FINANCIAL INSTITUTIONS, MARKETS AND SERVICES

Unit 1 Financial System of India- I : Functions and Structure

Structure

1.0 Introduction

1.1 Unit Objectives

1.2 Functions of Financial System

1.3 Structure of Indian Financial System

1.4 Role and Segments of Financial Markets

1.5 Summary

1.6 Key Terms and List of Select Abbreviations

1.7 Self Assessment Questions

1.8 Further Reading and References

1.0 Introduction

The economic development of any country largely depends on efficiency of the financial system. The well developed financial system helps economy to achieve growth in savings and investment. It also ensures proper functioning of financial intermediaries and facilitates flow of funds from surplus areas to deficit areas. The government as well as regulators implement suitable policies to make financial system more efficient and vibrant.

The financial system of any country is comprised of following components:

(i) Financial Markets

(ii) Financial and Capital Markets Intermediaries which includes banks & financial institutions

(iii) Financial services or products or instruments

(iv) Regulators including Government and Government appointed agencies.

1.1 Unit Objectives

The objectives of this unit are as under:

i) to know functions of financial system

ii) to understand structure of Indian financial system

iii) to have overview of role and segments of financial markets

1.2 Functions of Financial System

A. Financial System performs the following Functions:

1) **Mobilisation of Savings**

The financial system encourage individuals, corporate, and others to save for the purpose of economic development. The financial intermediaries play a significant role in mobilization of savings & making available funds to the entrepreneurs for investments. The household & corporate sectors saves through use of different financial products. For example, household sector uses bank deposit products & mutual funds products for the savings.

2) **Ensures Liquidity**

The financial system provides liquidity in respect of many financial assets like equity, debt instruments etc. This encourage investors to invest in financial assets. Indirectly this help corporate to raise funds from financial markets through issue of financial instruments. The financial system ensures liquidity for many of these financial assets through strengthening secondary market.

3) **Settlement of Commercial Transactions**

The financial system facilitates settlement of commercial transactions & financial claims arising out of sale & purchase of goods & Services. For this money is used as an instrument which is legally recognized. Therefore values of all transactions including sale & purchase of goods and services are expressed in terms of money only. Over a period of time, the financial system has evolved other instruments like cheques, demand drafts, credit card etc. for settlement of economic transactions. These instruments are recognized by law as a substitute for money. In view of this, market participants use new instruments like credit and debit card as well as new facilities like internet banking and mobile banking for settlement of business and commercial transactions

4) **Implementation of Economic Policies of Government**

The presence of strong financial system helps the Government to frame appropriate economic policies for increasing savings & investment, achieving desired economic growth in industry and agriculture sector, etc. It also facilities government borrowings from the domestic market for meeting planned budgetary expenditures. It also helps Government to attract foreign capital for its investment in domestic market.

5) **Support for Managing Risk in Financial Transactions**

The financial system not only facilitates to execute business and commercial transactions but also helps to manage risk in such transactions. On account of deregulation of financial markets, participants are exposed to various market risk. The financial system offers various financial products like derivative

etc. to manage risk in commercial transactions. The players who are part of financial system use variety of derivative products or financial contracts like forward futures, options and swaps to manage variety types of risk in commercial and business transactions.

1.3 Structure of Indian Financial System

Like financial system of any country, the Indian Financial System is also comprised of financial markets, financial intermediaries, financial instruments and regulators. The overall structure of Indian financial system is given in Table 1.1.

Financial Markets	Financial Intermediaries & other Participants	Financial Instruments/ Products/Services	Regulators and other Associated Institutions
i) Money Market	Banks, Primary Dealers, Financial Institutions, Insurance Companies, Mutual Funds, Corporate, Individuals etc.	*Call/notice/Term Money * Treasury Bills * Comercial Papers (CPs) * Certificate of Deposits * Collatenised Borrowings and Lending Obligations (CBLO) * Inter Bank participation Certificate (IBPC) * Repuretase Agreement (Repo)	RBI, FIMMDA & CCIL
ii) Bond Market			
A) Government Securities Market	Banks, Financial Institutions, Primary Dealers, Insurance Companies, Mutual Funds, Non-banking, Finance Companies, FIIs,	* Treasury Bills of 91 Days 182 days and 364 day. * Treasury Bills of 91 Days * Dated Government Securities * State Government Securities	RBI, FIMMDA & CCIL
B) Corporate Bond Market	Banks, Financial Institutions, Public Sector Undertakings, Private Companies, Insurance Companies, Mutual Funds, Individuals	* Tax free bonds * Bonds with put & call * Deep discount bonds * Floating rate bonds * Fixed Rate bonds. (Plain Vanilla bonds)	SEBI & Stock Exchanges

iii) Equity Market	Corporate, Banks, Financial Institutions, Individuals, Insurance Companies, Mutual Funds, Foreign Institutional Investors (FIIs) Brokers & Merchant Bankers, Depositories, Depository participants etc.	* Equity Shares * Preference Shares	SEBI & Stock Exchanges
iv) Foreign Exchange Market	Banks, Financial Institutions, Other Authorised Dealers, Brokers, Exporters & importers and individuals etc.	Inter-bank market for different currencies (Trading in currencies) Retail Market for Customers (i.e. purchase & sale of foreign currencies)	RBI, CCIL, FEDAI
v) Derivatives Markets a) Interest Rate Derivatives b) Currency Derivatives	a) Banks, Development Financial Institutions, NBFCs, Insurance Companies Corporate Banks, Development Financial Institutions, NBFCs, Insurance Companies Corporates, Exporters & Importers Individuals. Exporters & Importers, Individuals	* Interest Rate Swaps (IRS) * Interest Rate Futures (IRF) * Forward Rate Agreement Forward contract in currencies Currency options Currency FuturesCurrency Swaps	RBI, Stock Exchanges and CCIL RBI &Stock Exchanges, FEDAI
vi) Credit Market	Banks, NBFCs, Financial Institutions, Specialized Housing Finance Companies, Corporate & Individuals Forward contract in currencies Currency options Currency FuturesCurrency Swaps RBI &Stock Exchanges, FEDAI	Working Capital Loans, Housing Finance, Lease Finance, Hire Purchase Finance, Personal Loan & Consumer Loan, Term Loan etc.	RBI, and NHB (For Housing Finance Companies)

Table 1.1 : Structure of Indian Financial System

Financial Markets Financial Intermediaries & other Participants Financial Instruments/Products/Services Regulators and other Associated Institutions :

i) Money Market Banks, Primary Dealers, Financial Institutions, Insurance Companies, Mutual Funds, Corporate, Individuals etc. * Call/notice /Term Money* Treasury Bills* Commercial Papers (CPs)* Certificate of Deposits (CDs)* Collatenised Borrowings and Lending Obligations (CBLO)* Inter Bank participation Certificate (IBPC)* Repuretase Agreement (Repo) R B I , FIMMDA & CCIL

ii) Bond Market

A) Government Securities Market Banks, Financial Institutions, Primary Dealers, Insurance Companies, Mutual Funds, Non-banking, Finance Companies, FIIs, Individuals, etc.* Treasury Bills of 91 day, 182 day and 364 day.* Dated Government Securities* State Government Securities RBI, FIMMDA & CCIL

B) Corporate Bond Market Banks, Financial Institutions, Public Sector Undertakings, Private Companies, Insurance Companies, Mutual Funds, Individuals* Tax free bonds* Bonds with put & call options* Deep discount bonds* Floating rate bonds* Fixed Rate bonds(Plain Vanilla bonds) SEBI & Stock Exchanges

iii) Equity Market Corporate, Banks, Financial Institutions, Individuals, Insurance Companies, Mutual Funds, Foreign Institutional Investors (FIIs) Brokers & Merchant Bankers, Depositories, Depository participants etc.* Equity Shares* Preference Shares SEBI & Stock Exchanges

iv) Foreign Exchange Market Banks, Financial Institutions, Other Authorised Dealers, Brokers, Exporters & importers and individuals etc. Inter-bank market for different currencies (Trading in currencies)Retail Market for Customers (i.e. purchase & sale of foreign currencies)RBI, CCIL, FEDAI

v) Derivatives Markets

a) Interest Rate Derivatives Banks, Development Financial Institutions, NBFCs, Insurance Companies Corporate* Interest Rate Swaps (IRS)* Interest Rate Futures (IRF)* Forward Rate Agreement (FRA) RBI, Stock Exchanges and CCIL

b) Currency Derivatives Banks, Development Financial Institutions, NBFCs, Insurance Companies Corporates, Exporters & Importers, Individuals Forward contract in currenciesCurrency optionsCurrency FuturesCurrency Swaps R B I &Stock Exchanges, FEDAI

vi) Credit Market Banks, NBFCs, Financial Institutions, Specialized Housing Finance Companies, Corporate & Individuals Working Capital Loans, Housing Finance, Lease Finance, Hire Purchase Finance, Personal Loan & Consumer Loan, Term Loan etc. RBI, and NHB (For Housing Finance Companies)

1.4 Role and Segments of Financial Markets

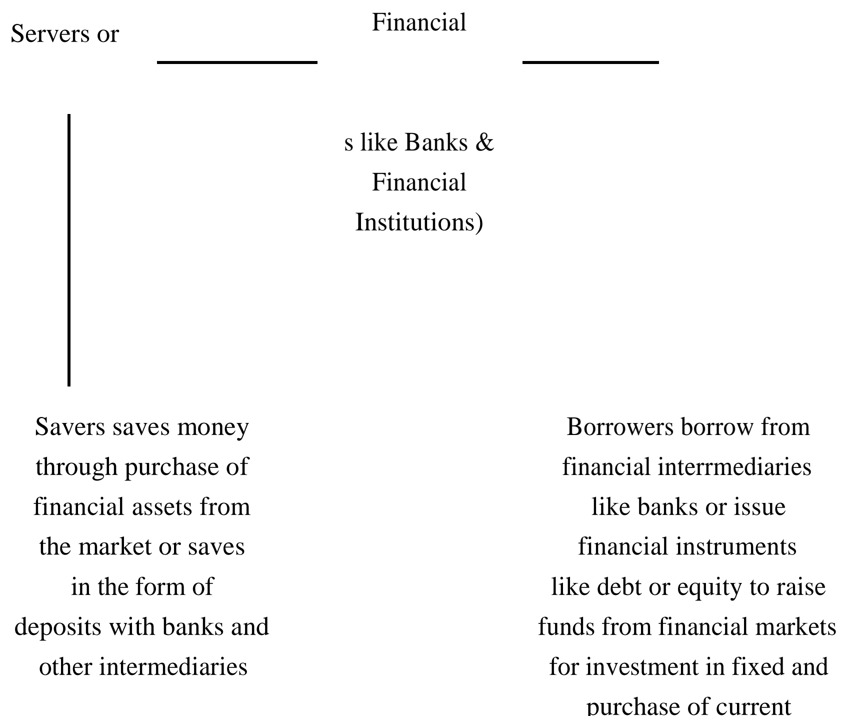
The economic growth of any country depends on its growth in financial markets. In financial economics a financial market is considered as a mechanism that allows people to easily buy and sell various financial products or services at low transaction cost and at prices that reflects the existing market conditions. Financial markets have evolved significantly over several hundred years and are subjected to constant innovations to improve liquidity and price discovery.

A financial market is considered to be a place where financial instruments are bought and sold at a certain price. Therefore a financial market can be defined as a market place where commercial transactions in financial assets are executed.

The main role of financial markets is to facilitate transfer of financial resources from those who saves it to those who are in need of financial resources for undertaking economic activities. Thus financial markets facilitate growth in savings and investment which is prerequisite to achieve economic development and sustainable growth. The investors having surplus money invest in various financial assets. This leads to growth in the savings. Similarly industrial and other commercial enterprises borrow funds either from financial intermediaries or raise funds directly from financial markets through issue of financial instruments. This leads to the investment in the economy. This role of financial market is shown in Chart A.

CHART A :

Flow of Funds from surplus sector (i.e. savers) to Deficit Sector (borrowers)



Formal v/s Informal Financial Markets :

The financial markets consist of formal and informal markets. The informal financial markets are nothing but private money lenders. They are partially regulated by the Government. Therefore, participants are not interested to participate in the informal financial markets. As against this, formal markets like money market, capital market and foreign exchange market etc. are recognized and well regulated by the specified regulator as wells by the Government. The participants in the financial markets like to be associated with formal structure of financial markets. The reasons for this are as follows:

i) It ensures fully transparency in the financial dealings in terms of trade, parties to the transaction, cost and value.

ii) Due to well defined rules and regulations, the participants have more confidence in undertaking deals in formal financial markets. The commercial transactions are carried out according to the well defined terms agreed upon.

iii) It has a proper regulatory framework which ensures adequate legal support to settle disputes and enforce contracts.

iv) It protects interest of investors especially of small investors.

v) It provides move liquidity, low transaction costs and price discovery for various financial assets.

Segments of Financial Markets :

The financial markets are divided into various segments. These segments are described below :

I) Money Market :

The Money market is an important component of the financial markets. It provides a platform where surplus funds of lenders are made available for borrowers to meet their short term financial needs. This is the market for short term financial instruments. In this market funds are raised for a period upto 365 days. The various financial instruments such as call/notice, term money, Treasury bill, commercial papers, etc., are available in these markets. This is a wholesale market. The participants in this market use money market instruments for managing liquidity on daily basis. In India money market is regulated by the Reserve Bank of India (RBI). While regulating money market the main aim of the RBI has been to ensure that the liquidity and short term interest rates are maintained at levels consistent with its monetary policy objectives. A well developed money market is a must for effective implementation of monetary policy and bringing integration among various segments of financial markets. The banks, financial institutions, primary dealers, non-banking finance companies, mutual funds, insurance companies etc. are major players in the money market. This market is well developed in India in terms of instruments, size and regulations. The structure of Indian money market is given in Table 1.2

Table 1.2 : Structure of Indian Money Market

i)	Call Money Market	1 day or 24 hours	Banks and Primary Dealers	
ii)	Notice Money	2 to 14 days	Banks & Primary	Reserve Bank of India the country is a regulator for the money market
				Fixed Income Money MarketDerivatives (FIMMDA) Issues
iv)	Commercial	7 days to 365 days	Companies, NBFCs, Institutions, Mutual funds.	transactions in the
v)	Certificate of Deposits	7 days to 365 days	Banks, Financial Institutions	
vi)	Treasury Bills	91 days, 182 days & 364 days	Banks, primary Dealers, Financial Institutions, NBFCs , Insurance Companies, Mutual	Clearing Cooperation of India Ltd (CCIL) ensures settlement of transactions in certain segments of money market such as repo, treasury bills and CBLO
vii)	Repurchase Agreement (Repo)	Upto 365 days (By & large transactions are carried out for a period upto 7 days)	Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, Housing Finance Companies etc.	
viii)	Collectivized	Upto 365 days (By & large market for this product is active for a period upto 90 days)	Banks Financial Institutions, Insurance Companies, Mutual Funds, Companies, etc.	
ix)	Borrowing & Lending Obligation (CBLO) Inter-Bank participation	Upto 180 days	Banks	

certificate

ii) Debt Market :

Debt market consists of Government debt securities and corporate debt securities. In India, the Government Debt Market is well developed in terms of instruments, size, participants and regulatory frame work. Both the Government of India and State Governments raise funds from this market through issue of various debt instruments. By and large these instruments are issued under the auctions. Investors prefer to invest in the Government debt instruments because there is no credit risk at all. The corporate debt market in India consists of debt instruments issued by banks and financial institutions, public sector undertakings, local bodies and private companies. Such bonds are issued with varied terms and conditions such as bonds with fixed coupon, floating rate bonds, bonds with put and call options and zero-coupon bonds etc. As compared to the Government debt market, corporate debt market in India is not developed. Only the primary market for corporate debt instruments is active. The structure of Indian debt market is given in Table 1.3

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Table 1.3: Structure of Indian Debt Market

Government Debt Market	**Corporate Debt Market**
1. Instruments • Dated Government securities for 2 to 30 years • Treasury Bills of 91 day, 182 day and 364 day • State Governments securities for a period up to 10 years	**1. Instruments** • Fixed interest rate bonds/ debentures • Floating rate bonds/ debentures • Bonds / Debentures with put and call options • Deep discount bonds.
2. Issuers • Government of India & State Governments	**2. Issuers** • Banks & Financial Institutions • Public Sector Undertakings • Private Sector Enterprises • Local bodies • (Municipal Corporations) • Non – Banking Finance • Companies
3. Investors • Banks • Primary Dealers • Financial Institutions • Insurance Companies • NBFCs • Mutual Funds • Foreign Institutional Investors Individuals	**3. Investors** • Banks • Financial Institutions • Mutual Funds • NBFCs • Insurance Companies • Individuals
4. Regulator * **RBI**	**4. Regulator** *** SEBI**
5. Settlement of Transactions * **Transactions in the Government securities are settled through CCIL**	**5. Settlement of Transactions** * In case of listed debt instruments transactions are settled through stock exchange settlement system * In case of unlisted debt instruments transaction are settled through OTC route

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iii) Equity Market

Equity market is one of the most important segments of financial markets. This market helps the companies to raise long term funds. This facilitates capital formation in the country. In India under the company law provisions the companies are allowed to issue both equity and preference shares. Issue of equity shares helps the companies to have permanent source of funds unless it decides to purchase these shares and return money back to the shareholders. As far as preference shares are concerned the companies in India cannot issue irredeemable preference shares. They are allowed to issue preference shares for a maximum period of 20 years. The companies subject to legal provisions are free to issue shares at par value, premium or discount. This market is comprised of primary and secondary market.

The primary market is more about issue of new shares. That is why it is called as New Issue market. While raising funds from the primary market the companies have to ensure that the cost of raising of funds is lower. They also require to disclose all the information in the offer document. The secondary market is also important as it ensures liquidity for the existing securities. In order to support primary market, the secondary market needs to be i) active, ii) disclose all information, iii) less volatile and efficient in terms of lowering transaction cost. Both primary and secondary markets are linked with each other. If the secondary market is active and vibrant then the primary market is also likely to be active and vibrant.

The equity market is deregulated in India and hence, the eligible companies are free to decide about the premium. In case of public issue of shares in the primary market, it is mandatory to appoint a registered merchant banker to act as a lead manager. Therefore, new equity shares are issued with the help of a merchant banker. The unlisted shares are issued through private placement. As discussed earlier, the secondary market for equity is noting but stock exchange which provides liquidity and price discovery. At present there are 21 stock exchanges in India. Of these, Bombay Stock Exchange (BSE) Ltd. and National Stock Exchange (NSE) Ltd. are the largest and most important stock exchanges in India. The shares are issued and traded in dematerialized form. This market is much more volatile. The equity market in India is well developed and vibrant. It is regulated by SEBI. The structure of Indian equity market is given in Table 1.4.

Primary Markets		Secondary Markets	Investors	Regulator & other
Instruments	**Issuers**	**For Listed Shares Stock Exchanges**	Investors	**Regulator's**
	Companies	Exchanges in India)	Banks	
		For unlisted Shares. Over the counter trade (OTC platform)	Financial Institutions	
Shares			Insurance Companies	Other Associated Institutions
			Venture Capital Undertakings	Merchant Bankers
			Foreign Institutional Investors (FIIs)	Depositories
			Non Banking Finance	Depository Participants
Preference Shares				

iv) Foreign Exchange Market

The foreign exchange market is defined as a market in which individuals, commercial enterprises, banks and brokers purchase and sell different foreign currencies. The term market in this definition does not indicate any physical place but to a communication system through which participants remain in continuous contact with each another. For example, the foreign exchange market for any currency such as US Dollar consists of all locations where US Dollar is bought and sold for other national currencies. These locations include London, Sydney, Tokyo, Hong Kong, Singapore, Mumbai, Dubai, Bahrain, Frankfurt, Paris, New York and San Francisco besides other locations. The market for foreign exchange transactions remains open for 24 hours and trades are executed continuously. With advancement in information technology, deals are also done through electronic dealing systems in which purchases and sales of different currencies are automatically done in response to changes in prices of currencies.

The foreign exchange market has a large number of participants including merchants, small, medium and large enterprises, and commercial and investment banks, individuals. This market is regulated by the Central Bank of the country i.e. RBI. The followings are major players in the foreign exchange market.

Banks : The banks are dominant players in the foreign exchange market. They trade in currency market on their proprietary account as well as on behalf of customers. They are authorised by the central bank of country to trade in currency

market. They are market makers in the foreign exchange market. They offer two way quotes i.e. bid and offer. Being active traders in the foreign exchange market commercial banks offer competitive rates to customers and help them to manage price risk arising on account of fluctuation in currency rates

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Retail Clients : Individuals and organizations engaged in the business of import and export of goods and services. They require to undertake such transactions for conversion of local currency into foreign currencies for meeting their foreign trade obligations. The retail market in foreign exchange is also the market in which travelers and tourists exchange one currency for another in the form of currency notes or travelers cheques.

RBI : Being a central bank of the country, RBI regulates the foreign exchange market in India. It intervenes in the market to buy or sell foreign currencies to influence exchange rates. Intervention can be defined as buying or selling of foreign currency by RBI with a view to maintain price stability in the foreign exchange market. In the case of limited flexibility or fixed exchange rate regimes, these interventions are absolutely essential. However, under deregulated market environment, RBI is not involved to defend any specified rate but may like to intervene so as to influence market sentiment, reduce short-term volatility and create 'orderly conditions' in the foreign exchange market. The structure of Indian Foreign Exchange Market is given in Table 1.5.

Types of Market	**Types of Market**	
Participants	Authorized Dealers like Banks and Financial Institutions	Individuals Exports and Imports Companies Brokers
Regulator	RBI	RBI
Other Institution	FEDAI	FEDAI
Act which is applicable	FEMA	FEMA

v) Derivatives Market

The derivatives are special type of financial instruments. These instruments are used to mange risk. And hence, such financial instruments are also called as hedging instruments or simply risk management instruments. Like any other market, derivatives market is comprised of derivative instruments, participants, regulator(s) and place where such transactions are executed or carried out.

The derivatives which are traded on an exchange are called exchange traded derivatives. Such trades generally take place through clearing house or corporation of the exchange and therefore trading in such derivatives take place with anonymity. As against this, a derivative contract which is privately negotiated is called an over the counter (OTC) derivative. Such trades have no anonymity and they

generally do not get traded through a clearing house of the exchange. Every derivative product can either OTC product (i.e. through private negotiations) or on an exchange traded product.

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Trades in derivatives market are different from trades in cash or spot market. The spot price is separately observed from the price of derivative product. It is essential to note that the price of the derivative product is driven by the spot price of the underlying variable.

The largest derivatives transactions in the world are found in the context of Government bonds (to hedge against interest rate risk), the market index (to hedge against the volatility in the prices of stock) and on exchange rates (to hedge against currency risk).

Derivatives market in Indian can be classified into four segments :

Rupee related derivatives like Interest Rate Swaps (IRS), Forward Rate Agreements (FRA) and Interest Rate Futures. Of these IRS and FRA were introduced in 1999. Banks and primary dealers have been allowed to be market makers in IRS and FRA derivatives market. Alongwith banks and primary dealers, others like financial institutions, insurance companies, corporates, NBFCs etc., have been permitted to use IRS and FRA for managing interest rate risk in their books of accounts. This market is regulated by RBI. The RBI and FIMMDA have issued detailed guidelines subject to which participants are required to participate in the IRS and FRA markets.

Stock related derivatives like stock options, stock index options and futures. Trading in such derivatives was introduced in June 2000. SEBI approved derivatives trading based on futures contract at both NSE and BSE in accordance with rules and regulations of the concerned stock exchanges. Stock index futures in India are available with one month, two months and three month’s maturities. This market is regulated by the concerned stock exchange as well as SEBI.

Currency related derivatives like forward contracts, currency options and currency swaps : Banks, corporate, financial institutions importers and exporters etc. have been active participants in these derivatives market. This market is regulated by the Reserve Bank of India. The currency future market is regulated by SEBI jointly with RBI and stock exchange.

1.6 Summary

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The economic development of any country mainly depends on efficiency of the financial system. The well developed financial system help economy to achieve a growth in savings and investment. The financial system is comprised of financial markets, instruments, participant and regulators. The financial markets are comprised of various segments which are regulated by different regulators and agencies. The financial markets facilitate growth in savings and investment both of which are must for economic growth of the country. Among the various functions, the most important function of financial markets is to provide liquidity and proper valuation of financial assets.

1.7 Key Terms and List of Select Abbreviations

a) Key Terms

(1) Derivative Product : It is nothing but a financial contract which is settled at a future date. The value of such product is derived from the value of underlying assets or other hedged items. This product is used as a hedging instrument to hedge against specific risk like price risk and also for speculative transactions.

(2) Forward Contract : It is customized contract between two parties where settlement takes place on a specified date in a near future at price which is decided at the beginning of the contract. Such contracts are executed to hedge against price risk in respect of assets like commodities and foreign currencies.

(3) Futures Contract : These are special types of forward contracts. Such contracts are designed and introduced by the stock exchanges. Because of this, it is called as standardized exchange traded contracts. These contracts are standard in terms of quantity; date and month of settlement and margin etc. Such contracts trade on stock exchange where stock exchange itself is a counter party and transactions are settled through clearing house of a stock exchange.

(4) Options Contract : It is a financial contract under which buyer of the options contract buys the right without any obligation to buy (call option) or sell (Put option) a standardized quantity (contract size) of a financial asset like equity, gold, foreign currency at or before pre-determined date (expiry date) at a price which is decided in advance. In India the buyer of an options contract can exercise his right on the expiration date.

(5) Swaps : It is a financial contract between two parties to exchange cash flows arising on account commitments with respect to their borrowings or assets without canceling the original transactions. Such

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done to hedge against interest rate risk currency risk.

(6) Money Market : It is a market for short term instruments like commercial papers (CPs), certificate of Deposits (CDs), Treasury Bills (TB), etc. Such instruments are used to borrow or lend funds for a period up to 12 months. This market is used by participants to manage their liquidity on regular basis. This market acts as an equilibrating mechanism for evening out short term surplus and deficit.

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(7) Debt Market : It is a market for debt instruments. It is comprised of the Government Securities Market and Corporate Debt and Bond Market. The Government borrows funds through issue of various Government Securities from the Government Securities Markets. This market is regulated by the RBI. The banks, financial Institutions, Local Bodies, Public Sector undertakings and companies in private sector borrow funds through issue of various debt instruments from corporate debt market. The market for long term corporate debt instruments is regulated by the RBI.

(8) Equity Market : It is a market for equity shares and preference shares. The companies issue such shares in the primary market to raise funds for longer period. The secondary market for equity is nothing but stock exchange which provides liquidity and price discovery in respect of listed shares. Such market is strictly regulated by the SEBI.

(9) Foreign Exchange Market : This is a market where individuals, commercialenterprises, banks and brokers purchase and sell different foreign currencies. The major players in this market are banks, retail clients like exporters and importers etc. This market is regulated by RBI.

(10) Derivatives Markets : This market is comprised of derivative products, participants and regulators. There are two types of derivatives namely exchangetraded derivatives like futures contracts and over the center (OTC) derivative products like forward contracts. Such market offers interest rate derivative products, equity-linked derivative products, currency derivative products & credit derivative products.

(11) Primary Market : It is a market for issue of view securities. Funds are raised through issue of new securities in the primary market. It is also called as New Issue Market (NIM).

(12) Secondary Market : It is a market place for trading in existing securities. The stock market is an integral part of secondary market. The stock market provides a platform for trading in old securities which are listed on a stock exchange. The secondary market for unlisted securities is yet to be developed.

b) List of Select Abbreviations

1) RBI : Reserve Bank of India

2) FIMMDA : Fixed Income Money Market Derivatives Association of India

3) CCIL : Clearing Corporation of India

4) SEBI : Securities Exchange Board of India

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5) FEDAI : Forex Dealers Association of India

6) NHB : National Housing Bank

7) NBFC : Non –Banking Finance Company

8) PD : Primary Dealer

9) CBLO : Collateralized Borrowing Lending Obligations

10) FEMA : Foreign Exchange Management Act.

1.8 Self-Assessment Questions

Q.1 State whether the following statements are true or false

1. Because of deregulation, participants in the financial markets are exposed to the market risk.
2. New securities are issued in the primary market.
3. Financial system is comprised of only financial markets and instruments.
4. The primary market does not help to raise funds for the business.

Q.2 Explain various functions of financial system

Q.3 Explain in brief the following segments of financial markets

i) Money Market

ii) Foreign Exchange Market

Q.4 Explain the impact of followings on financial markets

i) Use of information technology

ii) Deregulations

iii) Globalizations

Q.5 I) what do you mean by formal and informal markets

ii) Why the participants in the financial markets prefer to be associated with formal markets.

a) Further Reading and References

1. Financial Institution and Financial Markets in India, Functioning and Reforms, Bhasin Niti, Published by New Century Publications, Latest Edition
2. Growth and Development in Emerging Market Economies by H Kohli, Published by Sage Publications, Latest Edition
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4. Financial Markets and Exchanges Law by Blair Michel and Walker George, Oxford University Press, Latest Edition
5. Annual Reports of the RBI.
6. Website of RBI, SEBI, CCIL, FIMMDA

NOTES

Unit 2 Financial System of India – II: Financial and Capital Market Intermediaries and Developments in Financial System

Structure

2.1 Introduction

2.2 Unit Objectives

2.3 Financial Intermediaries and Its Role

2.4. Capital Market Intermediaries and Its Role

2.5 Developments in Financial System

2.6. Summary

2.7 Key Terms and List of Select Abbreviations

2.8 Self -Assessment Questions

2.9 Further Reading and References

2.1 Introduction

The financial intermediaries play a significant role in the financial markets. They mobilize savings from investors and make available funds to those who are in need of funds for productive purpose. Thus the financial intermediaries contribute towards growth in savings and investment. The capital market intermediaries help the companies to issue securities so as to raise funds from the market. In this unit, the role of financial and capital market intermediaries along with broad idea about regulatory framework is discussed.

2.2 Unit Objectives

The objectives of this unit are as under :

1. to understand the role of financial and capital market intermediaries in the financial markets.
2. to know who regulates financial and capital market intermediaries and their regulatory framework.
3. To study significant developments in the financial system.

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2.3 Financial Intermediaries and Its Role

The financial intermediaries are key to the development of financial markets and thus to achieve economic growth. The banks, non-banking finance companies, insurance companies and mutual funds etc. are major financial intermediary institutions in the financial markets. Their role is explained below:

2.3.1 Banks

Banks accept the deposits for the purpose of creating loan assets. The banks have various deposit products such as current, savings, recurring and term deposits. These deposits form almost 90 per cent of total funds of banks. In order to attract savings from the depositors banks have designed and introduced different deposit schemes. By offering various deposit products, banks encourage household sector to save more from their income. This activity of banks helps to nurture saving habits among the various classes of savers or investors. Banks use these deposits to provide financial assistance by way of working capital loans, long term loans and other types of loans to the individuals as well as Institutional borrowers. Therefore banks act as an agent between depositors and borrowers. Therefore,banks perform the role of financial intermediaries. Among all the financial intermediaries, banks are the most important financial intermediaries in the financial system. Banks also subscribe securities in the primary market and make funds available for the productive use. In India the RBI being a central bank of a country regulates the banking system with a view to ensure that banks are financially viable and strong.

2.3.2 Non-Banking Finance Companies (NBFCs)

These companies which are registered with the RBI accept term deposits (i.e. for a minimum period of 6 months and maximum period of 3 years) from the public. The NBFCs use deposits and other borrowings to provide leasing, hire-purchase, bill discounting and housing finance to the borrowers. Thus, NBFCs, like banks are financial intermediaries in the financial system. In India, NBFCs are allowed to undertake only fund based business. As per the RBI's guidelines, these NBFCs are classified into several categories such as asset finance companies, loan companies, investment companies, factoring companies etc. The NBFCs which accept public deposits and which are other than housing finance companies are regulated by the RBI. These NBFCs have to carry out their business as per the guidelines issued by the RBI. The NBFCs which are housing finance companies are regulated by the National Housing Bank (NHB) and hence these housing finance companies are required to carry out their business as per the guidelines issued by the NHB. These NBFCs face competition from banks and find it difficult to survive in a competitive market environment.

2.3.3 Insurance Companies

The Insurance Companies mobilize funds through sale of various life and non-life insurance policies. They get regularly funds in the form

from the policy holders. The insurance companies invest these funds in the equity and debt instruments and also provide financial assistance to the social and infrastructure projects. Thus the insurance companies perform the role of financial intermediaries between insurance policy holders and institutions/companies who are in need of financial assistance.

2.3.4 Mutual Funds

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The mutual funds sale various schemes of mutual funds to the small investors and mobilize the funds. They invest these funds in the money market instruments, like commercial papers, certificate of deposits, treasury bills as well as in the capital and debt market instruments like equity, long term debentures and bonds, Government securities etc. The nature of mutual funds business clearly shows that like banks and insurance companies, mutual funds are also act as financial intermediary institutions in the financial markets.

2.3.5 Development Financial Institutions

Along with financial intermediaries, like banks and NBFCsdevelopment financial institutions like Export Import Bank of India (EXIM Bank), Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD) and National Housing Bank (NHB) play a significant role in the financial markets.

These financial institutions also perform the role of financial intermediaries. They mobilize funds through issue of commercial papers, long term bonds and certificate of deposits. The investors having surplus funds, subscribe to these financial instruments. These institutions provide financial assistance to select sectors of an economy. For example, the EXIM Bank provides financial assistance to the exporters and importers, both in Indian rupees and in foreign currencies. It also function as the principal financial institution for coordinating the working of institutions engaged in financing export and import of goods and services with a view to promote the country's international trade. The SIDBI is the principal financial institution for the promotion, financing and development of the micro, small and medium enterprise in India. It provides refinance to primary lending institutions like banks and state finance corporations etc. in respect of their financial assistance to the micro, small and medium enterprises. It also coordinates the functions or activities of other institutions engaged in similar activities. The NABARD is an apex level development financial institution to facilitate credit flow to the agriculture, small, micro and cottage industries and other economic activities in rural areas to promote and develop these sectors. The NABARD also provides refinance facilities to the commercial banks, regional rural banks (RRBs) and agriculture co-operative banks in respect of their long term and short term credit for the promotion of economic activities including agriculture in the rural areas. The NHB functions as a principal agency to promote housing finance companies and to provide financial and non-financial support to the housing finance companies. It acts as an apex level financial institution for development of housing sector in India. It also provides refinance facility to the primary lending institutions in respect of housing loans.

Check your Progress

Q.1. State whether the following statements are true or false

(i) The non-banking finance companies (NBFCs) are not financial intermediaries in the financial market.

(ii) Only banks are financial intermediary institutions in the financial markets.

(iii) Insurance companies mobilize funds mainly through issue of commercial papers.

Q.2. What do you mean by financial intermediaries ?

Q.3. Explain in two or three lines about following financial intermediaries

i) Banks
ii) Insurance Companies
iii) Mutual Funds

2.4 Capital Market Intermediaries and Its Role

Capital market intermediaries play an important role in the development of a capital market. These intermediaries help the companies to issue financial instruments to raise short term as well as long term funds in the primary market and to facilitate trading in such instruments in the secondary market. The important capital market intermediaries are merchant bankers, credit rating agencies, etc. Their role in the capital market is explained below:

2.4.1 Merchant Banking Organizations orMerchant Bankers

A merchant banking organization is defined as that organization which acts as an intermediary between the issuers and investors who subscribe securities in the primary market.

According to the SEBI Rules on Merchant Bankers, 1992, a merchant banking organization is defined as that organization which is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

As per the SEBI guidelines on Merchant Bankers, other than banks and financial institutions, a body corporate is eligible to get registered as a merchant banker with the SEBI. In view of this, partnership firms and proprietary concerns are not allowed to undertake merchant banking business in India.

As per the SEBI guidelines, non-banking finance companies are prohibited from undertaking merchant banking business in India.

The SEBI has been authorized to regulate the activities of merchant bankers. In view of this, merchant banking organizations have to get registered with the SEBI and obtain certificate to undertake merchant banking business. Unless a certification of registration is obtained from the SEBI, no corporate body can act as a merchant banker. Once a registration certificate is issued by the SEBI, it remains valid for three years from the date of issue. The same certificate must be renewed after the completion of three years.

Before 1997, the SEBI had introduced 4 categories of merchant bankers in the capital market. These categories were as under:

Category I: To carry on the activity of issue management and to act as advisor, consultant, manager, underwriter and portfolio manager.

Category II: To act as an adviser, consultant, co-manager, underwriter and portfolio manager.

Category III: To act as an underwriter, advisor or consultant to an issue.

Category IV: To act only as adviser or consultant to an issue.

With effect from December 9, 1997, the SEBI has brought a change in the categories of merchant banking organizations in India and accordingly haskept only Category I merchant banking organizations for registration. These organizations have been permitted to act as a lead manager or co-manager to any public issue.

The data about number of merchant bankers registered with SEBI during 2007-2008 to 2012-2013 is given below:

Year Bankers	No. of Merchant
2007-2008	155
2008-2009	134
2009-2010	164
2010-2011	192
2011-2012	200
2012-2013	198

Source : Handbook of Statistics on Indian Securities Market, Published by the SEBI, 2013

Structure of Merchant Banking Firms

At present merchant banking activities are carried out by the following organizations:

1. **Commercial Banks :** Banks have been permitted to undertake merchant banking business as a part of universal banking business through a separate department. Most of the banks have a separate merchant banking division.

2. **Subsidiaries of Banks :** Few banks like SBI, BOB and Indian Bank have their own subsidiaries to undertake merchant banking business.

Activities of Merchant Bankers

The merchant bankers are required to focus on securities related business namely issue management and underwriting. The main activities of a merchant banker are as under:

- Issue management covering public and right issue of equity (i.e. to act as a lead manager to a public issue.)
- Public issue of debt instruments.
- Private placement of debt and equity securities.
- Buy back arrangement for purchase of its own equity shares by the companies.
- Providing underwriting support to a public issue.

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In addition to the above activities, merchant bankers also provide following services:

A) Corporate advisory services:

- Advising on merger, acquisition and demerger (including privatization, financial restructuring and valuation of firm or equity).
- Project appraisal (for investors, borrowers and creditors) and Loan Syndication (i.e. arranging funds from Indian and International financial markets for infrastructure projects including power, road, telecommunication and energy projects, etc.)

B) Investment Advisory Services

- Brokering services.
- Sale and distribution of securities.
- Sale of units of mutual fund schemes.
- Securities research. (Mainly Equity Research)
- Portfolio management service.

2.4.2 Underwriters

Underwriters are capital market intermediaries who undertake to subscribe to the securities which are offered by a company in case these securities are not fully subscribed by the public, in case of an underwritten issue. Underwriting is an arrangement wherein an underwriter enters into an agreement with the issuer company for purchasing the shares or bonds as the case may be as specified in their agreement if public or other persons fail to subscribe to them, for a commission. The underwriters help the issuers to raise funds through public issue even if there is no response from the public.

The category I merchant banking organisations and others who are registered with the SEBI as underwriters are allowed to provide underwriting support to a public issue. By and large banks, specialized merchant bankers and stock brokers provide underwriting support to a public issue.

The data about number of underwriters registered with SEBI during 2007-8 to 2012-13is given below:

Underwriters **Total**	Bankers)	**Underwriters**	
	(A)	(B)	(A+B)
2007-08	155	35	190
2008-09	134	19	153
2009-10	164	05	169
2010-11	192	03	195
2011-12	200	03	203
2012-13	198	03	201

Source : Handbook of Statistics on Indian Securities Market, