly-traded company and stand to gain a part of the profits. The risk-reward ratio with equity investments is often higher than most other forms of investment.

Bonds

Also known as fixed-income securities, a bond is a debt instrument that represents a loan given by an investor to a company or the government. When you buy a bond, you allow the bond issuer to issue you a fixed interest rate in exchange for using your capital. Examples of bonds include Treasury bills, municipal bonds, corporate bonds, government securities, etc.

Exchange Traded Funds (ETFs)

Exchange-traded funds, or ETFs, are a collection of investments such as shares, bonds, money-market instruments, etc., that track an underlying index. They are a mash-up of different investment avenues that offer the best attributes of the two assets – mutual funds and stocks. ETFs are traded on the stock exchanges and are quite like mutual funds in terms of their regulation, structure, and management. However, one of the main differences between ETFs and mutual funds is that the former can be actively traded on the bourses at any given time during the day, which allows investors to take advantage of real-time price differentials. On the contrary, mutual funds, whether active or passive, can only be bought/sold at the close of the trading day.

Fixed deposits

Bank fixed deposits (FDs) are among the safest investment options available to investors. They are offered by banks and other NBFCs and allow investors to park their idle cash for a specific duration and for a fixed rate of interest. The interest rate is predicated and unaffected by market fluctuations, which ensures greater safety of the investments. From the ease of flexibility to various options offered to an investor, fixed deposits are a boon to risk-averse investors.

Retirement planning

Saving for retirement as well as managing that income once you retire are two of the most critical aspects of financial planning. There are several types of retirement plans available to investors. Some of the most common investment options for retirement planning are Senior Citizens Savings Scheme (SCSS), National Pension System (NPS), Public Provident Fund (PPF), bank fixed deposits, etc. An investor looking to save for retirement might consider opting for safer investment avenues if they are nearing their retirement.

Cash and cash equivalents

Cash equivalents strive to protect an investor's original investment while also offering high liquidity. However, they tend to offer the lowest potential returns than other investment types. While they do not generally offer capital growth, they have the potential to deliver regular returns. They can also play an important role in protecting your capital and reducing the risk of your investment portfolio to a great extent. Examples of cash equivalents include time deposits, overnight funds, liquid funds, high-interest savings accounts, bank accounts, etc.

Real estate Investment

The real estate sector holds huge prospects for several industries such

as hospitality, retail, commercial housing, manufacturing, and much more. Investors have the option to invest in commercial or residential properties or even real estate mutual funds to earn significant returns on their investments. Timing is a crucial aspect when one considers investing in real estate. One should be mindful that real estate investments can be highly illiquid, i.e. it might get challenging to sell the property quickly in case of an urgent monetary requirement.

Provident funds

Provident funds (including Employee Provident Fund and Public Provident Fund) constitute a significant part of your retirement corpus. Provident fund is a mandatory, government-sponsored retirement scheme that aims at providing employees with a lump sum payment when the employee resigns or during retirement.

Insurance

Insurance products are often a part of a financial plan. They come in various forms like term insurance, life insurance, endowment plans, child plans, etc. Insurance products are developed to meet particular objectives, for instance, life insurance is designed to meet your expenses as you age whereas term insurance is designed to aid your beneficiaries in the unfortunate event of your death.

Each type of investment offers a varying level of risk-reward ratio. However, risk and returns shouldn't be the only considerations that determine what types of investment products you choose. An investor should also consider factors like asset allocation, fees, past performance, liquidity, etc. Your investment planning should ensure that your portfolio aligns with your risk tolerance, investment goals, and time horizon. The benefits are indicative in nature and the same may vary depending upon various market-linked factors. Mutual fund investments are subject to market risks.

15.5. Benefits of Investment

Investing offers several potential benefits for individuals looking to grow their wealth, achieve financial goals, and secure their future. Some key benefits of investment include:

1. **Wealth Accumulation**: Investing allows individuals to grow their wealth over time by generating returns on their invested capital. By allocating funds to various asset classes such as stocks, bonds, real estate, or mutual funds, investors have the opportunity to earn income and capital appreciation, thereby increasing their net worth.

2. **Income Generation**: Many investments, such as dividend-paying stocks, bonds, rental properties, and interest-bearing accounts, provide regular income in the form of dividends, interest, or rental payments. This income can supplement other sources of income and support individuals in meeting their living expenses or funding their lifestyle.
3. **Capital Appreciation**: Over the long term, investments have the potential to appreciate in value, allowing investors to benefit from capital gains when they sell their assets at a higher price than their initial purchase price. This capital appreciation can significantly enhance investment returns and contribute to wealth accumulation.
4. **Diversification**: Investing in a diversified portfolio of assets helps spread risk across different investments and asset classes. Diversification reduces the impact of adverse events or market downturns on overall investment performance and helps mitigate the risk of significant losses. It also allows investors to capture returns from different market segments and economic sectors.
5. **Inflation Hedge**: Investing provides a hedge against inflation, which erodes the purchasing power of money over time. Assets such as stocks, real estate, and commodities have historically outpaced inflation, helping investors preserve the real value of their wealth and maintain their standard of living over the long term.
6. **Achievement of Financial Goals**: Investing allows individuals to work towards achieving various financial goals, such as retirement planning, education funding, buying a home, or starting a business. By setting clear investment objectives, establishing a disciplined savings and investment strategy, and leveraging the power of compounding, investors can progress towards their goals effectively.
7. **Tax Benefits**: Certain investment vehicles offer tax advantages that can help investors reduce their tax liabilities and enhance after-tax returns. For example, contributions to retirement accounts like 401(k) s or IRAs may be tax-deductible, and investment gains within these accounts may grow tax-deferred or tax-free until withdrawal.
8. **Financial Security and Independence**: Successful investing can provide individuals with financial security and independence, allowing them to achieve financial freedom and pursue their desired lifestyle without being reliant solely on earned income.

Building a diversified investment portfolio can create a reliable source of passive income and support a comfortable retirement.

Overall, investing is a powerful tool for building wealth, generating income, achieving financial goals, and securing a brighter financial future. However, it's essential for investors to conduct thorough research, seek professional advice when needed, and maintain a long-term perspective to maximize the benefits of investment while managing risks effectively.

Let Us Sum Up

In this unit, you have learned the following:

An investment is an asset or item accrued with the goal of generating income or recognition. In an economic outlook, an investment is the purchase of goods that are not consumed today but are used in the future to generate wealth. In finance, an investment is a financial asset bought with the idea that the asset will provide income further or will later be sold at a higher cost price for a profit.

Investment is elucidated and defined as an addition to the stockpile of physical capital such as: Machinery, Buildings and Roads etc., i.e. anything that sums up to the future productive ability of the economy and changes in the catalogue (or the stock of finished commodities) of a manufacturer.

Note that **'**investment commodities**'** (such as machines) are also part of the final commodities – they are not intermediate commodities like raw materials. Machines manufactured in an economy in a given year are not 'used up' to produce other commodities but yield their services over a number of years.

Investment decisions by manufacturers, such as whether to buy new machinery, rely to a large extent, on the market place rate of interest. However, for simplicity, we presume here that enterprises plan to invest the same amount every year.

We can write the ex-ante investment demand as: $\mathbf{I = \bar{I}}$. whereas, $\bar{I}$ is a positive constant which represents the autonomous (given or exogenous) investment in the economy in a given year.

Check Your Progress

1. An ________ is essentially an asset that is created with the intention of allowing money to grow.
2. ________ are a collection of investments such as shares, bonds, money-market instruments, etc.

3. ________ refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price.

Glossary

Mutual Fund: A mutual fund is a company that brings together money from many people and invests it in stocks, bonds or other assets. The combined holdings of stocks, bonds or other assets the fund owns are known as its portfolio. Each investor in the fund owns shares, which represent a part of these holdings

Liquidity: Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price. Cash is the most liquid of assets, while tangible items are less liquid. The two main types of liquidity include market liquidity and accounting liquidity.

Answers to Check Your Progress

1. Investment
2. Exchange-traded funds
3. Liquidity

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-16

Share Market Indices

STRUCTURE

Overview

Objectives

16.1. Introduction

16.2. Meaning

16.3. Types of Stock Market Indices

16.4. Stock market indices create and developed

16.5. Formation of an Index

16.6. Importance of Stock Market Indices

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Stock Market Indices has been explained. Study about stock market index abbreviated as a stock index is an indicator that shows all the major changes in India's stock market. The same stocks are selected from amongst the securities already grouped and listed on the stock exchange to develop an index

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Stock Market Indices
- Understand the Purpose and Benefits of Stock market Indices

16.1. Introduction

A stock market index abbreviated as a stock index is an indicator that shows all the major changes in India's stock market. The same stocks are selected from amongst the securities already grouped and listed on the stock exchange to develop an index. However, the selection criteria are based upon the type of industry, the company's size, and its market capitalization. This indicator is used to minimize the mess up and indicate the proper position of the market. Changes in the price of underlying assets impact the overall value of the index.

If the price goes upwards, the stock index will rise, and if they go downwards, the stock will fall.

16.2. Meaning

A stock index, or stock market index, is an index that measures a stock market, or a subset of the stock market, that helps investors compare current stock price levels with past prices to calculate market performance.

Two of the primary criteria of an index are that it is investable and transparent. The methods of its construction are specified. Investors can invest in a stock market index by buying an index fund, which are structured as either a mutual fund or an exchange-traded fund, and "track" an index. The difference between an index fund's performance and the index, if any, is called tracking error. For a list of major stock market indices, see List of stock market indices...

Share market indices, also known as stock market indices, are composite measures that track the performance of a group of stocks representing a particular segment of the stock market. These indices serve as benchmarks for investors, providing insights into overall market trends, sector performance, and investment returns. Here are some commonly used share market indices:

1. **S & P 500**: The S & P 500 is a widely followed stock market index that tracks the performance of 500 large-cap companies listed on stock exchanges in the United States. It is considered a benchmark for the overall performance of the U.S. equity market and is used by investors as a measure of the U.S. economy's health.

2. **Dow Jones Industrial Average (DJIA)**: The Dow Jones Industrial Average is one of the oldest and most widely recognized stock market indices. It consists of 30 large-cap companies listed on stock exchanges in the United States, representing various sectors of the economy. The DJIA is often used as a barometer of the overall stock market's performance.

