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## **SYLLABUS**

**Class: - I Year**

**Subject: - Financial Services & Insurance**

<b>Units</b>	<b>Syllabus</b>
UNIT - I	<b>Overview of Financial Services</b> Meaning, Importance and Scope of financial services, Indian financial system, Brief Study of Financial Institutions - RBI, Commercial and Co-Operative Banks, Non banking financial institutions, Development Bank, Merchant Bank, Basics of Mutual Funds, Credit Rating, An overview of micro finance.
UNIT - II	<b>Financial Markets</b> Money Market in India: Importance, features and instruments, Measures to strengthen money market in India, Recommendations of the working group on money market. Capital Markets in India: New issue market and stock exchange, Importance of stock exchanges, Role of The Securities and Exchange Board of India (SEBI), Meaning and Classification of Mutual Funds, Operation of the Funds, Net Asset Value, and Regulation of Mutual Funds in India. Financial Instruments: Cash, Derivative, Foreign Exchange, Debt based and Equity based financial instruments.
UNIT - III	<b>Principles and Practices of Insurance</b> Concept, Principles & Types of Insurance-Life Insurance, Micro Insurance, Annuities, Health Insurance, General Insurance, Motor Insurance, Marine Insurance, Property Insurance and Other Miscellaneous Insurance, The Concept of Risk and Classification of Risks, Insurance Documents, Online Insurance, Process of claim and settlement, Policy Terms and Conditions, Legal and Regulatory Aspects of Insurance(IRDA).



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## UNIT - 1

### Meaning of Financial Services

Financial Services refer to economic services provided by various financial institutions that deal with the management of money. It is an intangible product of financial markets like loans, insurance, stocks, credit card, etc. Financial services are products of institutions such as banking firms, insurance companies, investment funds, credit unions, brokerage firms, and consumer finance companies.

1. **Customer Oriented:** Financial services are customer-focused services that are offered as per the requirements of customers. Financial institutions properly study customer needs before designing and offering such services. They are meant to fulfill the specific needs of a customer which differs from person to person.
2. **Intangibility:** These services are intangible which makes their marketing a challenging task for financial institutions. Such institutions need to focus on building their brand image by providing innovative and quality products to customers. Firms enjoying better credibility in market are easily able to sell off their products.
3. **Inseparable:** Financial Services are produced and delivered at the same time simultaneously. These services are inseparable and can't be stored in advance. Here production and supply function both occurs at the same time.
4. **Manages Fund:** Financial services are specialized at managing funds of people. These services enable peoples in allocating their idle lying funds into useful means for earning revenues. Financial services provide various means to people for converting their savings into investment.
5. **Financial Intermediation:** These services does the work of financial intermediation as it brings together the lender and borrower. Financial services mobilize the funds of people who are having enough of it and made it available to the one who are in need of it.
6. **Market Based:** Financial services are market based which changes as per the changing conditions. It is a dynamic activity which varies as per the variations in socio-economic environment and varying needs of customers. importance and scope of Financial services in points
7. **Distributes Risk:** Risk distribution is the key feature offered by financial services. These services transfer the risk of an individual not willing to take among different persons who all are willing to bear it. Financial institutions diversify the risk and secure people against damages by providing them various insurance policies. importance and scope of Financial services in points

### Importance and scope of financial services in points

1 Essential for economic growth: Financial services play a crucial role in the development of the economy by facilitating investment, providing access to credit, and facilitating trade.

2 Diverse Range of services: Financial services encompass a wide range of services including banking, insurance, investment management, and capital markets.

3 Access to credit: Financial services provide access to credit for individuals, businesses, and governments, enabling them to invest in their future and drive economic growth.



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4 Improved Standard Of Living: By providing access to credit and investment opportunities, financial services can improve the standard of living for individuals and communities.

5 Risk Management: Financial services help individuals and businesses manage financial risks through insurance and other risk management products.

6 Facilitation of trade: Financial services are essential for facilitating international trade by providing access to capital, currency exchange services, and trade financing.

7 Promotion of savings and investments: Financial services promote savings and investment by providing a range of savings and investment products.

8 Increased Financial Literacy: Financial services can also increase financial literacy and education, helping individuals make informed financial decisions.

9 Support for small businesses: Financial services play a crucial role in supporting small businesses by providing access to credit and investment capital.

10 Regulated Industry: Financial services are regulated by government agencies to ensure stability, transparency, and consumer protection in the financial system.

### **Meaning of Indian financial system**

The Financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by independent regulators in the sectors of insurance, banking, capital markets and various services sectors. Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

### **FEATURES OF INDIAN FINANCIAL SYSTEM:**

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

### **COMPONENTS/ CONSTITUENTS OF INDIAN FINANCIAL SYSTEM**

The following are the four major components that comprise the Indian Financial System:

1. Financial Institutions
2. Financial Markets



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3. Financial Instruments/ Assets/ Securities

4. Financial Services.

#### FINANCIAL INSTITUTIONS

Financial institutions are organizations that provide a variety of financial services and products to individuals, businesses, and governments. They play a crucial role in the functioning of the economy by channeling savings and investments into productive uses, facilitating transactions, and providing credit to help individuals and organizations grow.

#### Some common types of financial institutions include:

1 Banks: Offer various financial services, such as accepting deposits, granting loans, and offering investment products.

2 Credit unions: Non-profit organizations that provide similar services as banks, but are owned and controlled by their members.

3 Insurance companies: Provide protection against potential financial loss due to unforeseen events such as death, injury, or property damage.

4 Investment firms: Offer investment advice and manage investments for individuals and institutions.

5 Stockbrokers: Provide services to buy and sell stocks and other securities.

#### TYPES OF FINANCIAL INSTITUTIONS

Financial institutions can be classified into two categories:

A. Banking Institutions

B. Non - Banking Financial Institutions

#### Reserve Bank of India

The Reserve Bank of India (RBI) is the central bank of India and acts as the regulator of the country's monetary policy. It was established in 1935 and is headquartered in Mumbai, India.

1 Role in monetary policy: The RBI is responsible for controlling the supply of money in the economy and ensuring price stability through the use of monetary policy tools such as interest rate changes, open market operations, and reserve requirements.

2 Regulator of the banking system: The RBI regulates and supervises the banking system in India, including commercial banks, cooperative banks, and regional rural banks.

3 Issuer of currency: The RBI is the issuer of the Indian rupee and is responsible for the printing and circulation of currency in the country.



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4 Development functions: The RBI also has a developmental role, with a focus on promoting financial inclusion, promoting the growth of small and medium enterprises, and providing banking services in rural areas.

5 Banker to the government: The RBI acts as the banker to the government and is responsible for managing government finances, including the receipt and disbursement of public funds.

6 Foreign exchange management: The RBI is responsible for managing foreign exchange reserves and regulating foreign exchange transactions in the country.

7 Consumer protection: The RBI also plays a role in consumer protection by setting guidelines and regulations to protect the rights of banking customers.

### **Commercial banks**

The term commercial bank refers to a financial institution that accepts deposits, offers checking account services, makes various loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses. A commercial bank is where most people do their banking.

Commercial banks make money by providing and earning interest from loans such as mortgages, auto loans, business loans, and personal loans. Customer deposits provide banks with the capital to make these loans.

Commercial banks are an important part of the economy. Not only do they provide consumers with an essential service, but they also help create capital and liquidity in the market.

They ensure liquidity by taking the funds that their customers deposit in their accounts and lending them out to others. Commercial banks play a role in the creation of credit, which leads to an increase in production, employment, and consumer spending, thereby boosting the economy.

### **Role of Commercial Banks in Developing Economy**

- 1) Banks promote capital formation
- 2) Banks help in balanced regional development
- 3) Banks promote the right type of Industries
- 4) Banks create employment opportunities
- 5) Banks helps in trade and industry
- 6) Banks helps in developing nation to develop

### **Public sector Banks**

Public Sector Banks consist of the State Bank Group and Other Nationalised Banks. It was wholly and controlled by Government.

### **State Bank of India and its group**

The Reserve Bank of India, which is India's central bank, acquired a controlling interest in the Imperial Bank of India. On 1 July 1955, the Imperial Bank of India became the State Bank of



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India. In 2008, the Government of India acquired the Reserve Bank of India's stake in SBI so as to remove any conflict of interest because the RBI is the country's banking regulatory authority.

In 1959, the government passed the State Bank of India (Subsidiary Banks) Act. This made eight banks that had belonged to princely states into subsidiaries of SBI. This was at the time of the First Five Year Plan, which prioritised the development of rural India. The government integrated these banks into the State Bank of India system to expand its rural outreach. In 1963 SBI merged State Bank of Jaipur (est. 1943) and State Bank of Bikaner (est.1944).

#### Nationalised Banks

It refers to a bank in which govt. of India has **more than 50% stake**. It is also called the Public Sector Bank. So, there is no difference between public sector bank and nationalised bank.

#### Private Sector Banks

Private Sector Banks are those banks, where private individuals or private companies own a major part of the bank's equity. Even though these banks follow the nation's central bank's guidelines, but they can formulate their independent financial strategy for the customers. A large part of these banks are traded on the stock market and anyone can buy a significant part of these bank's shares from the stock market.

Most private sector banks are very agile in their financial strategy. These privates can make a quick financial decision according to the market condition. For this reason, interest rates fluctuate quickly on both deposits and loans. They offer very reliable services to the customers. They also offer various customized services to the customer to fulfil their individual financial needs. There is no job security in private banks. Most employees work very hard to satisfy the customer's financial requirements. In these banks, the employees get promotions on their merit and performance.

However, private sector banks charge a little extra for their financial services. Compared to other banks, the interest rate on deposits is low in most private sector banks. Even though getting a loan in the private banks is very easy, but they charge more interest on these loans. Axis Bank is one of the best examples of private sector banks in India. This bank is very competitive and offers the best services to its customers.

#### The Regional Rural Banks (RRBs)

**The Regional Rural Banks (RRBs)** were established in 1975 under the provisions of the Ordinance promulgated on 26th September, 1975 and Regional Rural Banks Act, 1976 with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto.

#### Co-operative banks





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Cooperative banks are a type of financial institution that is owned and controlled by its members, who are also customers of the bank. The primary aim of cooperative banks is to serve the financial needs of their members, rather than maximizing profits for external shareholders.

**Some key features of cooperative banks include:**

- 1 Member-owned: Cooperative banks are owned by their members, who are also customers of the bank. Members have a say in how the bank is run and share in its profits.
- 2 Focus on serving members: The main aim of cooperative banks is to serve the financial needs of their members, rather than maximizing profits.
- 3 Democratic control: Cooperative banks are run on a democratic basis, with members having an equal vote in major decisions, regardless of the size of their deposit.
- 4 Limited interest on loans: Cooperative banks often offer lower interest rates on loans to their members compared to commercial banks.
- 5 Community focus: Cooperative banks are often focused on serving the needs of specific communities, such as farmers, small business owners, or low-income households.

Cooperative banks can offer a range of financial products and services, including savings and checking accounts, loans, mortgages, and other types of financial services. They can play an important role in providing access to financial services to under banked communities

**Non-banking financial institution (NBFI)**

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.

**Development bank**

Development bank, national or regional financial institution designed to provide medium- and long-term capital for productive investment, often accompanied by technical assistance, in poor countries.

The number of development banks has increased rapidly since the 1950s; they have been encouraged by the International Bank for Reconstruction and Development and its affiliates. The large regional development banks include the Inter-American Development Bank, established in 1959; the Asian Development Bank, which began operations in 1966; and the African Development Bank, established in 1964. They may make loans for specific national or regional projects to private or public bodies or may operate in conjunction with other financial institutions. One of the main activities of development banks has been the recognition and promotion of private investment opportunities. Although the efforts of the majority of development banks are directed toward the industrial sector, some are also concerned with agriculture.



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### **Merchant Bank**

A merchant bank is a type of financial institution that provides various services to businesses, including underwriting, financing for trade, and issuing loans and securities. Merchant banks are typically more focused on providing financial services to companies and large corporations, rather than individual consumers.

#### **Some key services offered by merchant banks include:**

- 1 Corporate finance:** Merchant banks provide financial advice and assistance with mergers and acquisitions, initial public offerings (IPOs), and other types of corporate finance activities.
- 2 Trade financing:** Merchant banks assist businesses with financing trade activities, such as issuing letters of credit and providing short-term loans.
- 3 Investment banking:** Merchant banks often provide investment banking services, such as underwriting and selling securities.
- 4 Foreign exchange:** Merchant banks assist businesses with foreign exchange transactions and currency hedging.
- 5 Asset management:** Merchant banks can provide asset management services, such as managing portfolios of stocks, bonds, and other investments.

Merchant banks often have extensive networks and relationships with businesses, financial institutions, and governments around the world, which allows them to provide a range of specialized financial services to their clients.

### **Basics of Mutual Fund**

A mutual fund is a type of investment vehicle that pools money from many individual investors to purchase a diversified portfolio of stocks, bonds, or other securities. Mutual funds are managed by professional fund managers who invest the money in a variety of assets in accordance with the fund's investment objective.

#### **Some key features of mutual funds include:**

- 1 Diversification:** Mutual funds provide individual investors with access to a diversified portfolio of assets, which can help reduce the risk of investing in a single security.
- 2 Professional Management:** Mutual funds are managed by professional fund managers who have expertise in selecting and managing investments.
- 3 Liquidity:** Mutual funds are typically highly liquid, meaning that investors can buy and sell shares of the fund on any business day at the current net asset value (NAV) price.





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4 Low minimum Investment: Mutual funds often have a low minimum investment requirement, making it possible for individual investors to get started with a relatively small amount of money.

5 Cost-effectiveness: Because mutual funds pool money from many investors, the costs of buying and selling securities, as well as the costs of professional management, are spread across the entire fund. This can make mutual funds a cost-effective option for individual investors.

However, it's important to remember that mutual funds, like all investments, carry risk, and the performance of a fund can be affected by a variety of factors, such as changes in the market, economic conditions, and the performance of individual securities within the fund. It's important to carefully research and understand a mutual fund before investing.

### **Credit Rating**

A credit rating is an assessment of the creditworthiness of a borrower, such as a corporation, government, or financial institution. Credit ratings are issued by credit rating agencies, such as Moody's, Standard & Poor's (S&P), and Fitch Ratings, and provide investors with an independent evaluation of the borrower's ability to repay its debts.

Credit ratings are typically expressed as a letter grade, such as AAA, AA, A, BBB, etc. The highest credit rating, AAA, indicates the lowest default risk, while the lowest rating, D, indicates that the borrower has already defaulted on its debts.

### **Some key aspects of credit ratings include**

1 Financial health: Credit ratings take into account a borrower's financial health, including its revenue, earnings, debt levels, and cash flow.

2 Ability to repay debts: Credit ratings also assess a borrower's ability to repay its debts, taking into account its ability to generate cash flow, its debt structure, and other factors.

3 Market conditions: Credit ratings take into account the overall economic and market conditions, as well as industry-specific risks, to provide a more complete assessment of a borrower's creditworthiness.

4 Default risk: Credit ratings provide an assessment of the default risk of a borrower, which is the risk that it will not be able to repay its debts on time.

5 Impact on borrowing costs: Credit ratings can have a significant impact on the borrowing costs of a borrower. Higher credit ratings can result in lower borrowing costs, while lower credit ratings can result in higher borrowing costs.

Credit ratings are widely used by investors, including bondholders and banks, as a tool for making informed investment decisions. They provide a relatively objective and independent



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assessment of a borrower's creditworthiness and can help investors to understand the level of risk associated with a particular investment.

### **An overview of Micro Finance**

Micro finance is a financial service that provides small loans, savings accounts, insurance, and other financial services to low-income individuals, who may not have access to traditional banking services. The goal of microfinance is to provide access to financial services to people who would otherwise be excluded from the formal financial system and to help them improve their standard of living and reduce poverty.

### **Some key features of microfinance include:**

- 1 **Small Loans:** Microfinance institutions provide small loans to low-income individuals, typically ranging from a few hundred dollars to a few thousand dollars. These loans are used to start or expand a small business, purchase household goods, or pay for emergencies.
- 2 **Savings accounts:** Microfinance institutions also offer savings accounts, allowing low-income individuals to save money and earn interest on their deposits.
- 3 **Insurance:** Some microfinance institutions offer insurance products, such as life and health insurance, to their clients.
- 4 **Community-based lending:** Microfinance institutions often use a group-based lending model, where a group of individuals guarantee each other's loans and support each other's businesses.
- 5 **Empowerment:** Microfinance is seen as a tool for empowering women and marginalized communities by providing them with access to financial services and helping them to improve their standard of living.

Microfinance has been successful in providing financial services to millions of low-income individuals around the world and has been credited with helping to reduce poverty, increase economic growth, and improve the standard of living for many people. However, it is important to note that microfinance is not a panacea for poverty and that success depends on many factors, including the quality of the institutions providing the services, the regulatory environment, and the cultural and economic context.



## UNIT - II

### **FINANCIAL MARKETS**

#### **MONEY MARKET IN INDIA**

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

The characteristics of the money market are:

- (i) It is not a single market but a collection of markets for several instruments.
- (ii) It is a wholesale market of short-term debt instruments.
- (iii) Its principal feature is honour where the creditworthiness of the participants is important.
- (iv) The main players are: Reserve Bank of India (RBI), Discount and Finance House of India (DFHI), mutual funds, banks, corporate investors, non-banking finance companies (NBFCs), state governments, provident funds, primary dealers, Securities Trading Corporation of India (STCI). Public sector undertakings (PSUs), non-resident Indians and overseas corporate bodies.
- (v) It is a need-based market wherein the demand and supply of money shape the market.

#### **Functions of the Money Market**

A money market is generally expected to perform three broad functions:

- (i) Provide a balancing mechanism even out the demand for and supply of short-term funds.
- (ii) Provide a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy.
- (iii) Provide reasonable access to suppliers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price.

Besides the above functions, a well-functioning money market facilitates the development of a market for longer term securities. The interest rates for extremely short-term use of money serve as a benchmark for longer-term financial instruments.

#### **Benefits of an Efficient Money Market**

An efficient money market benefits a number of players. It provides a stable source of funds to banks in addition to deposits, allowing alternative financing structures and competition. It allows banks to manage risks arising from interest rate fluctuations and to manage the maturity structure of their assets and liabilities.

A developed interbank market provides the basis for growth and liquidity in the money market including the secondary market for commercial paper and treasury bills. An efficient money market encourages the development of non-bank intermediaries, thus increasing the competition



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for funds. Savers get a wide array of savings instruments to choose from and invest their savings. The money market provides an effective source of long-term finance to borrowers. Large borrowers can lower the cost of raising funds and manage short-term funding or surplus efficiently,

A liquid and vibrant money market is necessary for the development of a capital market, foreign exchange market, and market in derivative instruments. The money market supports the long-term debt market by increasing the liquidity of securities. The existence of an efficient money market is a precondition for the development of a government securities market and a forward foreign exchange market. Trading in forwards, swaps, and futures is also supported by a liquid money market as the certainty of prompt cash settlement is essential for such transactions. The government can achieve better pricing on its debt as it provides access to a wide range of buyers. It facilitates the government market borrowing programme. Monetary control through indirect methods (repos and open market operations) is more effective if the money market is liquid. In such a market, the market responses to the central bank's policy actions are both faster and less subject to distortion.

### **The Indian Money Market**

The average turnover of the money market in India is over Rs 40,000 crore daily. This is more than 3 per cent of the total money supply in the Indian economy and 6 per cent of the total funds that commercial banks have let out to the system. This implies that 2 per cent of the annual GDP of India gets traded in the money market in just one day. Even though the money market is many times larger than the capital market, it is not even a fraction of the daily trading in developed markets.

**Role of the Reserve Bank of India in the Money Market** The Reserve Bank of India is the most important constituent of the money market. The market comes within the direct purview of the Reserve Bank regulations.

The aims of the Reserve Bank's operations in the money market are:

- (i) to ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability;
- (ii) to ensure an adequate flow of credit to the productive sectors of the economy; and
- (iii) to bring about order in the foreign exchange market.

The Reserve Bank influences liquidity and interest rates through a number of operating instruments: cash reserve requirement (CRR) of banks, conduct of open market operations (OMOS), repos, change in bank rates and, at times, foreign exchange swap operations.

### **Steps to Develop the Money Market in India**

The money market in India is divided into the formal (organised) and informal (unorganised) segments. One of the greatest achievements of the Indian financial system over the last fifty years has been the decline in the relative importance of the informal segment and increasing presence and influence of the formal segment. Several steps were taken in the 1980s and 1990s to reform and develop the money market. The reforms in the money market were initiated in the latter half of the 1980s.

**In the 1980s** A committee to review the working of the monetary system under the chairmanship of Sakhamoy Chakravorty was set up in 1985. It underlined the need to develop money market instruments. As a follow up, the Reserve Bank set up a working group on the money market under the chairmanship of N Vagal which submitted its report in 1987. This committee laid the blueprint for the institution of a money market. Based on its recommendations the Reserve Bank initiated a number of measures:



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- 1.. The Discount and Finance House of India (DFHI) was set up as a money market institution jointly by the Reserve Bank, public sector banks, and financial institutions in 1988 to impart liquidity to money market instruments and help the development of a secondary market in such instruments
- (ii) Money market instruments such as the 182-day treasury bill, certificate of deposit, and interbank participation certificate were introduced in 1988-89. Commercial paper was introduced in January 1990
- 1.. To enable price discovery, the interest rate ceiling on call money was freed in stages from October 1988. As a first step, operations of the DFHI in the call/notice money market were freed from the interest rate ceiling in 1988. Interest rate ceilings on interbank term money (10.5-11.5 per cent), rediscounting of commercial bills (12.5 per cent), and interbank participation without risk (12.5 per cent) were withdrawn effective May 1989. All the money market interest rates are, by and large, determined by market forces. There has been a gradual shift from a regime of administered interest rates to market-based interest rates

**In the 1990s** The government set up a high-level committee in August 1991 under the chairmanship of M Narasimham (Narasimham Committee) to examine all aspects relating to structure, organisation, functions, and procedures of the financial system. The committee made several recommendations for the development of the money market. The Reserve Bank accepted many of its recommendations.

- 1.. The Securities Trading Corporation of India was set up in June 1994 to provide an active secondary market in 13-avoured securities and public sector bonds.
- (ii) Barriers to entry were gradually eased by (a) setting up the primary dealer system in 1995 and satellite dealer system in 1999 to inject liquidity in the market; (b) relaxing issuance restrictions and subscription norms in respect of money market instruments; (c) allowing the determination of yields based on the demand and supply of such paper; (d) enabling market evaluation of associated risks by withdrawing regulatory restrictions such as bank guarantees in respect of commercial papers; and (e) increasing the number of participants by allowing the entry of foreign institutional investors (FII), non-bank financial institutions, mutual funds, and so on.
- 1.. Several financial innovations in instruments and methods were introduced. Treasury bills of varying maturities and RBI repos were introduced. Auctioned treasury bills were introduced leading to market-determined interest rates.
- (iv) The development of a market for short-term funds at market-determined rates has been fostered by a gradual switch from a cash-credit system to a loan-based system, shifting the onus of cash management from banks to borrowers.
- 1.. Ad hoc and on-tap 91-day treasury bills were discontinued. They were replaced by Ways and Means Advances (WMA) linked to the bank rate. The introduction of WMA led to the limiting of the almost total funding of the government.
- (vi) Indirect monetary control instruments such as the bank rate-reactivated in April 1997, strategy of combining auctions, private placements, and open market operations-in 1998-99, and the liquidity adjustment facility (LAF)-in June 2000 were introduced.
- 1.. The minimum lock-in period for money market instruments was brought down to 15 days, (viii) The Reserve Bank started repos both on auction and fixed interest rate basis for liquidity management. Since June 5, 2000, the newly introduced liquidity adjustment facility has been effectively used to influence short-term rates





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by modulating day-to-day liquidity conditions. The transition to LAF was facilitated by the experiment with the Interim Liquidity Adjustment Facility (ILAF) from April 1999. This provided a mechanism for liquidity management through a combination of repos, export credit (ix) The interbank liabilities were exempted from cash reserve ratio and statutory liquidity ratio (SLR) refinance, and collateralised lending facilities. Stipulations for facilitating the development of a term money market.

### **Money Market Centres**

There are money market centres in India at Mumbai, Delhi, and Kolkata. Mumbai is the only active money market centre in India with money flowing in from all parts of the country getting transacted there.

### **Money Market Instruments**

The instruments traded in the Indian money market are

- (i) Treasury bills (T-bills)
- (ii) Call/notice money market–Call (overnight) and short notice (up to 14 days)
- (iii) Commercial paper (CP)
- (iv) (iv) Certificates of deposit (CD)
- (v) Commercial bills (CB)

Call/notice money market and treasury bills form the most important segments of the Indian money market. Treasury bills, call money market, and certificates of deposit provide liquidity for government and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries

### **4.2 TREASURY BILLS**

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

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

Features of T-bills

- (i) They are negotiable securities.
- (ii) They are highly liquid as they are of shorter tenure and there is a possibility of an interbank repos in them.
- (iii) There is absence of default risk.
- (iv) They have an assured yield, low transaction cost, and are eligible for inclusion in the securities for SLR purposes.
- (v) They are not issued in scrip form. The purchases and sales are effected through the Subsidiary General Ledger (SGL) account.
- (vi) At present, there are 91-day and 364-day T-bills in vogue. The 91-day T-bills are auctioned by RBI every Friday and the 364-day T-bills every alternate Wednesday that is, the Wednesday preceding the reporting Friday.
- (vii) Treasury bills are available for a minimum amount of Rs 25,000 and in multiples thereof.





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### **TYPES OF T-BILLS**

There are three categories of T-bills.

- (i) **On-tap bills:** On-tap bills, as the name suggests, could be bought from the Reserve Bank at any time at an interest yield of 4.663 per cent. They were discontinued from April 1, 1997, as they had lost much of their relevance.
- (ii) **Ad hoc bills:** Ad hoc bills were introduced in 1955. It was decided between the Reserve Bank and the government of India that the government could maintain with the Reserve Bank a cash balance of not less than Rs 50 crore on Fridays and Rs 4 crore on other days, free of obligation to pay interest thereon. And whenever the balance fell below the minimum, the government account would be replenished by the creation of ad hoc bills in favour of the Reserve Bank. Ad hoc 91-day T-bills were created to replenish the government's cash balances with the Reserve Bank. They were just an accounting measure in the Reserve Bank's books and, in effect, resulted in automatic 15avour15y1515ng of the government's budget deficit. A 15avour15y15 deficit is the increase in the net Reserve Bank credit to the central government which is the sum of the increase in the Reserve Bank's holdings of: (a) the government of India's dated securities; (b) 91-day treasury bills, and (c) rupee coins for changes in cash balances with the Reserve Bank.

In the 1970s and 1980s, a large proportion of outstanding ad hocs were converted into long-term dated and undated securities of the government of India. This conversion is referred as "funding" Their expansion put a constraint on the Reserve Bank conduct of monetary policy and hence they were discontinued from April 1, 1997. The outstanding ad hoc T-bills and tap bills as on March 31, 1997. Were funded on April 1, 1997, into special securities without any specified maturity at an interest rate of 4.6 per cent per annum. A system of Ways and Means Advances from April 1. 1997, was introduced to replace ad hoc bills and to accommodate temporary mismatches in the government of India receipts and payments,

- 1.. **Auctioned T-bills:** Auctioned T-bills, the most active money market instrument, were first introduced in April 1992. The Reserve Bank receives bids in an auction from various participants and issues the bills subject to some cut-off limits. Thus, theyield of this instrument is market determined. These bills are neither rated nor can they be rediscounted with the Reserve Bank. At present, the Reserve Bank issues T- bills of two maturities-91-days and 364-days.

### **Importance of T-Bills**

The development of T-bills is at the heart of the growth of the money market. T-bills play a vital role in the cash management of the government. Being risk free, their yields at varied maturitics serve as short-term benchmarks and help in pricing different floating rate products in the market. The T-bills market is the preferred central bank tool for market intervention to influence liquidity and short-term interest rates. The development of the T-bills market is a pre- condition for effective open market operations.

### **Development of T-Bills Market**

Ad hoc 91-day treasury bills were introduced in the mid-1950s. These bills were introduced to replenish on an automatic basis, the central government's cash balance with the Reserve Bank so that only the minimum required level was maintained. These bills opened up an era of



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uncontrolled monetisation of the central government's deficit. Before the 1960s, there was an active T-bills market owing to the weekly auctions of the 91-day T-bills.

In the mid-1960s, the auction system for the issue of 91-day T-bills was replaced by on-tap bills. Till 1974, the tap bills rate changed with changes in the bank rate which sustained the interest of the participants in the T-bills market.

However, after 1974, the discount rate on ad hoc and tap bills was fixed uniformly at 4.6 per cent. The T-bills market lost lustre due to the administered rate regime. However, the interest in T-bills revived with the introduction of the 182-day T-bills on auction basis in November 1986. It also revived because of the constitution of the Discount and Finance House of India in 1988 as a money market institution.

The 182-day T-bills were discontinued in 1992 and replaced by 364-day auction T-bills in April 1992 as part of reform measures. Subsequently, the 91-day auction T-bills were introduced in January 1993. The parallel existence of the 91-day tap T-bills and ad hoc T-bills continued till March 1997.

Thereafter, the 14-day intermediate T-bills and auction T-bills were introduced in April 1997 to provide an alternative avenue to state 16avour16y1616n and to facilitate some foreign central banks to invest surplus funds.

The 182-day T-bills were reintroduced to provide variety in treasury bills. However, both the 182-and 14-day T-bills have been discontinued since March 2001.

The Reserve Bank's purchase and holding of T-bills have become totally voluntary with the discontinuation of ad hoc and on-tap 91-day T-bills. Before the introduction of the auctioned T-bills, a substantial majority of the T-bills used to be held by the Reserve Bank. With the introduction of auctioned T-bills, more than 25 per cent of T-bills are held by investors other than the Reserve Bank. The auction procedures have been streamlined with notified amounts for all auctions being specified in case of competitive bids and non-competitive bids being accepted outside the notified amount. A uniform price-based auction for 91-day T-bills was introduced on an experimental basis in 1998-99. It has been successfully adopted.

#### **4.4 CALL/NOTICE MONEY MARKET**

##### **Introduction**

It is by far the most visible market as the day-to-day surplus funds, mostly of banks, are traded there. The call money market accounts for the major part of the total turnover of the money market. It is a key segment of the Indian money market. Since its inception in 1955-56, the call money market has registered a tremendous growth in volume of activity.

The call money market is a market for very short-term funds repayable on demand and with a maturity period varying between one day to a fortnight. When money is borrowed or lent for a day, it is known as call (overnight) money. Intervening holidays and/or Sundays are excluded for this purpose. When money is borrowed or lent for more than a day and upto 14 days, it is known as notice money. No collateral security is required to cover these transactions. The call money market is a highly liquid market, with the liquidity being exceeded only by cash. It is highly risky and extremely volatile as well.

##### **Why Call Money**

Call Money is required mostly by banks. Commercial banks borrow money from other banks to maintain a cash balance known as cash reserve requirement. This interbank borrowing has led to the development of the call money market.

CRR is an important requirement to be met by all commercial banks. The Reserve Bank stipulates this requirement from time to time. The CRR is a technique for monetary control



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effected by the Reserve Bank for achieving specific macro-economic objective/s such as maintaining desired levels of inflation, growth, exchange and so on. CRR refers to the cash that banks have to maintain with the Reserve Bank as a certain percentage of their total demand and time liabilities (DTL). The CRR, a primary instrument of monetary policy, has been brought down from 15 per cent in March 1991 to 4.75 per cent in October 2002.

Prior to May 2000, banks were required to maintain 85 per cent of their fortnightly reserve requirement on a daily basis. The networking among various branches of banks was not developed enough for the branches to report their respective net demand and time liabilities (NDTL) positions to the main branch on the first day of the fortnight itself. The NDTL of a bank is the sum of its liabilities to the banking system and its liabilities to the public.

With a view to providing further flexibility to banks and enabling them to choose an optimum strategy of holding reserves depending upon their intra-period cash flows, several measures were undertaken recently. In November 1999, a lagged reserve maintenance system was introduced under which banks were allowed to maintain reserve requirements on the basis of the last Friday of the second (instead of the first) preceding fortnight. From May 6, 2000, the requirement of minimum 85 per cent of the CRR balance on the first 13 days was maintained on a daily basis was reduced to 65 per cent. With effect from August 11, 2000, this was reduced to 50 per cent for the first seven days of the reporting fortnight while maintaining the minimum 65 per cent for the remaining seven days including the reporting Friday. The daily minimum CRR was reduced to enable the smooth adjustment of liquidity between surplus and deficit segments and better cash management to avoid sudden increase in overnight call rates:

Hence, once every fortnight on a reporting Friday, banks have to satisfy reserve requirements which often entails borrowing in the call/notice money market. It is a market in which banks trade positions to maintain cash reserves. It is basically an over the counter (OTC) market without the intermediation of brokers. Inter-bank trading accounts for more than 80 per cent of total transactions.

### **Participants in the Call Money Market**

The call money market was predominantly an inter-bank market till 1971 when UTI and LIC were allowed to operate as lenders. Until March 1978, brokers were also allowed to participate in the call money market who would effect transactions between lenders and borrowers for a brokerage. In the 1990s, the participation was gradually widened to include DFHI, STCI, GIC, NABARD, IDBI, money market mutual funds, and private sector mutual funds as lenders in this market.

The participants in the call money market as both lenders and borrowers are scheduled and non-scheduled commercial banks, foreign banks, state, district and urban cooperative banks, and DFHI. Other borrowing participants are the brokers and dealers in securities/bullion/bills market, and sometimes individuals of high financial status.

In 1996-97, the Reserve Bank permitted primary dealers to participate in this market as both borrowers and lenders. Entities that could provide evidence of surplus funds have been permitted to route their lending through primary dealers. The minimum size of operations for routing transactions has been reduced from Rs 20 crore to Rs 3 crore, with effect from May 9, 1998.

### **Role of the Reserve Bank in the Call Money Market**

The Reserve Bank intervenes in the call money market indirectly in two ways

- 1.. by providing lines of finance/additional funding to the DFHI and other call money dealers; and



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(ii) by conducting repo auctions.

Additional funding is provided through reverse repo auctions which increases liquidity in the market and brings down call money rates.

The Reserve Bank's repo auctions absorb excess liquidity in the economy and push up depressed call rates.

The Reserve Bank's intervention is necessary as there is a close linkage between the call money market and other segments of the money market and the foreign exchange market.

#### **Link Between Call Money Market and Other Financial Markets**

There is an inverse relationship between call rates and short-term money market instruments such as certificates of deposit and commercial paper. When call rates peak to a high level, banks raise more funds through certificates of deposit. When call money rates are lower, many banks fund commercial paper by borrowing from the call money market and earn profits through between money market segments.

A large issue of government securities also affects call money rates. When banks subscribe to large issues of government securities, liquidity is sucked out from the banking system. This increases the demand for funds in the call money market which pushes up call money rates. Similarly, a rise in the CRR or in the repo rate absorbs excess liquidity and call rates move up.

The call money market and the foreign exchange market are also closely linked as there exist arbitrage opportunities between the two markets. When call rates rise, banks borrow dollars from their overseas branches, swap them for rupees, and lend them in the call money market. At the same time, they buy dollars forward in anticipation of their repayment liability. This pushes forward the premia on the rupee-dollar exchange rate. It happens many a times that banks fund foreign currency positions by withdrawing from the call money market. This hikes the call money rates

#### **4.5(A) MONEY MARKET INTERMEDIARIES**

##### **The Discount and Finance House of India**

The DFHI was set up in April 1988 by the Reserve Bank with the objective of deepening and activating the money market. It commenced its operations from July 28, 1988.

It is a joint stock company in form and is jointly owned by the Reserve Bank, public sector banks and all India financial institutions which have contributed to its paid-up capital of Rs 200 crore in the proportion of 5-3-2. In addition, refinance facility with the Reserve Bank and credit of Rs 100 crore from 28 public sector banks on a consortium basis are the sources of its funds.

The role of the DFHI is to function as a specialized money market intermediary for stimulating activity in money market instruments and develop secondary market in these instruments. It also undertakes short term buy-back operations in the government and approved dated securities. DFHI mobilises funds/resources from commercial/cooperative banks, financial institutions, and corporate entities having resources to lend (which individually may not represent tradable volumes in wholesale market) which are pooled and lent in the money market. The two-way regular quotes in money market instruments provided by DFHI serve as a base to broaden the secondary market and give an assured liquidity to the instruments

DFHI was categorised as an eligible institution under the relevant of the RBI Act, 1934, in November 1989 so that the placement of funds with DFHI can be included as an asset with the banking system for netting purposes while calculating the net demand and time liabilities





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for reserve purposes. DFHI is also an authorised institution to undertake repo transactions in treasury bills and all dated government securities to impart greater liquidity to these instruments.

Since November 13, 1995, DFHI is an accredited primary dealer. With this accreditation, its role has undergone a transformation. Now it acts as a market maker, giving two-way quotes and takes large position on its account in government securities.

The DFHI deals in treasury bills, commercial bills, certificates of deposits, commercial paper, short term deposits, call/notice money market and government securities. The presence of the DFHI as intermediacy in the money market has helped the corporate entities, banks, and financial institutions to raise short-term money and invest short-term surpluses. The DFHI also extends repos, that is, buy-back facility upto 14 days, to banks and financial institutions in respect of money market. The cumulative turnover in each of these instruments is shown in Table 4:17.

The cumulative turnover of the DFHI in all financial transactions increased four-fold in a span of nine years. The major part of the turnover was in call money followed by government dated securities and treasury bills. Its business in CDs and CPs was negligible and business in commercial bills declined sharply in the 1990s. Its dealings in government securities exceeded those in treasury bills after being accredited as a primary dealer.

The DFHI has been concentrating on the call money market rather than activating other money market instruments like CPs, CDs and CBs. These instruments need to be developed further for activating and deepening the money market.

#### **4.5(B) MONEY MARKET MUTUAL FUNDS**

Money Market Mutual Funds (MMMFs) were introduced in April 1991 to provide an additional short-term avenue for investment and bring money market investment within the reach of individuals. These mutual funds would invest exclusively in money market instruments.

MMMFs bridge the gap between small individual investors and the money market. MMMF mobilises savings from small investors and invests them in short-term debt instruments or money market instruments.

A Task Force was constituted to examine the broad framework outlined in April 1991 and consider the implications of the scheme. Based on the recommendations of the Task Force, a detailed scheme of MMMF was announced by the Reserve Bank in April 1992.

The MMMFs portfolio consists of short-term money market instruments. An investor investing in MMMF gets a yield close to short-term money market rates coupled with adequate liquidity.

The Reserve Bank has been making several modifications to the scheme since 1995-96 to make it more flexible and attractive to a larger investor base such as banks, financial institutions, and besides individuals. Modifications such as the removal of ceiling for raising resources, allowing the private sector to set up MMMFs, permission to MMMFs to invest in rated corporate bonds and debentures, reduction in the minimum lock-in period to 15 days, and so on are steps towards making the MMMFs scheme attractive.

MMMFs were allowed to offer a 'cheque writing facility in a tie up with banks to provide more liquidity to unit holders.

Earlier, MMMFs could be set up either in the form of a money market deposit account (MMDA) or as a separate entity. Now, all MMMFs have to be set up as separate entities only in the form of a "Trust."



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The growth in MMMFs has been less than expected. Though, in principle, approvals were granted to 10 entities, only three MMMFs have been set up-one in the private sector Kothari Pioneer Mutual Fund, and the other two by IDBI and UTI. The total size of these funds is not very large.

The MMMFs, earlier under the purview of the Reserve Bank, come under the purview of regulation since March 7, 2000

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## **CAPITAL MARKET**

### **5.1 INTRODUCTION**

The capital market is an important constituent of the financial system. It is a market for long-term funds both equity and debt and funds raised within and outside the country.

The capital market aids economic growth by mobilising the savings of the economic sectors and directing the same towards channels of productive uses. This is facilitated through the following measures.

1.. Issue of primary securities in the primary market', that is, directing cash flow from the surplus sector to the deficit sectors such as the government and the corporate sector.

(ii) Issue of "secondary securities in the primary market, that is, directing cash flow from the surplus sector to financial intermediaries such as banking and non-banking financial institutions.

1.. 'Secondary market' transactions in outstanding securities which facilitate liquidity. The liquidity of the stock market is an important factor affecting growth. Many profitable projects require long-term finance and investment which means locking up funds for a long period. Investors do not like to relinquish control over their savings for a long time. Hence, they are reluctant to invest in long-gestation projects. It is the presence of the liquid secondary market that attracts investors because it ensures a quick exit without heavy losses or costs.

Hence, the development of an efficient capital market is necessary for creating a climate conducive to investment and economic growth.

### **Functions of a Capital Market**

The functions of an efficient capital market are as follows.

- 1.. Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular financial asset.
- (ii) Enable quick valuation of financial instruments both equity and debt.
- 1.. Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund
- (iv) Enable wider participation by enhancing the width of the market by encouraging participation through networking institutions and associating individuals.
- (v) Provide operational efficiency through
  - (a) simplified transaction procedure,
  - (b) lowering settlement timings, and
  - (c) lowering transaction costs
- (vi) Develop migration
  - (a) real sector and financial sector,
  - (b) equity and debt instruments,
  - (c) long-term and short-term funds,
  - (d) long-term and short-term interest costs,
  - (e) private sector and government sector, and
  - (f) domestic funds and external funds.



- (vi) Direct the flow of funds into efficient channels through investment, disinvestment, and reinvestment

### **Primary Capital Market and Secondary Capital Market**

The capital market comprises the primary capital market and the secondary capital market.

**Primary Market** Primary market refers to the long-term flow of funds from the surplus sector to the and corporate sector (through primary issues) and to banks and non-bank financial intermediaries (through secondary issues). Primary issues of the corporate sector lead to capital formation (creation of net fixed assets and incremental change in inventories).

The nature of fund-raising is as follows,

#### **Domestic**

Equity issues by

- Corporates (primary issues)
- Financial intermediaries (secondary issues)

Debt instruments by

- Government (primary issues)
- Corporates (primary issues)
- Financial intermediaries (secondary issues)

#### **External**

Equity issues through issue of

- Global Depository Receipts (GDR) and American Depository Receipts (ADR)

Debt instruments through

- External Commercial Borrowings (ECB)

#### **Other External Borrowings**

Foreign Direct Investments (FDI)

- in equity and debt form.

Foreign Institutional Investments (FIT)

- in the form of portfolio investments.

Non-Resident Indian Deposits (NRI)

- in the form of short-term and medium-term deposits.

The fund raising in the primary market can be classified as follows.

- 1.. Public issue by prospectus
- (ii) Private placement
  - 1.. Rights issues

**Secondary Market** Secondary market is a market for outstanding securities. An equity instrument, being an eternal fund, provides an all-time market while a debt instrument, with a defined maturity period, is traded at the secondary market till maturity. Unlike primary issues in the primary market which result in capital formation, the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments. The secondary market contributes to economic growth by 22avour22y2222ng funds into the most efficient channel through the process of disinvestment to reinvestment. The secondary market also provides instant valuation of securities (equity and debt instruments) made possible by changes in the internal environment, that is, through companywide and industrywide factors. Such a valuation



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facilitates the measurement of the cost of capital and rate of return of economic entities at the micro level.

The Indian secondary market can be segregated into two.

- (i) Secondary market for government securities and public sector undertaking bonds. For trading in issues of government securities and public sector undertakings, there are

- (a) recognised stock exchanges.
- (b) National Stock Exchange of India Limited (NSE),
- (c) Over the Counter Exchange of India (OTCEI), and
- (d) Interconnected Stock Exchange of India (ISE).

The participants in this market are registered brokers both individuals and institutions. They operate through a network of sub-brokers and sub-dealers and are connected through an electronic networking system.

- 1.. Secondary market for government securities and public sector undertaking bonds. The trading in government securities is basically divided into short-term money market instruments such as treasury bills and long-term government bonds ranging in maturity from 5-20 years. The main participants in the secondary market for government securities are primary dealers, banks, financial institutions, mutual funds, and others. The secondary market transactions in government securities are conducted through the Subsidiary General Ledger (SGL) since September 1994. Both the government securities and public sector undertaking bonds are now traded in the Wholesale Debt Market (WDM) segment of the National Stock Exchange, Bombay Stock Exchange (BSE), and Over the Counter Exchange of India.

## **5.2 HISTORY OF THE INDIAN CAPITAL MARKET**

The history of the capital market in India dates back to the eighteenth century when East India Company. Securities were traded in the country, Until the end of the nineteenth century, securities trading was unorganised and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860-61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for a half a decade. The bubble burst on July 1, 1865, when there was tremendous slump in share prices.

The capital market was not well organised and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market. In the post-independence period also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. The public sector undertakings were healthier than the private undertakings in as much as paid up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades. In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as Seta Baraar.



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Despite speculation, non-payment or defaults were not very frequent. The government enacted Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 also enacted. The decade of the 1950s was also characterised by the establishment of a network for the development of financial institutions and state financial corporations.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterised by a new liberalisation policy, emergence of SEBI as a regulator of capital market, advent of foreign institutional investors, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to an erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

#### **A brief history of the rise of equity trading in India**

**July 9, 1875:** Native brokers form the Native Share and Stock Brokers' Association in Bombay. Membership fee is Re. 1. The association has 318 members.

**1899:** Bombay Stock Exchange acquires own premises.

**1921:** Clearing houses are established for settlement of trades as volumes increase.

**1923:** KR P Shroff becomes the honorary president of BSE. **1925:** Bombay Securities Contract Control Act (BSCCA) comes into force. **December 1, 1939:** Stock exchange building is acquired.

**1943:** Forward trading banned till 1946. Only ready to deliver and hand delivery contracts permitted. **1956:** Securities Contract Regulation Act drafted on the lines of BSCCA comes into force. **1957:** BSE becomes the first exchange in India to get permanent recognition. **1964:** Unit Trust of India (UTI) is born.

**April 1, 1966:** KR P Shroff retires and Phiroze J Jeejeebhoy becomes chairman.

**June 29, 1969:** Morarji Desai bans forward trading.

**1973:** Construction of PI Towers, named after late Phiroze Jamshedji Jeejeebhoy, starts.

**January 2, 1986:** BSE Sensex launched as the first stock market index with 1978-79 as the base year. **November 1987:** SBI Mutual Fund launches Magnum Regular Income Scheme.

**April 1988:** Securities and Exchange Board of India (SEBI) set up.

**January 1992:** SEBI given statutory powers.

**May 1992:** Harshad Mehta securities scam breaks.

**May 27, 1992:** Reliance is the first Indian company to make a GDR issue.

**May 30, 1992:** The Capital Issues Control Act, 1947 is repealed.

**September 1992:** Foreign institutional investors are permitted to invest in the Indian securities market.

**November 1992:** Finance Minister Manmohan Singh inaugurates Over the Counter Exchange of India.

**October 30, 1993:** The first private sector mutual fund, Kothari Pioneer Mutual Fund, begins operations.





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**1993:** SEBI bans badla trading on BSE

**June 1994:** NSE commences operations in wholesale debt market segment. **November 1994:** The capital market segment INSE goes on stream. Trading is screen based for the first time in India

**March 1995:** BSE on line trading system (BOLT) replaces open outcry system. April 1995: The National Securities Clearing Corporation Limited, India's first clearing corporation is set up.

**October 1995:** NSE overtakes BSE as the largest stock exchange in terms of volume of trading

**April 1996:** Nifty is born. The National Securities Clearing Corporation Limited commences operations.

**November 1996:** The National Securities Depository Limited is created.

**May 1997:** BSE introduces screen based trading.

**February 1997:** SEBI releases norms for takeovers and acquisitions.

**November 1998:** SEBI recognises Interconnected Stock Exchange founded by 15 regional stock exchanges. This exchange starts functioning in February 1999

**February 1998.:** Launch of automated lending and borrowing mechanism (ALBM) on NSE.

**March 11, 1999:** Infosys Technologies is the first company to be listed on NASDAQ through a public offering of American Depository Receipts.

**March 22, 1999:** Central Depository Services (India) promoted by BSE commences operations.

**September 1999:** ICICI is the first Indian company to be listed on the New York Stock Exchange (NYSE)

**October 11, 1999:** For the first time in BSE's history, the Sensex closes above the 5,000 mark at 5,031.78.

**January 2000:** BSE creates a Z' category of scrips in addition to A, B1, and B2 comprising scrips that breached or failed to comply with the listing agreement.

**February 2000:** Internet trading commences on NSE On February 14, 2000, BSE sensex hits all-time high of 6.150. On February 21, NSE records peak market capitalisation of Rs 11,94,282 crore.

**April 10, 2000:** The Sensex is revamped to include Dr. Reddy's Lab. Reliance Petroleum, Satyam Computers and Zee Telefilms replacing Indian Hotels, Tata Chemicals, Tata Power, and IDBI.

**June 2000:** BSE and NSE introduce derivatives trading in the form of index futures.

**July 9, 2000:** BSE turns 125. October 19, 2000: Wipro lists on the NYSE.

**January 22, 2001:** Borrowing and Lending Securities Scheme (BLESS) launched on BSE to promote securities lending and borrowing activities.

**March 2001:** Ketan Parekh scam breaks. SEBI suspends all the broker directors of the BSE in relation to the KP scam.

**May 2001:** BSE advises compulsory demat for B2 scrips.

**June 2001:** Index options start trading on NSE.



## SEBI Meaning

- SEBI full form is Securities and Exchange Board of India
- SEBI is a statutory regulatory body established by the Government of India to regulate the securities market in India and protect the interests of investors in securities.
- It also regulates the functioning of the stock market, mutual funds, etc.

## What is SEBI and its functions?

The Securities and Exchange Board of India (Sebi) is a statutory regulatory body established by the Government of India in 1992 to regulate the securities market in India and protect the interests of investors in securities.

SEBI has the power to regulate and perform functions such as check the books of accounts of stock exchanges and call for periodical returns, approve by-laws of stock exchanges, inspect the books of financial intermediaries such as banks, compel certain companies to get listed on one or more stock exchanges, and handle the registration of brokers.

## Why is SEBI formed?

### Purpose of SEBI

SEBI was established to keep a check on unfair and malpractices and protect the investors from such malpractices. The organization was created to meet the requirements of the following three groups:

- Issuers: SEBI works toward providing a marketplace to the investors where they can efficiently and fairly raise their funds.
- Intermediaries: SEBI works towards providing a professional and competitive market to the intermediaries
- Investors: SEBI protects and supplies accurate information to investors.

## Objectives of SEBI

The fundamental objective of SEBI is to safeguard the interest of all the parties involved in trading. It also regulates the functioning of the stock market. SEBI's objectives are:

- To monitor the activities of the stock exchange.
- To safeguard the rights of the investors
- To curb fraudulent practices by maintaining a balance between statutory regulations and self-regulation.
- To define the code of conduct for the brokers, underwriters, and other intermediaries.

## Powers of SEBI

SEBI carries out the following tasks to meet its objectives: Protective functions, Regulatory functions, and developmental functions.

Functions that SEBI performs as a part of its **protective functions** are:

- It checks price manipulation
- It bans Insider trading
- It prohibits unfair and fraudulent trade practices
- It promotes a fair code of conduct in the security market
- It takes efforts to educate the investors regarding ways to evaluate the investment options better

As a part of its **regulatory functions**, SEBI performs the following role:





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- It has designed a code of conduct, rules, and regulations to regulate the brokers, underwriters, and other intermediaries.
- SEBI also governs a company's takeover.
- It regulates and registers the workings of share transfer agents, stockbrokers, merchant bankers, trustees, and others who are linked with the stock exchange.
- It regulates and registers the mutual funds as well.
- It conducts audits and inquiries of stock exchanges.

As a part of its **developmental functions**, SEBI performs the following role:

- It facilitates the training of the intermediaries.
- It aims at promoting activities of the stock exchange by having an adoptable and flexible approach.

### Structure of SEBI

The Board of SEBI comprises of nine members. The Board is an aggregate of the following:

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

The Chairman of SEBI, in addition to overseeing the Board, also looks over the Communications, Vigilance, and Internal Inspection Department.

There are four whole-time members in the organizational structure. The whole-time members are allocated a number of departments that they have to oversee. Each department is individually headed by an executive director. The executive directors report to specific whole-time members.

The organizational structure of SEBI consists of more than 25 departments, such as Foreign Portfolio Investors and Custodians (FPI&C), Corporation Finance Department (CFD), Information Technology Department (ITD), Department of Economic and Policy Analysis (DEPA-I,II, & III), Investment Management Department, Legal Affair Department, Treasury and Accounts Divisions (T&A), and National Institute of Securities Market (NISM)

### SEBI Act and SEBI Guidelines

SEBI was established as a non-statutory body in 1988, entrusted with observing the stock market activities. The SEBI Act of 1992 converted SEBI into a statutory authority with autonomous powers. The Act provided SEBI with the authority to regulate capital markets, not just observe but enforce guidelines.

The SEBI Act 1992 covers the following areas:

- Composition and actions of the SEBI Board members
- Powers and Functions of the Board
- Fund sources of SEBI, as in grants made available by the Union Government
- Rules on Penalties and legal pathways
- Defines the judicial authority of SEBI
- The extent of powers of the Union Government to supersede SEBI

SEBI also has to adhere to a list of SEBI guidelines, pertaining to areas such as:



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- Employee Stock Option schemes
- Disclosure and Investor Protection norms
- Legal Proceedings
- Anti-money laundering norms
- Listing and delisting of securities
- Opening of trading terminals overseas

## SEBI LODR regulations 2015

Listing Obligations and Disclosure Requirements (LODR) regulations for SEBI form one of the most important mandates. The regulation covers the extent of transparency and disclosures that listed companies have to abide by. In addition to the compulsory disclosure norms, the regulation also refines the listing agreement, which has to be entered between the stock exchange and the companies being listed.

The agreement consists of terms and conditions on governance, disclosures, and terms to maintain the listing status of the company. However, the new regulation in 2015 on LODR intends to consolidate all the previous amendments into one single document, making the document uniform across different segments of the capital market.

The SEBI (LODR) Regulations, 2015 entails the following:

- Disclosures and obligations that have to be acknowledged by the compliance officers of the listed company
- Listing down obligations uniform to all listed companies
- Distinct obligations for certain types of securities
- Segregating initial issuance and post-IPO norms
- Communication of the companies' fundraising activities
- Establishing timelines for notifying the exchanges of certain events
- Bringing SMEs under the ambit of the SEBI (LODR) Regulations

For a complete list of regulations that govern the market regulator, click [here](#).

## SEBI New Margin Rules

In September 2020, SEBI implemented new rules on margin pledge. The rule is expected to bring transparency and prevent misuse of clients' securities by brokerage firms. The new margin rules were directed to come into effect from June 1, but were delayed due to pandemic pushing the implementation date to September 1.

The new margin rules by SEBI mandate the following:

- The stock, being pledged, is to remain in the investor's de-mat account. As the stock is not changing accounts, the benefits from corporate events accrue directly to the investors
- Upfront collection of margins by brokers for any purchase or sale of securities, penalizing any sort of failure to do so. Clients could meet the margin requirements by the end of the day, which is now changed to the beginning of the day
- Power of Attorney (POA) cannot be assigned in the favour of the brokers for pledging. As under the old system, brokers could demand POA from the investors to execute decisions on their behalf



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- Margin pledge created separately for investors requiring margin
- Buy Today Sell Tomorrow (BTST) not allowed anymore for shares bought on margin. Investors are required to honor the delivery of share (T+2 days is the usual settlement period). Typically, investors would use intraday realized profits to meet the margin requirements, which is now amended by the new regulations. For a BTST trade, it can be initiated only if the net available margin is equal to or greater than 20 percent of the transaction value.

## Mutual Funds

A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates.

Mutual funds are a popular choice among investors because they generally offer the following features:

- Professional Management. The fund managers do the research for you. They select the securities and monitor the performance.
- Diversification or "Don't put all your eggs in one basket." Mutual funds typically invest in a range of companies and industries. This helps to lower your risk if one company fails.
- Affordability. Most mutual funds set a relatively low dollar amount for initial investment and subsequent purchases.
- Liquidity. Mutual fund investors can easily redeem their shares at any time, for the current net asset value (NAV) plus any redemption fees.

### Importance of mutual funds.

Most mutual funds fall into one of four main categories – money market funds, bond funds, stock funds, and target date funds. Each type has different features, risks, and rewards.

- Money market funds have relatively low risks. By law, they can invest only in certain high-quality, short-term investments issued by U.S. corporations, and federal, state and local governments.
- Bond funds have higher risks than money market funds because they typically aim to produce higher returns. Because there are many different types of bonds, the risks and rewards of bond funds can vary dramatically.
- Stock funds invest in corporate stocks. Not all stock funds are the same. Some examples are:
  - Growth funds focus on stocks that may not pay a regular dividend but have potential for above-average financial gains.
  - Income funds invest in stocks that pay regular dividends.
  - Index funds track a particular market index such as the Standard & Poor's 500 Index.
  - Sector funds specialize in a particular industry segment.
- Target date funds hold a mix of stocks, bonds, and other investments. Over time, the mix gradually shifts according to the fund's strategy. Target date funds, sometimes known as lifecycle funds, are designed for individuals with particular retirement dates in mind.

### Benefits and risks of mutual funds.

Mutual funds offer professional investment management and potential diversification. They also offer three ways to earn money:



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- **Dividend Payments.** A fund may earn income from dividends on stock or interest on bonds. The fund then pays the shareholders nearly all the income, less expenses.
- **Capital Gains Distributions.** The price of the securities in a fund may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, the fund distributes these capital gains, minus any capital losses, to investors.
- **Increased NAV.** If the market value of a fund's portfolio increases, after deducting expenses, then the value of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

All funds carry some level of risk. With mutual funds, you may lose some or all of the money you invest because the securities held by a fund can go down in value. Dividends or interest payments may also change as market conditions change.

A fund's past performance is not as important as you might think because past performance does not predict future returns. But past performance can tell you how volatile or stable a fund has been over a period of time. The more volatile the fund, the higher the investment risk.

**Process to Purchase and sell mutual funds**

Investors buy mutual fund shares from the fund itself or through a broker for the fund, rather than from other investors. The price that investors pay for the mutual fund is the fund's per share net asset value plus any fees charged at the time of purchase, such as sales loads.

Mutual fund shares are "redeemable," meaning investors can sell the shares back to the fund at any time. The fund usually must send you the payment within seven days.

Before buying shares in a mutual fund, read the prospectus carefully. The prospectus contains information about the mutual fund's investment objectives, risks, performance, and expenses. See How to Read a Mutual Fund Prospectus Part 1, Part 2, and Part 3 to learn more about key information in a prospectus.

**Understanding fees**

As with any business, running a mutual fund involves costs. Funds pass along these costs to investors by charging fees and expenses. Fees and expenses vary from fund to fund. A fund with high costs must perform better than a low-cost fund to generate the same returns for you.

Even small differences in fees can mean large differences in returns over time. For example, if you invested \$10,000 in a fund with a 10% annual return, and annual operating expenses of 1.5%, after 20 years you would have roughly \$49,725. If you invested in a fund with the same performance and expenses of 0.5%, after 20 years you would end up with \$60,858.

It takes only minutes to use a mutual fund cost calculator to compute how the costs of different mutual funds add up over time and eat into your returns. See the Mutual Fund Glossary for types of fees.

**Avoiding fraud**

By law, each mutual fund is required to file a prospectus and regular shareholder reports with the SEC. Before you invest, be sure to read the prospectus and the required shareholder reports. Additionally, the investment portfolios of mutual funds are managed by separate entities known as "investment advisers" that are registered with the SEC. Always check that the investment adviser is registered before investing.



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## Regulation of mutual funds in India

The name itself suggests that a '**Mutual fund**' is like an investment channel that helps several investors to combine their resources to purchase stocks, bonds, and other securities for their earnings.

These combined funds which are referred to as **Assets Under Management (AUM)** are then invested in a mutual fund company's manager who has expertise in it. The mutual fund company is called as an **Asset Management Company (AMC)**.

This combined underlying holding of the fund is called the '**portfolio**' and each investor owns some portion of this portfolio and this portion which the person holds is in the form of units.

### History of mutual funds in India

- In India, the industry dealing with mutual funds was established in the year **1963** with the development of the **Unit Trust of India (UTI)** which was an initiative of the Indian government and the Reserve Bank of India.
- The SBI Mutual Fund became the first NON-UTI mutual fund in India in the year 1987.
- The year 1993 heralded a new era in this industry of mutual funds as it was marked by the entry of private companies.
- The SEBI Mutual Fund Regulations came into being in 1996 after the passing of the Securities and Exchange Board of India (SEBI) Act of 1992.
- After this, the Mutual fund companies have extended and grown exponentially with the help of foreign institutions setting companies in India through joint ventures and properties.
- The **Association of Mutual Funds in India (AMFI)**, a non-profit organization, was founded in 1995 as the industry developed. It was formed with the objective of promoting healthy and ethical marketing practices in the mutual fund industry of India.
- SEBI has made the certificate of AMFI mandatory for all those who are engaged in marketing mutual fund products.

### Objective of mutual funds

The objectives of mutual funds are as follows:

- It helps in generating an additional source of income other than the general earnings.
- It helps in financing some of the future needs a person dreams of, such as buying a home, post-retirement plans, education of children and their education, legacy planning, etc.
- It can help in increasing the savings a person possesses.
- It is useful in reducing tax liabilities.
- It helps in protecting your savings from inflation.

A mutual fund is a commercial product that invests in stocks or bonds.

A mutual fund is a pool of investment which is managed professionally for the purpose of purchasing various securities and culminating them into a strong portfolio that will give you attractive returns over and it will be above the risk-free returns which are currently being offered by the market.

If you own a mutual fund then it is like getting a slice of an apple. Just like that the investors get units of the fund which are in proportion to their investments.





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For example, if there is a mutual fund that has total assets of \$5000 and someone invests \$500, he/she will receive 10% units of that fund.

### Mutual funds meaning

- **Mutual Fund** is like a financial vehicle that consists of all the money collected from different investors in securities such as stocks, bonds, and assets.
- It is operated by money managers who allocate the fund's assets and produce income for the fund's investors.
- It gives investors access to diversified portfolios at a low price.
- It is divided into several kinds of categories on the basis of investment objectives, kinds of securities they invest in, and the type of return they are expecting.
- It charges annual fees known as expense ratio or in some cases commissions.

### Regulation of Mutual Funds in India

The term "**regulation**" means a rule or directive made and controlled by an authority.

- Mutual funds are regulated by the **Securities and Exchange Board of India (SEBI)**.
- In 1996, SEBI formulated the Mutual Fund Regulation.
- SEBI is additionally the apex regulator of capital markets and its intermediaries.
- The issuance and trading of capital market instruments also come under the purview of SEBI.
- Along with SEBI, mutual funds are regulated by RBI, Companies Act, Stock exchange, Indian Trust Act and Ministry of Finance.
- RBI acts as a regulator of Sponsors of bank-sponsored mutual funds, especially in the case of funds offering guaranteed returns.
- In order to provide a guaranteed returns scheme, a mutual fund needs to take approval from RBI.
- The Ministry of Finance acts as a supervisor of RBI and SEBI and appellate authority under SEBI regulations.
- Mutual funds can appeal to the Ministry of finance on the SEBI rulings.

### Who regulates mutual funds in India

- Primarily, mutual funds are regulated by the Securities and Exchange Board of India (SEBI).
- A mutual fund should have the approval of RBI in order to provide a guaranteed returns scheme.
- The Ministry of Finance acts as a supervisor of RBI and SEBI and appellate authority under SEBI regulations.
- The Association of Mutual Funds in India (AMFI) has been made to develop this Mutual Fund Industry of India on professional and ethical lines and to enhance and maintain standards in all areas with a view to protect and promote the interests of mutual funds and their unitholders.





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## Advantages of mutual funds

- It offers you professional management. Through mutual funds, investors get access to the professional money managers who have expertise and experience in the field of buying, selling and monitoring investments by the investors.
- It helps you in holding a wide variety of shares at a much lower price than you really could own by yourself. If one investment in the Fund decreases in value that does not mean that the other will also be decreased, it may increase as well. By holding shares in the market you can take advantage of the changing environment in the industry. It helps in diversification.
- It gives opportunities to the small investors to take part in the professional asset management and they can have low investment minimums.
- Most of the mutual funds allow investors to deal with shares on any business day. Many funds provide you with an automatic purchase program. It is according to the convenience of the investors and helps them in gaining the best out of the money invested.

## Mutual fund benefits

There are various benefits of investing in Mutual Funds, such as:

- The higher level of diversification since the basket of a portfolio will be aimed at spreading the investment in order to offer protection against concentration risks.
- They provide regular liquidity as shareholders of open-ended funds and unit investment trusts may sell their holdings back to the fund at regular intervals at a price equal to the NAV of the fund's holdings.
- Managed by professional investors who have rich experience in investment and can understand the nerves of the market.
- Since mutual funds are regulated by a Government body i.e. AMFI in India, it offers protection and comfort to the investors before considering investment opportunity.
- All mutual funds are required to report the same level of information to the investors which makes it relatively easier for comparison in case of diversification.
- These funds provide regular reports of their performance and are also easily available on the internet to understand past trends as well as the strategies implemented.

## Investing mutual funds in India

- After submitting an application form along with a cheque or bank draft at the branch office or designated Investor Service Centres (ISC) of mutual Funds or Registrar & Transfer Agents one can invest in mutual funds.
- Investment can also be made online through the websites of the respective mutual funds.
- One may also invest through a Mutual Fund Distributor registered with AMFI or choose to invest directly.
- A Mutual Fund Distributor can be – an individual or a non-individual entity e.g. Banks etc.



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## Association of mutual funds in India

The Association of Mutual Funds in India has been established to develop the industry of Mutual funds in India. Its aim is to make this industry on professional, ethical and healthy lines. This is done to enhance this industry and maintain standards so that the interests of the shareholders are promoted and protected.

AMFI was incorporated on 22<sup>nd</sup> August 1995 as a non-profit organization.

It is an association of SEBI registered mutual funds in India of all the registered Asset Management Companies.

## Financial Instruments

### INTRODUCTION TO DERIVATIVES

The emergence of the market for derivative products, most notably forwards, futures and options, can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. By their very nature, the financial markets are marked by a very high degree of volatility. Through the use of derivative products, it is possible to partially or fully transfer price risks by locking in asset prices. As instruments of risk management, these generally do not influence the fluctuations in the underlying asset prices. However, by locking in asset prices, derivative products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors.

### DERIVATIVES DEFINED

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the “underlying”.

In the Indian context the Securities Contracts (Regulation) Act, 1956 (SCRA) defines “derivative” to include

1. A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.



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2. A contract which derives its value from the prices, or index of prices, of underlying securities. Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

#### **EMERGENCE OF FINANCIAL DERIVATIVE PRODUCTS**

Derivative products initially emerged as hedging devices against fluctuations in commodity prices, and commodity-linked derivatives remained the sole form of such products for almost three hundred years. Financial derivatives came into spotlight in the post-1970 period due to growing instability in the financial markets. However, since their emergence, these products have become very popular and by 1990s, they accounted for about two-thirds of total transactions in derivative products. In recent years, the market for financial derivatives has grown tremendously in terms of variety of instruments available, their complexity and also turnover. In the class of equity derivatives the world over, futures and options on stock indices have gained more popularity than on individual stocks, especially among institutional investors, who are major users of index-linked derivatives. Even small investors find these useful due to high correlation of the popular indexes with various portfolios and ease of use

#### **FACTORS DRIVING THE GROWTH OF DERIVATIVES**

Over the last three decades, the derivatives market has seen a phenomenal growth. A large variety of derivative contracts have been launched at exchanges across the world. Some of the factors driving the growth of financial derivatives are:

1. Increased volatility in asset prices in financial markets,
2. Increased integration of national financial markets with the international markets,
3. Marked improvement in communication facilities and sharp decline in their costs,



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4. Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and

5. Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets leading to higher returns, reduced risk as well as transactions costs as compared to individual financial assets.

### **DERIVATIVE PRODUCTS**

Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps. We take a brief look at various derivatives contracts that have come to be used.

#### **Forwards:**

A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

#### **Futures:**

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts.

#### **Options:**

Options are of two types – calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date. Warrants: Options generally have lives of upto one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

#### **LEAPS:**

The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of upto three years.

#### **Baskets:**

Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average of a basket of assets. Equity index options are a form of basket options.

#### **Swaps:**



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Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

- Interest rate swaps: These entail swapping only the interest related cash flows between the parties in the same currency.
- Currency swaps: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.

**Swaptions:** Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

#### **PARTICIPANTS IN THE DERIVATIVES MARKETS**

The following three broad categories of participants – hedgers, speculators, and arbitrageurs trade in the derivatives market. Hedgers face risk associated with the price of an asset. They use futures or options markets to reduce or eliminate this risk. Speculators wish to bet on future movements in the price of an asset. Futures and options contracts can give them an extra leverage; that is, they can increase both the potential gains and potential losses in a speculative venture. Arbitrageurs are in business to take advantage of a discrepancy between prices in two different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

#### **ECONOMIC FUNCTION OF THE DERIVATIVE MARKET**

In spite of the fear and criticism with which the derivative markets are commonly looked at, these markets perform a number of economic functions.

1. Prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices.
2. The derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them.
3. Derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of





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participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

4. Speculative trades shift to a more controlled environment of derivatives market. In the absence of an organized derivatives market, speculators trade in the underlying cashmarkets. Margining, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets.

#### **History of derivatives markets**

Early forward contracts in the US addressed merchants' concerns about ensuring that there were buyers and sellers for commodities. However 'credit risk' remained a serious problem. To deal with this problem, a group of Chicago businessmen formed the Chicago Board of Trade (CBOT) in 1848. The primary intention of the CBOT was to provide a centralized location known in advance for buyers and sellers to negotiate forward contracts. In 1865, the CBOT went one step further and listed the first 'exchange traded' derivatives contract in the US, these contracts were called 'futures contracts'. In 1919, Chicago Butter and Egg Board, a spin-off of CBOT, was reorganized to allow futures trading. Its name was changed to Chicago Mercantile Exchange (CME). The CBOT and the CME remain the two largest organized futures exchanges, indeed the two largest "financial" exchanges of any kind in the world today.

The first stock index futures contract was traded at Kansas City Board of Trade. Currently the most popular stock index futures contract in the world is based on S&P 500 index, traded on Chicago Mercantile Exchange. During the mid eighties, financial futures became the most active derivative instruments generating volumes many times more than the commodity futures. Index futures, futures on T-bills and Euro-Dollar futures are the three most popular futures contracts traded today. Other popular international exchanges that trade derivatives are LIFFE in England, DTB in Germany, SGX in Singapore, TIFFE in Japan, MATIF in France, Eurex etc.



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- 1.. An important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity. The derivatives have a history of attracting many bright, creative, well-educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense. In a nut shell, derivatives markets help increase savings and investment in the long run. Transfer of risk enables market participants to expand their volume of activity.

#### **EXCHANGE-TRADED vs. OTC DERIVATIVES MARKETS**

Derivatives have probably been around for as long as people have been trading with one another. Forward contracting dates back at least to the 12<sup>th</sup> century, and may well have been around before then. Merchants entered into contracts with one another for future delivery of specified amount of commodities at specified price. A primary motivation for pre-arranging a buyer or seller for a stock of commodities in early forward contracts was to lessen the possibility that large swings would inhibit marketing the commodity after a harvest. As the word suggests, derivatives that trade on an exchange are called exchange traded derivatives, whereas privately negotiated derivative contracts are called OTC contracts. The OTC derivatives markets have witnessed rather sharp growth over the last few years, which has accompanied the modernization of commercial and investment banking and globalisation of financial activities. The recent developments in information technology have contributed to a great extent to these developments. While both exchange-traded and OTC derivative contracts offer many benefits, the former have rigid structures compared to the latter. It has been widely discussed that the highly leveraged institutions and their OTC derivative positions were the main cause of turbulence in financial markets in 1998. These episodes of turbulence revealed the risks posed to market stability originating in features of OTC derivative instruments and markets.

The OTC derivatives markets have the following features compared to exchange traded derivatives:



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1. The management of counter-party (credit) risk is decentralized and located within individual institutions,
2. There are no formal centralized limits on individual positions, leverage, or margining,
3. There are no formal rules for risk and burden-sharing,
4. There are no formal rules or mechanisms for ensuring market stability and integrity, and for safeguarding the collective interests of market participants, and
5. The OTC contracts are generally not regulated by a regulatory authority and the exchange's self-regulatory organization, although they are affected indirectly by national legal systems, banking supervision and market surveillance.

Some of the features of OTC derivatives markets embody risks to financial market stability. The following features of OTC derivatives markets can give rise to instability in institutions, markets, and the international financial system:

- 1.. the dynamic nature of gross credit exposures;
- (ii) information asymmetries;
  - 1.. the effects of OTC derivative activities on available aggregate credit;
- (iv) the high concentration of OTC derivative activities in major institutions; and
  - 1.. the central role of OTC derivatives markets in the global financial system.

Instability arises when shocks, such as counter-party credit events and sharp movements in asset prices that underlie derivative contracts occur, which significantly alter the perceptions of current and potential future credit exposures. When asset prices change rapidly, the size and configuration of counter-party exposures can become unsustainably large and provoke a rapid unwinding of positions.

There has been some progress in addressing these risks and perceptions. However, the progress has been limited in implementing reforms in risk management, including counterparty, liquidity and operational risks, and OTC derivatives markets continue to pose a threat to international financial stability. The problem is more acute as heavy reliance on OTC derivatives creates the possibility of systemic financial events, which fall outside the more formal clearing house structures. Moreover, those who provide OTC derivative products, hedge their risks through the use of exchange traded derivatives. In view of the inherent risks associated with OTC derivatives, and their dependence on exchange traded derivatives, Indian law considers them illegal.

**BSE's Derivatives Market**



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BSE created history on June 9, 2000 by launching the first Exchange-traded Index Derivative Contract i.e. futures on the capital market benchmark index – the BSE Sensex. The inauguration of trading was done by Prof. J.R. Varma, member of SEBI and Chairman of the committee which formulated the risk containment measures for the derivatives market. The first historical trade of 5 contracts of June series was done that day between the Members Kaji & Maulik Securities Pvt. Ltd. And Emkay Share & Stock Brokers Ltd. At the rate of 4755.

In sequence of product innovation, BSE commenced trading in Index Options on Sensex on June 1, 2001, Stock Options were introduced on 31 stocks on July 9, 2001 and Single Stock Futures were launched on November 9, 2002.

September 13, 2004 marked another milestone in the history of the Indian capital market, when BSE launched Weekly Options, a unique product unparalleled worldwide in the derivatives markets. BSE permitted trading in weekly contracts in options in the shares of four leading companies namely Reliance Industries, Satyam, State Bank of India, and TISCO ( now Tata Steel) in addition to the flagship index-Sensex.

**ROADMAP TO BECOME A MEMBER OF THE BSE DERIVATIVES SEGMENT**





BSE Committee of Executives may call you for a personal interview



Applications approved by BSE Committee of Executives will be sent to SEBI for approval and registration



- After the BSE Committee of Executives approval, the MSD will issue election and admission letter to the Member.



**After SEBI 's Approval**

After receipt of SEBI registration, applicants account will be debited by Rs. 50,000.00 in case of Clearing Membership



For Commencement of Business in the Derivatives Segment, please contact Relationship Managers (BDM Department)



**START TRADING IN DERIVATIVES**

### 1.7.2 Types of Memberships in the BSE Derivatives Segment







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### **Trading Member**

- A Trading Member should be an existing Member of BSE cash segment.
- A Trading Member has only trading rights but no clearing rights. He has to associate with a Clearing Member to clear his trades.

### **Trading-Cum-Clearing Member**

- A Trading-cum-Clearing Member should be an existing Member of BSE cash segment.
- A TCM can trade and clear his trades. In addition, he can also clear the trades of his associate Trading Members.

### **Professional Clearing Member / Custodial Clearing Member:**

- A Professional Clearing Member need not be a Member of BSE cash segment.
- A PCM has no trading rights and has only clearing rights i.e. he just clears the trades of his associate Trading Members & institutional clients.

### **Limited Trading Member**

- A Limited Trading Member need not be a Member of BSE cash segment.
- A LTM has only trading rights and no clearing rights. He has to associate with a Clearing Member to clear his trades.

### **Self Clearing Member**

- A Self Clearing Member should be an existing Member of the BSE cash segment.
- An SCM can clear and settle trades on his own account or on account of his client only and not for any other Trading Member



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## **UNIT- III**

### **Principles and Practices of Insurance**

#### **Concept**

Insurance is a risk management tool that involves transferring the risk of a loss from an individual or entity to an insurance company. The principles and practices of insurance are built on the following concepts:

- 1 Risk assessment: The first step in the insurance process is to assess the risk of loss. This involves evaluating the likelihood and potential impact of an event that could cause a loss.
- 2 Pooling of risk: Insurance companies pool risk by aggregating many policyholders' premiums into a common pool. This allows for the spread of risk and reduces the impact of any one loss.
- 3 Premiums: Policyholders pay a regular fee, called a premium, to the insurance company in exchange for protection against loss. Premiums are calculated based on the level of risk associated with the policy.
- 4 Underwriting: The process of evaluating and classifying a risk to determine the terms and conditions of insurance coverage. This includes evaluating the policyholder's application, past claims history, and other factors that could impact the risk of loss.
- 5 Claims handling: The process of evaluating and settling claims made by policyholders for covered losses.



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6 Reserving: Insurance companies set aside funds, known as reserves, to pay for claims as they arise. These reserves are calculated based on estimates of the expected frequency and severity of losses.

7 Reinsurance: Insurance companies may also transfer some of their risk to other insurance companies through the use of reinsurance. This allows insurance companies to manage their overall risk exposure.

8 Regulation: Insurance is regulated by governments to ensure that insurance companies have the financial resources to pay claims and to protect policyholders from unfair practices.

### **Principles & Types Of Insurance**

Insurance is a contract between the insured and the insurance company, in which the insurance company agrees to provide financial protection or reimbursement to the insured in exchange for payment of premiums.

#### **The following are some of the most important principles of insurance:**

1 Insurable interest: The insured must have a valid reason for seeking insurance coverage, such as ownership of an asset or responsibility for someone else's well-being.

2 Utmost good faith: The insured must disclose all relevant and material information to the insurance company when applying for insurance.

3 Indemnity: Insurance is intended to restore the insured to the same financial position they were in before the loss occurred.

4 Proximate cause: The cause of loss must be the dominant or predominant factor in producing the loss.



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5 Loss minimization: The insured must take reasonable steps to minimize the extent of their loss.

### **Life Insurance**

Life insurance is a type of insurance policy that provides financial support to the beneficiaries of the insured person in the event of their death. The purpose of life insurance is to provide financial security to the beneficiaries and help them cope with the financial consequences of the insured person's death

**Definition:** Life insurance is a contract between the policyholder and the insurance company, in which the insurance company agrees to pay a death benefit to the beneficiaries of the policyholder in exchange for the payment of premiums.

**Types of life insurance:** There are two main types of life insurance policies: term life insurance and permanent life insurance.

**Term life insurance:** Provides coverage for a specified term, usually 1, 10, 20, or 30 years. If the insured person dies within the term of the policy, the death benefit is paid to the beneficiaries. If the insured person does not die within the term of the policy, the policy simply expires and no death benefit is paid.

**Permanent life insurance:** Provides coverage for the entire life of the insured person. There are several types of permanent life insurance policies, including whole life, universal life, and variable life. Unlike term life insurance, permanent life insurance policies accumulate cash value over time, which the policyholder can access while they are still alive.

**Purpose:** The purpose of life insurance is to provide financial security to the beneficiaries of the policyholder in the event of their death.



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**Death benefit:** The death benefit is the amount of money that the insurance company agrees to pay to the beneficiaries of the policyholder in the event of their death.

**Premiums:** The policyholder must pay a premium to the insurance company to maintain the life insurance policy. The premium is based on factors such as the policyholder's age, health, and death benefit amount.

**Importance:** Life insurance is important for people who have dependents who rely on their income for financial support. It helps to ensure that the dependents will be able to maintain their standard of living in the event of the policyholder's death.

**Considerations:** When choosing a life insurance policy, it is important to consider factors such as the policyholder's age, health, and financial situation. The policyholder should also consider the death benefit amount they need to provide financial security to their beneficiaries and the premium they can afford to pay.

**Regular review:** It is important to review and update the life insurance policy regularly to ensure that it continues to meet the policyholder's needs and the needs of their beneficiaries.

### **Micro Insurance**

Micro insurance is a type of insurance designed specifically for low-income individuals and families who are often excluded from traditional insurance markets. The aim of micro insurance is to provide coverage for risks such as death, illness, or injury, to help protect against financial hardship.

**Some key features of micro insurance include:**





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**Affordability:** Micro insurance products are designed to be affordable for low-income individuals and families, with low premiums and benefits that are appropriate for their needs.

**Simplicity:** Micro insurance products are usually straightforward and easy to understand, with few complicated terms and conditions.

**Accessibility:** Micro insurance is designed to be accessible to those who are traditionally excluded from the insurance market, such as people living in rural areas or those with limited financial resources.

**Community-based:** Many micro insurance products are provided through community-based organizations, such as cooperatives or self-help groups, which helps to build trust and increase participation.

**Innovative delivery:** Micro insurance products are often delivered through innovative channels, such as mobile phones or local agents,

## **Annuities**

An annuity is a financial product that provides a stream of payments to an individual, usually in exchange for a lump sum of money. There are several types of annuities, including fixed annuities, variable annuities, and indexed annuities.

### **Key features of annuities include:**

**Guaranteed income:** An annuity provides a guaranteed stream of income for a specified period of time, or for the life of the annuity holder.



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**Tax benefits:** Some annuities provide tax benefits, such as tax-deferred growth or tax-free withdrawals.

**Customizable:** Annuities can be customized to meet the needs of the individual, including the choice of payment frequency, investment options, and the length of the income stream.

**Death benefit:** Some annuities include a death benefit that pays out to a designated beneficiary in the event of the annuity holder's death.

**Risk management:** An annuity can help manage investment risk by providing a guaranteed income stream, which can be useful for those who are close to retirement or those who have a low tolerance for risk.

### **Health Insurance**

Health insurance is a type of insurance coverage that pays for medical and surgical expenses incurred by the insured. The main purpose of health insurance is to provide financial protection against high medical costs.

#### **There are several types of health insurance plans, including:**

**Individual Health Insurance:** Coverage for one person, usually purchased by those who do not have employer-sponsored coverage.

**Group Health Insurance:** Coverage for a group of people, typically offered through an employer or a professional organization.

**HMO (Health Maintenance Organization):** A type of health insurance plan that typically requires individuals to choose a primary care physician and receive referrals to see specialists.



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PPO (Preferred Provider Organization): A type of health insurance plan that allows individuals to see any healthcare provider they choose, but offers lower out-of-pocket costs for using in-network providers.

POS (Point of Service) Plan: A type of health insurance plan that combines features of HMOs and PPOs, offering more flexibility in choosing healthcare providers.

In addition to the above types, there are also government-sponsored health insurance programs such as Medicare and Medicaid, which provide coverage for eligible individuals.

Health insurance plans typically have copayments, deductibles, and coinsurance, which are cost-sharing arrangements that require individuals to pay a portion of their medical expenses. The exact details of these cost-sharing arrangements vary depending on the plan.

Overall, having health insurance is important for protecting against financial hardship in the case of illness or injury. It is important to carefully consider one's health insurance options and choose a plan that best meets their needs

### **General Insurance**

General insurance refers to insurance coverage for non-life or property and casualty risks. It provides financial protection against unexpected events, such as accidents, natural disasters, theft, and liability claims. Unlike life insurance, which provides financial protection for the policyholder in the event of death, general insurance provides financial protection for a variety of risks that individuals and businesses face



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In general insurance, the insurance company assesses the risk associated with the insured event and sets the premium based on that risk. The policyholder pays the premium, and in the event of a covered loss, the insurance company pays the claim.

It is important for individuals and businesses to understand the different types of general insurance products and choose the right coverage for their needs. This can help reduce the financial impact of unexpected events and provide peace of mind.

### **Types of General Insurance**

#### **Motor Insurance**

Motor insurance, also known as auto insurance or car insurance, is a type of general insurance that provides financial protection for car owners in the event of an accident, theft, or other covered loss. It is required by law in most countries, and the minimum level of coverage may vary by jurisdiction.

#### **Motor insurance typically covers the following:**

**Liability coverage** - This covers third-party claims for injury or property damage caused by the policyholder while driving their vehicle.

**Collision coverage** - This covers damage to the policyholder's vehicle resulting from an accident with another vehicle or an object, regardless of who is at fault.

**Comprehensive coverage** - This covers damage to the policyholder's vehicle from non-collision events, such as theft, fire, or natural disasters.



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**Personal injury protection (PIP) or medical payments coverage** - This covers medical expenses for the policyholder and their passengers in the event of an accident, regardless of who is at fault.

**Uninsured/underinsured motorist coverage** - This covers the policyholder's expenses if they are involved in an accident with a driver who does not have insurance or does not have enough insurance to cover the damages.

Motor insurance, also known as auto insurance or car insurance, is a type of general insurance that provides financial protection for car owners against financial losses resulting from accidents, theft, or other incidents involving their vehicle.

The main components of a motor insurance policy include:

**Third-party liability coverage** - covers the policyholder against financial losses resulting from damage or injury to others in an accident involving their vehicle.

**Own damage coverage** - covers the policyholder against financial losses resulting from damage to their own vehicle, such as collision or theft.

**Personal accident cover** - provides financial protection for the policyholder and passengers in the event of injury or death in an accident involving their vehicle.

### **Marine Insurance**

Marine insurance is a type of general insurance that provides financial protection for shipping and transportation of goods by sea, air, or land. It covers the risks associated with the transportation of goods, including damage to or loss of the goods, and liability for damage or injury to others.

**The main components of marine insurance include:**





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**Hull insurance** - covers the policyholder against financial losses resulting from damage to the vessel or cargo ship.

**Cargo insurance** - covers the policyholder against financial losses resulting from damage or loss of the goods being transported.

**Liability insurance** - provides protection against legal claims for damage or injury to others, such as maritime liability insurance for ships and their crew.

**Freight insurance** - covers the policyholder against financial losses resulting from the failure of the carrier to deliver the goods as agreed.

The premium for marine insurance is determined based on several factors, including the type of goods being transported, the mode of transportation, the route, and the value of the goods.

It is important for businesses involved in shipping and transportation of goods to understand the different components of marine insurance and to choose a policy that meets their needs and budget. Having marine insurance can provide peace of mind and protect against financial losses resulting from damage or loss of goods during transportation.

### **Property Insurance**

Property insurance is a type of general insurance that provides financial protection for individuals and businesses against losses resulting from damage to or loss of their property. The property can be a home, a commercial building, personal possessions, or other real or personal property.



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**The main types of property insurance include:**

**Homeowners insurance** - covers damage to or loss of a policyholder's home and personal possessions, as well as liability claims for injury or damage to others on the policyholder's property.

**Commercial property insurance** - covers damage to or loss of commercial buildings, as well as the contents of the building, such as equipment and inventory.

**Renters insurance** - covers damage to or loss of a policyholder's personal possessions, as well as liability claims for injury or damage to others, in a rented property.

**Flood insurance** - covers losses resulting from flooding, which is not typically covered by standard homeowners or commercial property insurance policies.

The premium for property insurance is based on several factors, including the type and value of the property being insured, the location of the property, the policyholder's claims history, and the level of coverage desired.

**Miscellaneous Insurance**

Miscellaneous insurance refers to a variety of insurance products that do not fit into the traditional categories of life, health, motor, property, marine, or liability insurance. This type of insurance covers a wide range of personal and business-related risks and is designed to provide financial protection against unexpected events or losses.

**Some common types of miscellaneous insurance include:**

**Travel insurance** - covers financial losses resulting from trip cancellations, medical emergencies, lost or stolen luggage, and other travel-related incidents.



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**Pet insurance** - covers veterinary expenses for a policyholder's pet in the event of illness or injury.

**Wedding insurance** - covers financial losses resulting from cancellations, postponements, or other unexpected events that may occur during the planning or execution of a wedding.

**Technology insurance** - covers financial losses resulting from damage or theft of electronic equipment, such as computers, smartphones, and other devices.

**Professional liability insurance** - covers financial losses resulting from claims of professional malpractice or negligence in various industries, such as healthcare, law, and consulting.

The premium for miscellaneous insurance is based on several factors, including the type of coverage, the level of coverage desired, and the policyholder's history of losses and claims.

### **The concept of risk & classification of risk , Insurance documents**

The concept of risk in insurance refers to the likelihood of a loss occurring. Insurance is designed to provide financial protection against such losses by transferring the risk from the policyholder to the insurer.

Risks can be classified into several categories, including:

Pure risk - risks that result in a loss but no gain, such as theft or damage to property.



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Speculative risk - risks that may result in either a loss or a gain, such as investing in the stock market.

Moral hazard - refers to the increased likelihood of a loss occurring due to the policyholder's behavior, such as not taking necessary precautions to prevent theft or damage to property.

In the insurance industry, risks are also classified based on their frequency and severity. For example, some risks are more frequent but less severe (such as small losses from theft or damage to property), while others are less frequent but more severe (such as natural disasters or catastrophic events).

Insurance documents are legal contracts that outline the terms and conditions of an insurance policy, including the type and amount of coverage, the premium to be paid, and the responsibilities of both the policyholder and the insurer. These documents include the insurance policy, the application for coverage, and any endorsements or amendments to the policy.

It is important for policyholders to carefully review and understand all insurance documents before purchasing a policy, in order to ensure that the coverage meets their specific needs and provides adequate protection against potential losses.

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