3. **Nasdaq Composite**: The Nasdaq Composite is an index that tracks the performance of more than 2,500 stocks listed on the Nasdaq Stock Market, including technology, biotechnology, and internet-related companies. It is often used as a gauge of the performance of the technology sector and growth stocks.

4. **FTSE 100**: The FTSE 100, also known as the Financial Times Stock Exchange 100 Index, is a benchmark index of the 100

largest companies listed on the London Stock Exchange in the United Kingdom. It represents a diverse range of sectors, including finance, energy, healthcare, and consumer goods.

5. **Nifty 50**: The Nifty 50 is the benchmark stock market index of the National Stock Exchange of India (NSE), comprising the 50 largest and most liquid stocks listed on the exchange. It is widely used by investors as a measure of the Indian equity market's performance and is an indicator of the Indian economy's health.
6. **DAX**: The DAX is the primary stock market index of the Frankfurt Stock Exchange in Germany, consisting of the 30 largest and most liquid companies listed on the exchange. It represents a broad spectrum of sectors in the German economy, including manufacturing, automotive, and financial services.
7. **Hang Seng Index**: The Hang Seng Index is the primary stock market index of the Hong Kong Stock Exchange, comprising the 50 largest and most liquid companies listed on the exchange. It is widely used as a benchmark for the performance of the Hong Kong equity market and the broader Asian region.
8. **CSI 300**: The CSI 300 Index is a capitalization-weighted stock market index of the 300 largest and most liquid stocks listed on the Shanghai and Shenzhen Stock Exchanges in China. It is used as a benchmark for the performance of the Chinese equity market and is closely watched by investors worldwide.

These are just a few examples of share market indices from around the world. Each index serves as a valuable tool for investors, providing a snapshot of market performance and serving as a reference point for evaluating investment returns and portfolio performance

16.3. Types of Stock Market Indices

Stock market indices are essential tools used to gauge the performance of various segments of the stock market. Here are some common types of stock market indices:

1. **Broad Market Indices**: These indices track the overall performance of a specific stock market or a major segment of it. Examples include:
   - S&P 500: Tracks the performance of 500 large-cap stocks listed on stock exchanges in the United States.
   - Dow Jones Industrial Average (DJIA): Tracks the performance of 30 large, publicly owned companies in the United States.

- FTSE 100: Tracks the performance of the 100 largest companies listed on the London Stock Exchange by market capitalization.

2. **Sectoral Indices**: These indices measure the performance of specific sectors within the stock market. Examples include:
   - Technology Select Sector SPDR Fund (XLK): Tracks the performance of technology companies in the United States.
   - S&P 500 Financials Sector (XLF): Tracks the performance of companies in the financial sector listed on the S&P 500.
3. **Global Indices**: These indices measure the performance of stock markets from multiple countries or regions. Examples include:
   - MSCI World Index: Represents large and mid-cap equity performance across 23 developed markets.
   - MSCI Emerging Markets Index: Measures equity market performance in emerging markets.
4. **Market Capitalization Weighted Indices**: These indices weigh components based on their market capitalization. Examples include:
   - NASDAQ-100: Tracks the performance of 100 of the largest domestic and international non-financial companies listed on the NASDAQ Stock Market.
   - Russell 2000: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 8% of the total market capitalization of the Russell 3000 Index.
5. **Price Weighted Indices**: These indices weigh components based on their stock prices rather than their market capitalization. Examples include:
   - Dow Jones Industrial Average (DJIA): Uses a price-weighted methodology, where stocks with higher prices have more influence on the index's value.
6. **Equal Weighted Indices**: These indices give equal weight to each constituent, regardless of their market capitalization or stock price. Examples include:
   - S&P 500 Equal Weight Index: Assigns an equal weight to each stock in the S&P 500.
7. **Volatility Indices**: These indices measure the market's expectation of future volatility. Examples include:

- CBOE Volatility Index (VIX): Often referred to as the "fear index," it measures the market's expectation of 30-day volatility for the U.S. stock market.

These are just a few examples of the types of stock market indices available. Each index serves a specific purpose and provides investors with valuable insights into the performance of different segments of the market.

16.4. Stock Market Indices Create and Developed

A stock market index is created by adding similar stocks based on their market capitalization, company size or industry. Later on, the index is computed based on the selection of stocks. However, each stock will come with a different price and price change in one stock would not be equal to the price range in another stock. Hence, the index value cannot be decided based on the simple sum of the prices of all the stocks. Due to this, assigning weights to stocks comes into the picture. Each stock in the index is assigned a specific weightage based on its price lying in the market or because of its market capitalization. The weight defines the impact that changes in the stock price has on the index value. There are two most commonly used stock market indices are:

a) Market-Cap Weightage

Market capitalization refers to the total market value of a company in the stock exchange. It is calculated by multiplying the total number of outstanding stocks floated by the company and the share price of a stock. However, the stocks are selected based on the market capitalization compared to the total market capitalization of the index for an index that uses market-cap weightage. Suppose a stock has a market capitalization of Rs. 100,000, whereas the underlying index has a total market cap of Rs. 2, 00,000. Thus, the weightage given to the stock will be 50%. An investor must keep in mind that the market capitalization of a stock keeps on changing every day with the change in its price, and because of this reason, the weightage of the stock keeps changing daily.

Several indices in India use Free-float market capitalization. Here the total shares listed by companies are not used to calculate market capitalization. Instead, they use the number of shares available to trade publicly.

b) Price Weightage

In this method, the index value is measured based on the market capitalization rather than measuring on the stock price of the company. Thus, the higher prices of the stocks receive more significant weightage

in the index as compared to the stocks which have lower prices.

16.5. Formation of an Index

A stock market index is formed by combining equities with similar market capitalizations, business sizes, or industries. The index is thereafter computed based on the stock pick. However, each stock will have a distinct price, and the price range in one stock will not be the same as the price range in another. As a result, the index value cannot be determined by simply adding the prices of all the stocks.

As a result, allocating weights to stocks enters the picture. Each stock in the index is given a certain weightage depending on its current market price or market capitalization. The weight defines the impact of stock price fluctuations on the index value. The two most widely used stock market indices are:

a) Market Cap Weightage

Market capitalization refers to a company's overall market value on the stock exchange. It is computed by multiplying the total number of outstanding stocks issued by the corporation by the stock price. However, for a market-cap-weighted index, the stocks are chosen based on their market capitalization relative to the overall market capitalization of the index.

Assume a stock has a market capitalization of Rs. 100,000, and the underlying index has a total market capitalization of Rs. 2,000,000.

As a result, the stock will be given a weightage of 50%. An investor should keep in mind that the market capitalization of a company changes every day with the change in its price, and as a result, the weightage of the stock changes daily. In India, several indices use free-float market capitalization. The total number of shares listed by corporations is not used to determine market capitalization in this case. Instead, they use the number of publicly traded shares.

b) Price Weightage

The index value is calculated utilizing market capitalization rather than the company's stock price in this technique. As a result, equities with higher prices receive more substantial weightage in the index than stocks with lower prices.

16.6. Importance of Stock Market Indices

The stock market index acts like a barometer which shows the overall conditions of the market. They facilitate the investors in identifying the general pattern of the market. Investors take the stock market as a

reference to decide about which stocks to go for investing. The following are the importance of stock market index.

1) Aids in Stock-Picking:

In a share market, you would thousands of companies listed on the exchange. Broadly, picking the appropriate stock for investment may seem like a nightmare. Without a benchmark, you may not be able to differentiate between the stocks. Simultaneously sorting the stocks becomes a challenge. In this situation, a stock market acts like an instant differentiator. It classifies the companies and their shares based on key characteristics like the size of company, sector, and industry type and so on.

2) Acts as a Representative:

Investing in equities involves risk and you need to take an informed decision. Studying about stocks individually may seem very impractical. Indices help to fill the knowledge gaps that exist among the investors. They represent the trend of the whole market or a certain sector of the market. In India, the NSE Nifty the BSE Sensex act as the benchmark indices. They are believed to indicate the performance of the entire stock market. In the same manner, an index which is made up of pharma stocks is assumed to portray the average price of stocks of companies operating in the pharmaceutical industry.

3) The Parameter for Peer Comparison:

Before including a stock in your portfolio, you have to assess whether it's worth the money. By comparing with the underlying index, you can easily judge the performance of a stock. If the stock gives higher returns than the index, it's said to have outperformed the index. If it gives lower returns than the index, it's said to have underperformed the index. You would definitely want to invest in a multibagger so as to justify the risk assumed. Else you can be better off investing in low-cost professionally managed index funds. You may also compare the index with a set of stocks like the Information technology sector. As an investor, you can know market trends easily.

4) Reflects Investor Sentiment:

When you are participating in equity markets, amongst other things, knowing investor sentiment becomes an important aspect. It is because the sentiment affects the demand for a stock which in turn impacts the overall price. In order to invest in the right stock, you should know the reason behind the rise/fall in its prices. At this juncture, indices help to gauge the mood of investors. You may even recognize investor sentiment for a particular sector and across market capitalizations.

5) Helps in Passive Investment:

Passive investment refers to investing in a portfolio of securities which replicates the stocks of an index. Investors who want to cut down on the cost of research and stock selection prefer to invest in index portfolio. Consequently, the returns of the portfolio will resemble that of the index. If an investor's portfolio resembles the Sensex, then his portfolio is going to deliver returns of around 8% when the Sensex earns 8% returns.

Stock market indices developed:

An index is made up of similar stocks based on market capitalization, industry or company size. Upon selection of stocks, the index value is computed. Each stock will have a different price and price change in one stock would not be proportionately equal to the price change in another. So, the value of the index value cannot be arrived at as a simple sum of the prices of all the stocks. Here is when the importance of assigning weights to stocks comes into play. Each stock in the index is assigned a particular weightage based on its market capitalization or price. The weight represents the extent of the impact that the stock's price change has on the value of the index. The two most commonly used stock market indices are as follows:

1) Market-cap weightage:

Market capitalization refers to the total market value of the stock of a company. It is calculated by multiplying the total number of outstanding stocks floated by the company with the share price of a stock. It, therefore, considers both the price as well as the size of the stock. In an index which uses market-cap weightage, the stocks are assigned weightage based on their market capitalization as compared to the total market capitalization of the index. Suppose a stock has a market capitalization of Rs. 50,000/- whereas the underlying index has a total market-cap of Rs. 1,00,000/-. Thus, the weightage given to the stock will be 50%. It is important to note that market capitalization of a stock changes every day with the fluctuation in its price. Due to this reason, weightage of the stock would change daily. But usually such a change is marginal in nature. Moreover, the companies with higher market-caps get more importance in this method.

In India, free-float market capitalization is used by most of the indices. Here, the total number of shares listed by a company is not used to compute market capitalization. Instead, use only the amount of shares available for trading publicly. Consequently, it gives a smaller number than the market capitalization.

2) Price Weightage:

In this method, the value of an index value is computed based on the stock price of a company rather than the market capitalization. Thus, the stocks which have higher prices receive greater weightages in the index as compared to the stocks which have lower prices. This method has been used in The Dow Jones Industrial Average in the US and the Nikkei 225 in Japan. Suppose a stock has a market capitalization of Rs.50,000/- whereas the underlying index has a total market-cap of Rs.1,00,000/-. Thus, the weightage given to the stock will be 50%.

What is NSE & BSE?

Started in 1994, the National Stock Exchange (NSE) is the largest stock exchange in India in terms of total and average daily turnover for equity shares. Being a pioneer in technology, NSE has a fully-integrated business model to provide high-quality data and services to market participants and clients. It includes trading services, exchange listings, indices, market data feeds, clearing and settlement services, financial education offerings and technology solutions. NSE ensures that trading and clearing members and listed companies follow the rules and regulations of the exchange.

Founded in 1875, Bombay Stock Exchange Ltd. (BSE), is the fastest stock exchange in the world which has the speed of 6 microseconds. It provides an efficient, integrated, transparent and secure market for trading in equity, currencies, debt instruments, derivatives, mutual funds. It provides an array of services like clearing, settlement, risk management, education and market data services. It has a global reach with overseas customers and a nation-wide presence. It provides depository services through its Central Depository Services Ltd. (CDSL) arm. The S&P BSE SENSEX is India’s most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa.

Let Us Sum Up

In this unit, you have learned about the following:

Stock market index abbreviated as a stock index is an indicator that shows all the major changes in India's stock market. The same stocks are selected from amongst the securities already grouped and listed on the stock exchange to develop an index. However, the selection criteria are based upon the type of industry, the company's size, and its market capitalization. A stock index, or stock market index, is an index that measures a stock market, or a subset of the stock market, that

helps investors compare current stock price levels with past prices to calculate market performance.

Check Your Progress

1. ________can invest in a stock market index by buying an index fund,
2. A ________ is created by adding similar stocks based on their market capitalization, company size or industry
3. Market capitalization refers to the total market value of the ________ of a company.

Glossary

BSE: BSE stands for Bombay Stock Exchange. BSE is Asia's oldest stock exchange. The volumes traded in NSE are way more than that traded in BSE

NSE: NSE stands for National Stock Exchange. NSE is the biggeststock exchanges in India.

Answers to Check Your Progress

1. Investors
2. Stock market index
3. Stock

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
3. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Block-5: Introduction

Block-5: Insurance has been divided in to four Units.

Unit-17: Insurances explains about the Introduction, Meaning and Definition, Component of Insurance Coverage, Features of Insurance Coverage, Benefit of Insurance Coverage, Types of Insurance Coverage and Need of Insurance.

Unit-18: Role of IRDA deals with Introduction, Function of IRDA, IRDA Work, and Role of IRDA in Insurance Sector, Importance of IRDA in Insurance Sector and the Types of Insurance Policy Regulate by IRDA.

Unit-19: Financial Derivatives describes about the Introduction, Meaning, and Financial Derivative Work, Participants in a Derivative Work, Types of Financial Derivative and the Need of Financial Derivative.

Unit-20: Health Insurance discuss with the Introduction, Meaning, Types of Health Insurance, Benefit of Health Insurance, How Health Insurance Works? And the Need for Health Insurance.

In all the units of Block -5 **Insurance**, the Check your progress, Glossary, Answers to Check your progress and Suggested Reading has been provided and the Learners are expected to attempt all the Check your progress as part of study.

Unit-17

Insurances

STRUCTURE

Overview

Objectives

17.1. Introduction

17.2. Meaning and Definition

17.3. Component of Insurance Coverage

17.4. Features of Insurance Coverage

17.5. Benefit of Insurance Coverage

17.6. Types of Insurance Coverage

17.7. Need of Insurance

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Insurance has been explained. Study about benefit of having insurance is that it prevents burning a hole into your pocket in unprecedented times. It gives you financial assistance for your losses and damage.

The basic function of all types of insurance coverage is to provide damage control to the insured by bringing in a lot of people who pay to cover their risks. The fund is further used for capital formation through investment in the markets.

This helps the insurance companies to keep running and settle/adjust the claims of the insured people. It also boosts the economy. It is an agreement by which a person pays a company and the company promises to pay money if the person becomes injured or dies or to pay for the value of property lost or damaged. It is the amount for which something is insured. It is the business of insuring persons or property.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Insurance
- Understand the Component and Benefit of Insurance

17.1. Introduction

Insurance coverage is a contract in the form of a financial protection policy. This policy covers the monetary risks of an individual due to unpredictable contingencies. The insurer and the insured get a legal contract for the insurance, which is called the insurance policy.

The insurance policy has details about the conditions and circumstances under which the insurance company will pay out the insurance amount to either the insured person or the nominees. Insurance is a way of protecting yourself and your family from a financial loss.

Generally, the premium for a big insurance cover is much lesser in terms of money paid. The insurance company takes this risk of providing a high cover for a small premium because very few insured people actually end up claiming the insurance. This is why you get insurance for a big amount at a low price.

Any individual or company can seek insurance from an insurance company, but the decision to provide insurance is at the discretion of the insurance company. The insurance company will evaluate the claim application to make a decision. Generally, insurance companies refuse to provide insurance to high-risk applicants

17.2. Meaning and Definition

Insurance coverage can be defined as a contract in the form of a financial protection policy. This policy covers the monetary risks of an individual due to unpredictable contingencies. The insured is the policyholder whereas the insurer is the insurance-providing company/the insurance carrier/the underwriter. The insurers provide financial coverage or reimbursement in many cases to the policyholder.

The policyholder pays a certain amount called 'premium' to the insurance company against which the latter provides insurance cover. The insurer assures that it shall cover the policyholder's losses subject to certain terms and conditions. Premium payment decides the assured sum for insurance coverage or 'policy limit'.

Insurance coverage has the below mentioned salient features:

- It is a kind of risk management plan to use an insurance policy as a hedge against an uncertain loss
- Insurance coverage does not mitigate the magnitude of loss one may face. It only assures that the loss is shared and distributed among multiple people
- Various clients of an insurance company pool in their risks.

Hence, they pay the premiums together. So when one or a few incur a financial loss, the claimed money is given out of this accumulated fund. This makes each client bear a nominal fee

Insurance coverage can be provided for medical expenses, vehicle damage, property loss/damage, etc. depending on the type of insurance Premium, policy limit, and deductible are the main components of an insurance coverage policy. The policy buyer should check them thoroughly while buying an insurance policy.

17.3. Component of Insurance Coverage

Insurance Premium Policy

The premium of an insurance policy is the amount that you need to pay to purchase a specific amount of insurance cover. It is typically expressed as a regular cost, be it monthly, quarterly, half-yearly, or annually, that you incur during the premium payment term.

There are various factors based on which an insurance company calculates the premium of an insurance policy. The idea behind is to check the eligibility of an insured individual for the specific type of insurance policy that he/she wants to buy.

For example, if you are healthy and do not have a medical history of getting treatment for severe bodily diseases, you will likely to pay less for health insurance or life insurance policy than someone suffering from multiple ailments.

You should also know that different insurance companies may ask for different premiums for similar types of policies. So, selecting the right one at a price you can afford does require some effort.

Policy Limit

It is defined as the maximum amount that an insurance company is liable to pay for the losses covered under the insurance policy. It is determined based on the period (policy term), loss or injury, and similar other factors.

Typically, higher the policy limit, higher will be the premium payable. For a life insurance policy, the maximum amount that an insurer pays to the nominee is known as the sum assured.

Deductible

Deductible related to an insurance policy is the amount or percentage that the policyholder agrees to pay out of pocket before the insurer sets in to settle a claim. You can also think of it as a deterrent to small, insignificant claims that many people file under their insurance policies.

Deductibles are applicable per policy or per claim as defined by the terms of a specific type of policy. Generally, insurance policies bought with high deductibles are less expensive as the higher out-of-pocket expense results in fewer claims

17.4. Features of Insurance Coverage

Insurance policies are the much-needed support pillar one requires at the time of need. The salient features of insurance are

1. **Easy to purchase:** One of the features of an insurance policy is its ease of purchase. Due to the widespread use of the internet, people can now easily purchase a policy by sitting in their comfort zone. Most insurance companies provide the option of both online and offline purchases of the policies so people can choose as per their comfort.
2. **A partner in a financial crisis:** The basic purpose of an insurance policy is to provide financial help when in need. Be it health, vehicle, or any other insurance policy, the aim is to extend the monetary aid.
3. **Abundant options:** The current insurance market is full of a number of options. A customer need not stick to a few options. There is great flexibility to surf all the options available and then make the final decision.

17.5. Benefit of Insurance Coverage

An insurance policy performs various functions and comes with multiple benefits. Below are some of its most fundamental advantages, along with some of the secondary and the rest are additional ones. The basic functions of insurance coverage are:

1) Provides Protection : Insurance coverage does reduce the impact of loss that one bears in perilous situations. It provides monetary reimbursement during financial crises. It not only protects the insured from financial woes but also helps in checking mental stress arising out of it.

2) Provides Certainty: Insurance coverage provides a feeling of assurance to the policyholders. The insured pays a small portion of the income for this certainty that will help in the future. So, there is a certainty of handsome financial aid against the premium. It will protect the policy buyer when met with accidents, hazards, or any vulnerabilities.

3) Risk Sharing: The very manner in which insurance policy functions makes it a cooperative scheme. An insurer would be unable to pay from

one's capital. An insurance company pools in collective risks and premiums because it covers a large number of risk-exposed people. The payout to the one who claims insurance coverage is out of this fund. Thereby, all policyholders share the risk of the one who actually suffered the loss.

4) Value of Risk: Insurance policy assesses the volume of risk and also anticipates the various causes of it. It evaluates the amount for insurance coverage and the premium payment amounts on a risk value basis. It safeguards against unforeseen events and consequential loss.

Above were the primary benefits of an insurance coverage policy. Apart from the above, it also has some additional benefits and secondary functions that it performs such as the ones mentioned below:

1. **Capital Generation:** The fund generated from the various premiums acts as a pooled investment for the insurance company. The insurers invest this lump sum into money market instruments. For instance, in stocks, mutual funds, and other productive channels. This helps in generating income and profit for the business. It guards against the loss of capital for the company.

2. **Economic Growth:** Insurance policies mobilize domestic savings into providing financial stability. It also directs towards loss mitigation due to damage or destruction for the insured community. It not only equivalently spreads the risks but also promotes trade and commerce by utilizing the fund.

3. **Saving Habits:** Insurance policies help inculcate saving habits among individuals. They keep a portion of income to pay premiums that will act as a guard for unknown future predicaments. Many insurance plans come as insurance- cum-savings or insurance-cum-investment schemes. This further encourages people to save and invest.

17.5. Types of Insurance Coverage

Insurance policies can cover up medical expenses, vehicle damage, loss in business or accidents while traveling, etc. Life Insurance and General Insurance are the two major types of insurance coverage. General Insurance can further be classified into sub-categories that clubs in various types of policies. These are:

1) Life Insurance

One can avail the life insurance in order to protect the family due to premature death or death during the tenure of the policy. It provides the family with a lump sum when the insured person meets with an untimely death. This helps the grieving family to battle with financial struggles that

may occur in absence of a breadwinner.

Is Term Insurance the same as Life Insurance?

Term Insurance is the most common form of life insurance where you pay the premium for the pre-decided term. If you pass away within the term period, the money you are insured of is given to the family. But it remains with the insurance company if you survive through the term policy's tenure. Unlike term plans, whole life insurance or endowment plans pay upon maturity as well if you outlive the term. Some Pension Plans, or post-retirement plans also carry insurance coverage. One is to pay the premium up to a certain time. You receive the promised amount upon maturity. The family gets the money upon the untimely death of the insured.Hence, Term Insurance is one among many types of Life Insurance plans.

What is Unit Linked Insurance Plan?

Unit Linked Insurance Plan is an investment-cum-insurance plan. The premiums provide coverage as well as they are for the purchase of units of market-linked equity, debt, and other instruments. This has the potential to provide an opportunity for wealth creation apart from the life cover provision. Life Insurance Coverage Plans also come with tax benefits under Section 80C.

2) General Insurance

Non-life insurance policies count as general insurance policies that include insurance coverage for home, auto, education, etc. as mentioned below:

3) Health Insurance

You can buy health insurance for yourself or for your family that may include your spouse, parents, siblings, and children. Some insurance companies have tie-ups with hospitals. So here you can use your policy number to avail of cashless services in-network hospitals. In other cases, you can claim reimbursement for hospitalization and treatments. Do check the coverage of the type of disease/illness/health issue. Also, verify what type of costs are covered.

4) Education Insurance

Education insurance can also serve as an investment scheme. You pay premiums by the time your child is 18 years of age or attains a certain age as decided by the insurance policy. You can have a lump sum with imposed regulations that you can use for a child's educational purposes and not any other. Use an education calculator to estimate the amount you may need when the child

grows up. Such calculators are often provided by insurance companies or insurance offering sites. The parent/ foster parent/legal guardian is the owner of the policy.

5) Home/Property Insurance

If man-made or natural calamities damage your valuable property then this policy can cover the financial loss and provide monetary aid. Losses due to theft, floods, or any other mishaps can be alleviated.

6) Motor/Auto/Vehicle Insurance

This is one of the mandatory policies in current times. First of all, it protects your valuable asset against road accidents or any other damage and covers the losses. Secondly, the traffic rules suggest you carry insurance papers while driving.

7) Travel Insurance

You may have seen that you get an option to buy insurance for minimal costs when booking a rail or air ticket. Alternatively, you can buy travel insurance if you are a frequent flyer and especially if you travel internationally. You can claim for baggage loss, trip cancellation, or delay in flight.

Apart from the types of insurances discussed above, there are miscellaneous insurance coverage policies for furniture, goods, machines, etc. There are other types of insurance such as Fire Insurance (damage due to fire), Marine Insurance (for cargo ships), Tenant Insurance, Landlord's Insurance, and so on. Group Medical Insurance Policies often cover the employees of an organization if the latter has any.

17.7. Need of Insurance

Insurance serves several important purposes in individuals' and businesses' financial planning and risk management strategies. Here are some of the key needs for insurance:

1. **Protection against Financial Loss**: Insurance provides financial protection against unexpected events that could result in financial loss. This includes events such as accidents, illnesses, natural disasters, theft, and other unforeseen circumstances. By paying a premium, individuals and businesses transfer the risk of potential financial loss to the insurance company.

2. **Healthcare Coverage**: Health insurance helps individuals manage the costs of medical expenses, including hospitalization, surgeries, doctor visits, prescription medications, and preventive

care. Without health insurance, medical bills can quickly become overwhelming and lead to financial hardship.

3. **Property Protection**: Property insurance, including homeowners insurance and renters insurance, protects against losses to one's home or personal belongings due to events like fire, theft, vandalism, or natural disasters. It provides financial reimbursement to repair or replace damaged property.

4. **Liability Coverage**: Liability insurance protects individuals and businesses from legal claims and financial liabilities arising from injuries, property damage, or other harms caused to others. It covers legal defense costs as well as any settlements or judgments awarded against the insured party.

5. **Income Replacement**: Life insurance provides financial support to beneficiaries in the event of the policyholder's death. It can help replace lost income, pay off debts, cover funeral expenses, and provide financial stability for loved ones.

6. **Business Continuity**: Business insurance protects companies from financial losses due to property damage, liability claims, business interruption, and other risks. It helps businesses recover and continue operating after unexpected events, minimizing the impact on revenue and operations.

7. **Legal Requirements**: In many cases, insurance is required by law or regulation. For example, auto insurance is mandatory in most jurisdictions to cover potential damages caused by vehicle accidents. Employers may also be required to provide workers' compensation insurance to employees to cover medical expenses and lost wages for work-related injuries or illnesses.

8. **Peace of Mind**: Insurance provides peace of mind by reducing uncertainty and financial stress associated with potential risks and losses. Knowing that one is protected against unexpected events can alleviate anxiety and allow individuals and businesses to focus on their daily activities and long-term goals.

Overall, insurance plays a crucial role in helping individuals and businesses manage risks, protect assets, and achieve financial security. By transferring risk to insurance companies, policyholders gain peace of mind and financial stability in the face of uncertain events.

Let Us Sum Up

In this unit, you have learned the following:

The benefit of having insurance is that it prevents burning a hole into

your pocket in unprecedented times. It gives you financial assistance for your losses and damage.

The basic function of all types of insurance coverage is to provide damage control to the insured by bringing in a lot of people who pay to cover their risks. The fund is further used for capital formation through investment in the markets.

This helps the insurance companies to keep running and settle/adjust the claims of the insured people. It also boosts the economy. It is an agreement by which a person pays a company and the company promises to pay money if the person becomes injured or dies or to pay for the value of property lost or damaged.

It is the amount for which something is insured. It is the business of insuring persons or property.

Check Your Progress

1. The ________ provide financial coverage or reimbursement in many cases to the policyholder.
2. The insurance company will ________ the claim application to make a decision
3. The________ of an insurance policy is the amount that you need to pay to purchase a specific amount of insurance cover

Glossary

Unit Linked Insurance Plan: is an investment-cum-insurance plan. The premiums provide coverage as well as they are for the purchase of units of market-linked equity, debt, and other instruments.

General Insurance: Non-life insurance policies count as general insurance policies that include insurance coverage for home, auto, education, etc.

Life Insurance: One can avail the life insurance in order to protect the family due to premature death or death during the tenure of the policy.

Answers to Check Your Progress

1. Insurers
2. Evaluate
3. Premium

Suggested Readings

1. Bhole (2009) "Financial Institutions and Markets", 4th Edition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-18
Role of IRDA

STRUCTURE

Overview

Objectives

18.1. Introduction

18.2. Function of IRDA

18.3. IRDA Work

18.4. Role of IRDA in Insurance Sector

18.5. Importance of IRDA in Insurance Sector

18.6. Types of Insurance Policy Regulate by IRDA

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the role of Insurance Regulatory and Development Authority (IRDA) has been explained. Study the Insurance Regulatory and Development Authority of India is a regulatory body under the jurisdiction of Ministry of Finance, Government of India and is tasked with regulating and licensing the insurance and re-insurance industries in India.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of IRDA
- Understand the Role of IRDA

18.1. Introduction

IRDA or Insurance Regulatory and Development Authority of India is the apex body that supervises and regulates the insurance sector in India. The primary purpose of IRDA is to safeguard the interest of the policyholders and ensure the growth of insurance in the country. When it comes to regulating the insurance industry, IRDA not only looks over the life insurance, but also general insurance companies operating within the country.

18.2. Function of IRDA

The Insurance Regulatory and Development Authority of India (IRDAI) is the regulatory body responsible for overseeing and regulating the insurance industry in India. The functions of IRDAI include:

1. **Regulation and Supervision**: IRDAI regulates and supervises the insurance industry to ensure compliance with various laws, regulations, and guidelines. It monitors the activities of insurance companies, intermediaries, and other entities operating within the insurance sector.
2. **Licensing and Registration**: IRDAI grants licenses and registrations to insurance companies, brokers, agents, surveyors, and other intermediaries. It sets eligibility criteria, standards, and procedures for obtaining and renewing licenses.
3. **Consumer Protection**: IRDAI aims to protect the interests of policyholders and insurance consumers. It establishes rules and guidelines to ensure fair treatment, transparency, and disclosure of information to customers. IRDAI also handles grievances and complaints filed by policyholders against insurance companies and intermediaries.
4. **Product Approval**: IRDAI reviews and approves insurance products before they can be offered to the public. It assesses the suitability, pricing, terms, and conditions of insurance policies to safeguard the interests of policyholders.
5. **Market Development**: IRDAI promotes the development and growth of the insurance market in India. It introduces initiatives, reforms, and policies to enhance insurance penetration, expand the range of insurance products and services, and increase insurance coverage across different segments of the population.
6. **Financial Stability and Solvency**: IRDAI monitors the financial health and solvency of insurance companies to ensure their ability to fulfill policyholder obligations. It sets capital adequacy requirements, risk management standards, and solvency margins to maintain stability and protect policyholders' interests.
7. **Regulation of Intermediaries**: IRDAI regulates insurance intermediaries such as brokers, agents, corporate agents, web aggregators, and insurance marketing firms. It establishes standards of conduct, eligibility criteria, and licensing requirements for intermediaries to promote professionalism,

integrity, and ethical practices in the distribution of insurance products.

8. **Promotion of Insurance Awareness**: IRDAI undertakes initiatives to promote insurance awareness and financial literacy among consumers. It educates the public about the importance of insurance, the benefits of various insurance products, and the rights and responsibilities of policyholders.
9. **Policy Formulation and Review**: IRDAI formulates policies, guidelines, and regulations governing various aspects of the insurance industry. It periodically reviews and updates existing regulations to adapt to changing market dynamics, technological advancements, and regulatory requirements.
10. **International Cooperation**: IRDAI collaborates with international insurance regulators and organizations to exchange knowledge, best practices, and expertise. It participates in global forums, conferences, and initiatives to enhance regulatory cooperation, harmonize standards, and promote cross-border insurance activities.

Overall, IRDAI plays a vital role in ensuring the stability, integrity, and development of the insurance sector in India while safeguarding the interests of policyholders and promoting financial inclusion and consumer protection.

18.3. IRDA Work

Consider that to run any professional set-up or otherwise, it is very important to maintain decorum. And so, the one who breaks the rule and disturbs the peace needs to be checked immediately. Similar to this, IRDA works and acts as mentioned below in different situations. IRDA is an autonomous body with the only mission to regulate fair practices in the insurance market to prevent loss of customers. The industry is now expected to reach US$280 billion by the year 2020. It poses that there is a long way to go and hence there arises a dire need for IRDA actions. To keep up the growth, here is how IRDA works:

- To protect the interest of policyholders at the time of claims, issuance of the policy, and cancellation of the policy is the ultimate motive. Hence, it monitors that no insurance company can deny the claim on their free will unless it falls beyond the scope of the cover.
- There is a need to tame the market to a single tune which brings the players together and then compete with each other simply based on the discounts. And so, IRDA clearly states the code of

conduct for all insurance companies, surveyors, and loss assessors.

- To prevent any misdeed, it calls for both annual and need-based audit, conduct investigation, and call for information from either the insurance companies or intermediaries.
- Regulate the rates and terms offered by the insurance companies to bring equality for the customers.
- If there arises any dispute between the insurer and the policyholder, then IRDA will step in to provide a resolution.
- To prevent different insurers quote rates as per their convenience, they bound the major risks to the Tariff Advisory Committee. After this, the insurers keep in mind the percentage of premium income they would need to fund the professional organizations.
- Keeping in mind the development of both the urban and the rural sector, IRDA bounds the insurers with a minimum percentage to carry both life and non -life business.

The scope of work is wide and IRDA as a body works abiding its limit without favoring any single insurance companies.

18.4. Role of IRDA in Insurance Sector

At one point of time, some insurance companies used to deny coverage to their policyholders. The basis of the denial was either their choice of business to underwrite or was their understanding of good risk and bad risk. To regulate the market and minimize any sort of partial acts, the IRDA was established.

Like the banking system in India is regulated as per the guidelines of RBI. It restricts the bankers to not behave unruly with the account holders. The banking institutes are allowed to offer loans and interest as per the rates pre-defined by RBI. It leaves no room for the monopoly to take over which in turn works best for the masses. Financial Institutes like banks and insurance companies will be successful in our democracy until market practices are for the majority and not just for fraction of people.

IRDA on the same lines of industrial practice plays a vital role like

- Ensures and encourages the systematic growth of the insurance industry just to benefit the common people who invest in policies to look for safety.
- Protects the interest of the policyholders so that they trust the system.

- Promote high standards of integrity and fair dealings in the market.
- Resolve disputes of all kinds and speed up claim settlement.
- Set standards and conduct vigilance to check for scams or frauds.

The Indian economy is growing which further promotes the entrance of new insurance players in the market. To keep the pace of growth even-handed, IRDA needs to maintain standards of quality. It will further contribute to strengthening the financial capacity of a country as a whole.

18.5. Importance of IRDA in Insurance Sector

The Insurance Regulatory and Development Authority of India (IRDAI) plays a crucial role in the insurance sector in India, and its importance can be understood in several key aspects:

1. **Regulatory Oversight**: IRDAI is responsible for regulating and supervising the insurance industry in India. It sets regulatory standards, guidelines, and frameworks to ensure the stability, integrity, and solvency of insurance companies. By establishing and enforcing regulations, IRDAI protects the interests of policyholders and stakeholders in the insurance sector.
2. **Consumer Protection**: One of the primary functions of IRDAI is to safeguard the interests of policyholders and ensure fair treatment by insurance companies. It mandates transparency in insurance products, pricing, terms, and conditions, helping consumers make informed decisions. IRDAI also handles consumer grievances and complaints, ensuring timely resolution and redressal.
3. **Market Development**: IRDAI promotes the development and growth of the insurance market in India by fostering innovation, competition, and efficiency. It encourages the introduction of new insurance products, distribution channels, and technologies to expand insurance coverage and penetration across the country. IRDAI's initiatives aim to enhance financial inclusion and support economic development.
4. **Financial Stability**: IRDAI monitors the financial health and performance of insurance companies to maintain the stability and sustainability of the insurance sector. It sets prudential norms, capital requirements, and risk management standards to mitigate financial risks and ensure the solvency of insurers. IRDAI's

oversight helps prevent systemic risks and contagion effects that could disrupt the broader financial system.

5. **Compliance and Enforcement**: IRDAI enforces regulatory compliance among insurance companies, intermediaries, and other stakeholders in the insurance sector. It conducts inspections, audits, and assessments to ensure adherence to regulatory requirements, ethical standards, and best practices. IRDAI imposes penalties, sanctions, or corrective actions for violations, deterring misconduct and promoting market discipline.
6. **Education and Awareness**: IRDAI educates consumers, intermediaries, and other market participants about insurance products, services, and regulations. It conducts awareness campaigns, disseminates information through various channels, and promotes financial literacy to empower individuals to make informed insurance decisions. IRDAI's efforts contribute to enhancing public trust and confidence in the insurance sector.
7. **International Cooperation**: IRDAI engages in international cooperation and collaboration with other regulatory bodies, industry associations, and multilateral organizations to exchange knowledge, best practices, and regulatory experiences. It participates in forums, conferences, and initiatives to strengthen regulatory frameworks, harmonize standards, and address global challenges in the insurance industry.

Overall, the importance of IRDAI in the insurance sector lies in its role as a regulatory authority, consumer protector, market developer, and guardian of financial stability. Its actions and initiatives contribute to the sustainable growth, resilience, and inclusiveness of the insurance industry, benefiting both insurers and policyholders in India.

18.6. Types of Insurance Policies Regulated by IRDA

The Insurance Regulatory and Development Authority of India (IRDAI) regulates various types of insurance policies in India to ensure fair practices, consumer protection, and stability in the insurance sector. Some of the key types of insurance policies regulated by IRDAI include:

1. **Life Insurance**: Life insurance policies provide financial protection to the insured's family or beneficiaries in case of the insured's death. These policies may offer various benefits, such as lump-sum payouts, annuities, or investment components. Examples include term insurance, whole life insurance, endowment plans, unit-linked insurance plans (ULIPs), and pension plans.

2. **Health Insurance**: Health insurance policies cover medical expenses incurred by the insured due to illness, injury, or hospitalization. They may include coverage for hospitalization, surgery, diagnostic tests, medication, and other healthcare services. Health insurance policies may be offered on an individual basis or as family floater plans covering multiple family members.
3. **Motor Insurance**: Motor insurance policies provide coverage for losses or damages to vehicles, as well as liability coverage for third-party bodily injury or property damage resulting from accidents. In India, motor insurance is mandatory under the Motor Vehicles Act, and policies typically include two main types of coverage: third-party liability insurance and own-damage insurance (comprehensive insurance).
4. **Travel Insurance**: Travel insurance policies offer coverage for unforeseen events that may occur during domestic or international travel, such as trip cancellation or interruption, medical emergencies, lost baggage, and travel-related accidents. Policies may vary in coverage and benefits depending on the insurer and the type of travel.
5. **Home Insurance**: Home insurance policies protect homeowners against financial losses resulting from damage or destruction to their property and belongings due to perils such as fire, theft, natural disasters, or vandalism. These policies may include coverage for the structure of the home, personal belongings, and liability for injuries or damages to others on the property.
6. **Commercial Insurance**: Commercial insurance policies provide coverage for businesses against various risks and liabilities, including property damage, business interruption, liability claims, employee injuries, and professional errors or omissions. Examples of commercial insurance products include property insurance, liability insurance, business interruption insurance, and specialized coverage for specific industries.
7. **Crop Insurance**: Crop insurance policies offer protection to farmers against losses caused by natural disasters, pests, diseases, or adverse weather conditions that affect crop yield or quality. These policies help mitigate the financial risks associated with agricultural production and ensure the stability of farmers' income.
8. **Other Specialized Insurance**: IRDAI also regulates other types of specialized insurance products, such as marine insurance, fire

insurance, aviation insurance, personal accident insurance, and cyber insurance, among others. These policies cater to specific risks and needs of individuals, businesses, or industries.

Overall, IRDAI plays a crucial role in overseeing and regulating the insurance industry in India, ensuring that insurers comply with regulatory standards, maintain solvency, and provide fair and transparent services to policyholders.

Let Us Sum Up

In this unit, you have learned the following:

The Insurance Regulatory and Development Authority of India is a regulatory body under the jurisdiction of Ministry of Finance, Government of India and is tasked with regulating and licensing the insurance and re-insurance industries in India.

Check Your Progress

1. The primary purpose of ________is to safeguard the interest of the policyholders and ensure the growth of insurance in the country.
2. IRDA not only looks over the life insurance, but also ________ operating within the country.
3. IRDA is an ________ with the only mission to regulate fair practices in the insurance market to prevent loss of customers.

Glossary

Financial Market: A financial market is a market in which people trade financial securities and derivatives at low transaction costs. Some of the securities include stocks and bonds, raw materials and precious metals, which are known in the financial markets as commodities

Insurance: An arrangement with a company in which you pay themRegular amounts of money and they agree to pay the costs if, for example, you die or are ill, or if you lose or damage something.

Answers to Check Your Progress

1. IRDA
2. General insurance companies
3. Autonomous body

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-19

Financial Derivatives

STRUCTURE

Overview
Objectives
19.1. Introduction
19.2. Meaning
19.3. Financial Derivative Work
19.4. Participants in a Derivative Work
19.5. Types of Financial Derivative
19.6. Need of Financial Derivative
Let Us Sum Up
Check Your Progress
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Overview

In this unit the concept of financial derivatives has been explained. Study the derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often simply called the "underlying".

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Financial Derivative
- Understand the Need of Financial Derivative

19.1. Introduction

Financial derivatives are contracts whose value is derived from the underlying asset. Hedgers and speculators widely use these contracts to take advantage of market volatility.

The buyer of the contract agrees to buy the asset at a specific price on a specific date.

Similarly, the seller also enters into one such contract. The different types of derivatives include futures and options, forwards and swaps. This article covers in detail what financial derivatives are, how it works, types and the different players in the derivatives market.

19.2. Meaning

Derivatives are financial contracts. The value of financial derivatives is dependent on the underlying asset. The assets can be stocks, bonds, commodities, currencies, etc. The value of the underlying asset changes with the market movements. The key motives of a derivative contract are to speculate on the underlying asset prices in the future and to guard against the price volatility of an underlying asset or commodity.

To better understand a financial derivative, let us take an example of Company ABC. You are certain that the share prices of Company ABC are likely to go up. You can buy a derivative contract by placing an accurate bet to leverage the price movement.

Furthermore, derivative contracts can also act as a cushion for your investment to limit losses. Taking another example, derivative contracts are used to fix the price of a commodity to minimize losses. For instance, dealing in the commodities market doesn't necessarily involve the physical delivery of the commodity.

To elaborate, a futures contract for onions doesn't involve buying and selling onions. The value of the contract is derived from the cost of buying and selling onions. Therefore, derivatives aim to create a balanced exchange rate for assets. Hence, they are popular options to hedge against price volatility.

19.3. Financial Derivative Work

Financial derivatives are financial instruments whose value is derived from the value of an underlying asset, index, rate, or other reference. They are widely used by various market participants for purposes such as hedging, speculation, and arbitrage. Here's an overview of how financial derivatives work:

1. **Types of Derivatives**: There are several types of financial derivatives, including:
    - **Forwards and Futures**: Contracts obligating the buyer to purchase, and the seller to sell, an asset at a predetermined price (forward) or to buy or sell the asset at a future date at a price agreed upon today (futures).
    - **Options**: Contracts that give the holder the right, but not the obligation, to buy (call option) or sell (put option) an underlying asset at a predetermined price within a specified period.
    - **Swaps**: Agreements between two parties to exchange cash flows or other financial instruments based on specified

parameters, such as interest rates, currency exchange rates, or commodity prices.

2. **Role of Underlying Assets**: Derivatives derive their value from underlying assets such as stocks, bonds, commodities, currencies, interest rates, or market indices. The performance of the underlying asset determines the value and payoff of the derivative contract.
3. **Price Determination**: The prices of derivatives are influenced by various factors, including the current price of the underlying asset, time to expiration, volatility, interest rates, and market sentiment. Derivatives pricing models, such as the Black-Scholes model for options, help estimate the fair value of derivatives.
4. **Risk Management**: One of the primary uses of derivatives is risk management. For example, companies may use futures contracts to hedge against fluctuations in commodity prices, interest rates, or foreign exchange rates, reducing their exposure to adverse market movements.
5. **Speculation and Trading**: Derivatives also provide opportunities for speculation and trading. Traders can take positions in derivatives contracts to profit from anticipated price movements in the underlying assets, without owning the assets themselves.
6. **Leverage**: Derivatives often allow investors to control a larger position in the underlying asset with a smaller amount of capital, a concept known as leverage. While leverage can amplify potential returns, it also increases the potential for losses.
7. **Clearing and Settlement**: Derivatives trades are typically cleared and settled through centralized clearinghouses, which act as intermediaries between buyers and sellers. Clearinghouses mitigate counterparty risk by ensuring that both parties fulfill their contractual obligations.
8. **Regulation**: Derivatives markets are subject to regulatory oversight to ensure transparency, stability, and investor protection. Regulators establish rules governing derivatives trading, margin requirements, reporting, and disclosure to maintain market integrity.

Overall, financial derivatives play a crucial role in modern financial markets, offering opportunities for risk management, speculation, and investment diversification, while also posing risks related to leverage, market volatility, and counterparty exposure. Understanding how

derivatives work is essential for investors, traders, and financial professionals operating in these markets.

19.4. Participants in a Derivative Market

Participants in derivative markets include various entities such as:

1. **Individual Investors**: Retail traders and investors who engage in derivatives trading through brokerage accounts. They may use derivatives for speculation, hedging, or portfolio diversification.
2. **Institutional Investors**: Hedge funds, pension funds, mutual funds, and other large financial institutions that trade derivatives to manage risk, enhance returns, or execute complex investment strategies.
3. **Commercial Hedgers**: Companies involved in various industries, such as agriculture, energy, and manufacturing, use derivatives to hedge against price fluctuations in commodities, currencies, interest rates, or other underlying assets relevant to their businesses.
4. **Market Makers and Liquidity Providers**: These are typically large financial institutions or specialized trading firms that facilitate trading in derivative markets by providing liquidity, quoting bid and ask prices, and absorbing buying and selling orders.
5. **Speculators**: Traders who aim to profit from short-term price movements in derivative contracts without having an underlying exposure. Speculators may include individual traders, proprietary trading firms, or algorithmic trading strategies.
6. **Brokerage Firms**: Entities that act as intermediaries between buyers and sellers in derivative markets, executing trades on behalf of clients and providing various trading services, including research, market analysis, and risk management tools.
7. **Exchanges and Clearinghouses**: Derivative exchanges serve as centralized marketplaces where buyers and sellers can trade standardized derivative contracts. Clearinghouses act as intermediaries, guaranteeing the performance of trades and managing counterparty risk by ensuring that both parties fulfill their contractual obligations.
8. **Regulators and Oversight Bodies**: Government agencies and regulatory bodies play a crucial role in overseeing derivative markets, ensuring compliance with regulations, and maintaining market integrity and stability. They establish rules, monitor

trading activities, and enforce laws to safeguard investors and maintain fair and orderly markets.

These participants interact within derivative markets to manage risk, speculate on price movements, allocate capital efficiently, and facilitate price discovery. The diverse range of participants contributes to the liquidity and functionality of derivative markets, making them an integral component of the global financial system.

19.5. Types of Financial Derivatives

1) **Futures**: Futures are a type of derivatives contract where the buyer and seller enter into an agreement to fix the quantity and price of the asset. The agreement has the quantity, price and date of the transaction mentioned. Upon entering into the contract, the buyer and seller are obligated to fulfil their duty regardless of the asset's current market price. Futures contracts are popular for hedging risk and speculation. However, the main purpose is to fix the price of the asset against volatility. With a futures contract, you can take advantage of the margins. A margin requirement is a minimum amount that you must deposit in order to trade futures on an exchange. The higher the leverage, the lower is the margin. For example, if a commodity's exchange margin is set at 5%, the leverage is 20 times. This indicates a deposit value of INR 5; you can trade for INR 100. The trader must repay the entire amount when the contract expires. As a result, higher leverage indicates high risk.

2) **Options**: Options also derive their value from the underlying asset. The option holder is not obligated to buy or sell the asset on expiry. Following are the two types of options.

3) **Call Option**: The buyer of a call option has the right, but not the obligation, to purchase the asset at the statedprice on the specified date. For example, if you buy a call option on Company ABC to buy 100 shares at INR 200 on a certain date. The share price of Company ABC has plummeted to INR 150 on the expiration date price on the specified date. For example, if you buy a call option on Company ABC to buy 100 shares at INR 200 on a certain date. The share price of Company ABC has plummeted to INR 150 on the expiration date.

   As a result, you are unwilling to execute the contract since it is a loss proposition. You have the option not to purchase the stock. You will just lose the premium paid to enter the contract in such a case. As a result, instead of losing INR 5,000, you will just lose the premium you paid.

4) **Put Option:** A put option holder has the right but not the obligation to sell the underlying asset at a specific price on a specific date. Suppose you acquire a put option on a Company ABC to sell 100 shares at INR 200 on a certain date, for example. The share price of Company ABC has increased to INR 250 on the expiration date, and you are unwilling to execute the contract since you would lose money. You have the option of not selling the stock and saving INR 5,000.

5) **Forwards:** Forward contracts are similar to futures contracts. The contract holder is under the obligation to fulfil the contract. However, these contracts are not standardized and do not trade on the exchange. Forward contracts are over the counter contracts. As a result, these are customized contracts to suit the requirements of the buyers and sellers (parties to the contract).

6) **Swaps:** Swaps are derivative contracts that help two parties to exchange their financial obligations. Corporates use swap contracts to minimize and hedge their uncertainty risk of certain projects. There are four types of swaps. Namely, interest rate swaps, currency swaps, commodity swaps and credit default swaps. The most popular type of swap is a credit default swap. A credit default swap provides insurance from a debt default. The buyer of the swap gives the seller the premium payments. In case of a default, the seller will pay the buyer the face value of the asset. At the same time, the seller will get possession of the asset.

19.6. Need of Financial Derivatives

Financial derivatives serve several important purposes in the global financial markets, providing various benefits to investors, institutions, and businesses. Here are some key reasons why financial derivatives are needed:

1. **Risk Management**: Derivatives allow market participants to hedge against various types of financial risks, including interest rate risk, currency risk, commodity price risk, and equity price risk. By using derivatives such as futures, options, swaps, and forwards, investors can protect themselves from adverse movements in prices or rates, thereby reducing their exposure to potential losses.

2. **Price Discovery**: Derivatives markets play a vital role in determining the prices of underlying assets or financial instruments. Through the trading of derivatives contracts, market participants collectively contribute to price discovery, which helps

in establishing fair and efficient prices for underlying assets, commodities, currencies, and securities.

3. **Liquidity Enhancement**: Derivatives markets enhance overall market liquidity by providing a platform for trading standardized contracts with high turnover and trading volumes. This liquidity benefits investors by enabling them to enter and exit positions more easily, reducing transaction costs, and improving market efficiency.
4. **Portfolio Diversification**: Derivatives offer investors opportunities to diversify their investment portfolios and manage risk more effectively. By including derivatives with different risk-return profiles in their portfolios, investors can achieve greater diversification, potentially enhancing overall portfolio performance and reducing volatility.
5. **Speculation and Investment**: Derivatives provide investors with opportunities for speculation and investment in various asset classes, including stocks, bonds, currencies, commodities, and interest rates. Through derivatives trading, investors can capitalize on their market views, implement trading strategies, and potentially generate profits from price movements and market trends.
6. **Efficient Capital Allocation**: Derivatives markets facilitate the efficient allocation of capital by allowing investors to take positions in various asset classes without the need for large upfront investments. This flexibility enables investors to deploy capital more efficiently, access a broader range of investment opportunities, and manage their exposure to different markets and risks.
7. **Risk Transfer and Transfer of Ownership**: Derivatives enable the transfer of financial risks and ownership rights between different parties in the market. For example, futures and options contracts allow for the transfer of price risk, while swaps facilitate the exchange of cash flows between counterparties based on predefined terms and conditions.
8. **Arbitrage Opportunities**: Derivatives markets create opportunities for arbitrage, where investors can profit from price discrepancies or inefficiencies between related assets or markets. Arbitrageurs play a crucial role in ensuring market efficiency by exploiting mispricing and helping to align prices across different trading venues.

9. **Regulatory Compliance and Capital Management**: Derivatives are used by financial institutions and corporations for regulatory compliance, capital management, and balance sheet optimization purposes. For example, banks may use derivatives to hedge their exposure to interest rate or currency fluctuations, while companies may use derivatives to manage commodity price risks or lock in favorable financing terms.

Overall, financial derivatives serve as valuable tools for managing risk, enhancing market liquidity, facilitating price discovery, and providing investment opportunities in the global financial markets. While derivatives offer various benefits, it's essential for market participants to understand the associated risks and use these instruments prudently and responsibly.

Let Us Sum Up

In this unit, you have learned about the followings:

A derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often simply called the "underlying".

Check Your Progress

1. ________are contracts whose value is derived from the underlying asset.
2. Contracts that take place through a broker are________
3. ________ like to protect themselves from possible price fluctuations.

Glossary

Hedgers: Hedgers like to protect themselves from possible price Fluctuations in the future. Hedgers are active in the Commodities market where the price fluctuations

Volatility: Furthermore, financial derivative contracts are not risk-free. They come with an inherent risk of market. Therefore, it is Risky to trade in the derivatives market without proper hedging Mechanisms.

Answers to Check Your Progress

1. Financial derivatives
2. exchange-traded derivatives
3. Hedgers

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Unit-20

Health Insurance

STRUCTURE

Overview

Objectives

20.1. Introduction

20.2. Meaning

20.3. Types of Health Insurance

20.4. Benefit of Health Insurance

20.5. How Health Insurance Works?

20.6. Need for Health Insurance

Let Us Sum Up

Check Your Progress

Glossary

Answers to Check Your Progress

Suggested Readings

Overview

In this unit the concept of Health Insurance has been explained. Study about every policy has its own exclusions or medical procedures and situations that it will not cover. Make sure you check what's covered and what isn't before you purchase a plan. You should also check if there's a co- pay clause, how much you will have to co-pay and what the waiting periods are. Shorter waiting periods and voluntary co-pay are ideal.

Objectives

After reading this unit, student should be able to:

- Know the Introduction of Health Insurance
- Understand the Need of Health Insurance

20.1. Introduction

Health insurance covers cost of an insured individual's medical and surgical expenses. Subject to the terms of insurance coverage, either the insured pays costs out-of-pocket and is subsequently reimbursed or the insurance company reimburses costs directly.

20.2. Meaning

Health insurance is a type of insurance coverage that pays for medical and surgical expenses incurred by the insured. It provides financial

protection against the high costs of healthcare services, including hospitalization, doctor visits, prescription medications, diagnostic tests, and surgical procedures. Health insurance can be purchased by individuals, families, or employers to help cover medical expenses and mitigate the financial burden associated with illness or injury.

20.3. Types of Health Insurance.

Health insurance comes in various forms, each tailored to meet specific needs and preferences of individuals, families, and employers. Here are some common types of health insurance:

1. **Individual Health Insurance**: Individual health insurance plans are purchased by individuals directly from insurance companies or through health insurance marketplaces. These plans provide coverage for a single person and may offer a range of benefits, including hospitalization, doctor visits, prescription drugs, and preventive care.
2. **Family Health Insurance**: Family health insurance plans provide coverage for the entire family, including the policyholder, spouse, and dependent children. These plans typically offer comprehensive coverage for medical expenses and may include options for adding additional family members.
3. **Employer-Sponsored Health Insurance**: Employer-sponsored health insurance plans are offered by employers to their employees as part of their employee benefits package. These plans may be fully funded by the employer, partially funded with employee contributions, or offered as voluntary benefits. Employer-sponsored plans often provide group coverage to eligible employees and their dependents.
4. **Group Health Insurance**: Group health insurance plans provide coverage to members of a group, such as employees of a company, members of a professional association, or members of a trade union. These plans offer collective coverage to eligible individuals within the group and may provide cost savings, broader benefits, and easier access to healthcare services compared to individual plans.
5. **Health Maintenance Organization (HMO)**: HMO plans require members to choose a primary care physician (PCP) from a network of healthcare providers. PCPs coordinate all aspects of their patients' healthcare and must provide referrals for specialist consultations and treatments. HMO plans typically require members to use network providers for non-emergency services

and may have lower out-of-pocket costs compared to other types of plans.

6. **Preferred Provider Organization (PPO)**: PPO plans offer more flexibility in choosing healthcare providers and do not require members to select a primary care physician. Members can seek care from both in-network and out-of-network providers, although using in-network providers usually results in lower out-of-pocket costs. PPO plans typically do not require referrals for specialist care and offer a broader network of providers compared to HMO plans.
7. **Point of Service (POS) Plans**: POS plans combine features of HMO and PPO plans, allowing members to choose a primary care physician and receive coordinated care within a network of providers. POS plans offer the flexibility to seek care from out-of-network providers but may require referrals for specialist care. Members may have lower out-of-pocket costs for in-network services and higher costs for out-of-network services.
8. **High-Deductible Health Plans (HDHPs)**: HDHPs have higher deductibles and lower premiums compared to traditional health insurance plans. These plans are often paired with health savings accounts (HSAs) or health reimbursement arrangements (HRAs) to help members save for out-of-pocket medical expenses and receive tax benefits. HDHPs may be suitable for individuals who are relatively healthy and want to save on premiums while maintaining coverage for catastrophic medical expenses.
9. **Catastrophic Health Insurance**: Catastrophic health insurance plans offer limited coverage for essential healthcare services with high deductibles and lower premiums. These plans are designed to provide financial protection against major medical expenses, such as hospitalization and surgery, but may require members to pay out-of-pocket for routine medical expenses until they reach the deductible.
10. **Short-Term Health Insurance**: Short-term health insurance plans provide temporary coverage for individuals who need insurance for a limited period, such as during a gap in coverage or while waiting for eligibility for other health insurance options. These plans offer basic coverage for essential medical services and may have lower premiums but often have limited benefits and coverage exclusions.

Each type of health insurance has its own features, benefits, and limitations, and individuals should carefully consider their healthcare needs, budget, and preferences when selecting a health insurance plan. It's essential to review plan details, coverage options, provider networks, and cost-sharing requirements to choose the best health insurance option for individual or family needs.

20.4. Benefits of Health Insurance

Here are some key features and benefits of health insurance:

1. **Coverage for Medical Expenses**: Health insurance policies typically cover a wide range of medical expenses, including hospitalization, outpatient services, emergency care, prescription drugs, laboratory tests, and preventive care.
2. **Financial Protection**: Health insurance provides financial protection against unexpected medical expenses. By paying a premium, individuals transfer the financial risk of healthcare costs to the insurance company, reducing the potential financial burden of illness or injury.
3. **Access to Healthcare Services**: Health insurance enables individuals to access healthcare services from a network of providers, including hospitals, doctors, specialists, and healthcare facilities. Insured individuals can receive timely medical care without worrying about the high costs of treatment.
4. **Preventive Care Services**: Many health insurance plans offer coverage for preventive care services, such as routine check-ups, vaccinations, screenings, and wellness exams. These services help individuals maintain good health, detect health problems early, and prevent serious illnesses.
5. **Choice of Providers**: Health insurance plans often allow individuals to choose their healthcare providers from a network of preferred providers. This flexibility enables insured individuals to receive care from doctors and hospitals of their choice, subject to network coverage and cost-sharing requirements.
6. **Financial Assistance for Chronic Conditions**: Health insurance provides financial assistance for the management and treatment of chronic health conditions, such as diabetes, hypertension, asthma, and heart disease. Insured individuals can access medications, treatments, and services needed to manage their conditions effectively.
7. **Emergency Medical Coverage**: Health insurance policies typically cover emergency medical expenses, including

ambulance services, emergency room visits, and urgent care treatment. This coverage ensures prompt medical care in emergency situations without incurring significant out-of-pocket expenses.

8. **Family Coverage Options**: Health insurance plans may offer family coverage options, allowing individuals to include their spouse and dependent children under the same policy. Family coverage provides comprehensive medical insurance protection for the entire household.
9. **Income Replacement**: Some health insurance policies offer income replacement benefits, such as disability insurance, to replace lost income due to illness or injury. These benefits help insured individuals maintain financial stability and meet their financial obligations during periods of illness or disability.
10. **Regulatory Protections**: Health insurance is subject to regulatory protections and consumer rights under applicable laws and regulations. These protections include coverage mandates, benefit requirements, premium rate regulations, and consumer privacy safeguards to ensure fair and equitable access to healthcare services.

Overall, health insurance plays a crucial role in providing financial security, access to healthcare services, and protection against the high costs of medical care. It helps individuals and families manage healthcare expenses, maintain good health, and cope with unexpected illnesses or injuries.

20.5. How Health Insurance works?

Health insurance works by providing financial coverage for medical expenses incurred by the insured individual or their dependents. Here's a general overview of how health insurance typically operates:

1. **Premiums**: The insured individual pays a regular fee, known as a premium, to the insurance company. This premium can be paid monthly, quarterly, or annually, depending on the policy terms.
2. **Coverage**: In exchange for the premium, the insurance company provides coverage for a range of medical services and treatments outlined in the policy. This coverage can vary widely depending on the type of plan and the specific terms of the policy. Common types of coverage include doctor visits, hospital stays, prescription drugs, and preventive care.
3. **Deductibles**: Many health insurance plans have a deductible, which is the amount of money the insured individual must pay out

of pocket for medical expenses before the insurance company begins to cover costs. Deductibles can vary depending on the plan, with higher deductibles typically associated with lower premium costs.

4. **Co-payments and Co-insurance**: In addition to the deductible, the insured individual may be responsible for co-payments or co-insurance. A co-payment is a fixed amount paid for certain services (e.g., a $20 co-payment for a doctor's visit), while co-insurance is a percentage of the cost of the service that the insured individual is required to pay (e.g., 20% of the cost of a medical procedure).
5. **Networks**: Many health insurance plans have networks of healthcare providers, including doctors, hospitals, and clinics, with whom they have negotiated discounted rates. Insured individuals may pay less for services received from providers within the network compared to those outside the network.
6. **Claims**: When an insured individual receives medical care, the healthcare provider submits a claim to the insurance company for payment. The insurance company reviews the claim to ensure that it meets the terms of the policy, and then reimburses the provider for covered services.
7. **Benefits and Exclusions**: Health insurance policies outline the specific benefits covered, as well as any exclusions or limitations. It's important for insured individuals to review their policy documents carefully to understand what is and isn't covered.
8. **Renewal and Changes**: Health insurance policies are typically renewed annually, although changes may be made to the policy terms, premiums, or coverage options during the renewal process.

Overall, health insurance provides financial protection against the high costs of medical care, helping insured individuals access the healthcare services they need without facing significant financial hardship.

20.6. Need of Health Insurances

Health insurance is essential for several reasons, providing individuals, families, and communities with financial security, access to healthcare services, and protection against the high costs of medical care. Here are some key reasons why health insurance is needed:

1. **Financial Protection**: Health insurance provides financial protection against the high costs of medical treatment and healthcare services. Without insurance, individuals and families

may face significant financial burdens and potential bankruptcy due to unexpected medical expenses resulting from illness, injury, or chronic conditions.

2. **Access to Healthcare Services**: Health insurance ensures access to a wide range of healthcare services, including hospitalization, doctor visits, specialist consultations, diagnostic tests, prescription medications, and preventive care. Insured individuals can receive timely medical treatment and preventive services without worrying about affordability or access barriers.
3. **Preventive Care and Early Detection**: Health insurance plans often cover preventive care services, such as routine check-ups, screenings, vaccinations, and wellness exams. These services help individuals maintain good health, detect health problems early, and prevent serious illnesses or complications, leading to better health outcomes and reduced healthcare costs over time.
4. **Treatment for Illness and Injury**: Health insurance covers the costs of medical treatment and services needed to manage and treat illnesses, injuries, and medical conditions. Insured individuals can receive necessary medical care, surgeries, therapies, and medications prescribed by healthcare providers, ensuring access to appropriate treatment and recovery support.
5. **Emergency Medical Care**: Health insurance provides coverage for emergency medical care, including ambulance services, emergency room visits, and urgent care treatment. Insured individuals can receive prompt medical attention during emergencies without worrying about the high costs of emergency services or hospitalization.
6. **Chronic Disease Management**: Health insurance supports the management and treatment of chronic diseases and conditions, such as diabetes, hypertension, asthma, heart disease, and cancer. Insured individuals can access medications, treatments, specialists, and support services needed to manage chronic conditions effectively and improve their quality of life.
7. **Maternity and Newborn Care**: Health insurance often includes coverage for maternity care, prenatal services, childbirth, and newborn care. Insured individuals can receive medical care and support during pregnancy, delivery, and postpartum period, ensuring the health and well-being of mothers and newborns.
8. **Mental Health and Substance Abuse Treatment**: Health insurance covers mental health services, counseling, therapy, and substance abuse treatment for individuals with mental health

disorders or substance use disorders. Insured individuals can access mental health professionals, support services, and treatment programs to address their mental health needs and improve their overall well-being.

9. **Rehabilitative Services and Therapies**: Health insurance covers rehabilitative services, physical therapy, occupational therapy, and other therapies needed to recover from injuries, surgeries, or disabilities. Insured individuals can access rehabilitation programs and therapies to regain mobility, function, and independence after illness or injury.
10. **Regulatory Compliance and Legal Requirements**: Health insurance is often required by law or regulation, such as the Affordable Care Act (ACA) in the United States, which mandates individuals to have health insurance coverage or pay a penalty. Employers may also be required to provide health insurance benefits to employees under certain laws or regulations.

Overall, health insurance is essential for protecting individuals and families from financial hardship, ensuring access to healthcare services, promoting preventive care and early detection, and supporting the management and treatment of illnesses, injuries, and medical conditions. It plays a crucial role in promoting health and well-being, reducing healthcare disparities, and improving healthcare outcomes for individuals and communities.

How to Choose Health Insurance Plan?

There are several health insurance policies available in the market. To enjoy cover without any hassles, you need to find the policy that best looks after your unique needs. Here are some important factors to consider while choosing a health insurance policy:

Check the Sum Insured

Many insurance providers have a limit on the maximum sum insured you can choose. If you'd like a high sum insured, you need to find a health policy that offers you what you're looking for. A good rule of thumb is to get cover that is a minimum of six times your salary. If you earn INR 1 lakh per month, look for a policy that offers at least INR 6 lakhs as the sum insured. You should also look for other benefits. If you're planning on starting a family in a few years, make sure maternity costs are covered. Of course, you will have to check the waiting period as maternity benefits are subject to slightly longer waiting periods.

Scout the Network Hospitals

Different insurance providers may have different hospitals in their

network. Ideally, look for a policy that offers cashless claims at all the top hospitals in your city. You should also make sure that your preferred hospital is on the list. This will make the entire process of getting the treatment you want much easier.

Check the Fine Print

Every health insurance policy has various limits and sub-limits. You need to check the policy documents thoroughly to understand exactly how much coverage you will get per treatment or hospitalization. For example, some policies may help cover the per day room cost, but only up to INR 2,000 per day. If you happen to be in a hospital where the room rent is INR 4,000, you'd have to pay for half the cost of the room. You should also check the limits of pre- and post-hospitalization expenses. Some plans offer cover for only 30 days pre-hospitalization and 60 days post-hospitalization. Others offer 60 and 90 days respectively.

Look for Additional Benefits

Given that the insurance market is fairly competitive, different policies offer various benefits. No-claim bonuses and the restoration of your sum insured are some of the most popular ones. You should always check whether your chosen insurance policy will provide these benefits. Always look for policies that offer you additional benefits.

Let Us Sum Up

Every policy has its own exclusions or medical procedures and situations that it will not cover. Make sure you check what's covered and what isn't before you purchase a plan. You should also check if there's a co- pay clause, how much you will have to co-pay and what the waiting periods are. Shorter waiting periods and voluntary co-pay are ideal.

Check Your Progress

1. ________ covers cost of an insured individual's medical and surgical expenses.
2. A family floater plan allows you to cover your________ under a single policy and everybody shares the sum insured amount.
3. every health insurance provider will tie-up with a number of network hospitals where you can enjoy________

Glossary

Health Insurance:	Health insurance is an insurance product which covers Medical and surgical expenses of an insured individual. It reimburses the expenses incurred due to illness or injury or Pays the care provider of the insured individual directly
Group Health	Unlike individual and family floater policies, group health
Insurance plans	can be purchased by a group manager for a large number of individuals

Answers to Check Your Progress

1. Health insurance
2. Family members
3. Cashless claims

Suggested Readings

1. Bhole (2009) “Financial Institutions and Markets”, 4thEdition, McGraw Hill Education publishers, New Delhi.
2. Bimal Jaiswal (2020), Financial Markets and Institutions, Sathyabawan Publications, Chennai.

Model End Semester Examination Question Paper

BA (Hons)-Economics

Course Code: **DCECN-12**/ Course Title: **Financial Economics-I**

Max. Marks: 70 **Time:** 3 hours

PART – A (2 Marks) 5X2=10 Marks

Answer any FIVE questions out of EIGHT questions

[All questions carry equal marks]

(1).Define Money Market.

(2).What is CRR?

(3).Define Commercial Bank.

(4).What is financial system?

(5).Define Capital Market.

(6).What is SEBI?

(7).State the meaning of Share Market.

(8).What is health insurance?

PART - B (5-Marks) 4X5=20 Marks

Answer any FOUR questions out of SEVEN questions

[All questions carry equal marks]

(9).Explain the components of Money Supply.

(10).Enumerate the functions of commercial banks.

(11).Explain the functions of SEBI.

(12).Write a short note on Stock Exchange.

(13).Discuss the various types of investments.

(14)Explain the features of Insurance.

(15).Explain about IRDA.

PART - C (10 Marks) 4X10= 40 Marks

Answer any FOUR questions out of SEVEN questions

[All questions carry equal marks]

(16).Explain about Money Market.

(17).Discuss the instruments of Monetary Policy.

(18).Explain the various types of Bank.

(19).Discuss the concept of Capital Market.

(20).Discuss about Non-Banking Institutions.

(21).Explain the concept of Bonds and types of Bonds.

(22).Explain about financial derivatives.

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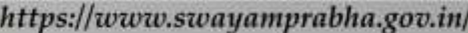

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34	Health Sciences
35	Metallurgical and Material Science Engineering, Mining and Ocean Engineering
36	Skills and Logistics (IT - Enabled Sector, Banking, Financial and Insurance sector Skills Logistics, Supply Chain Management and Transportation, Life skills)
Channels 37 to 38 are managed by **IIT Tirupati**	
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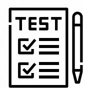

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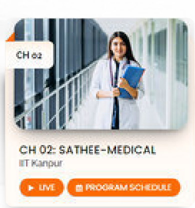

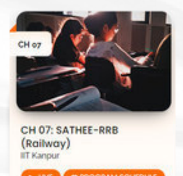

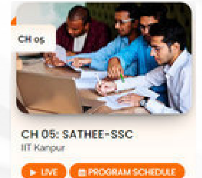

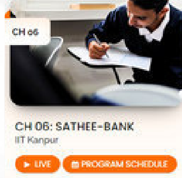

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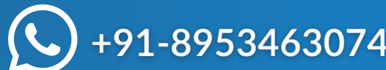

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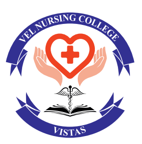

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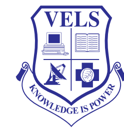

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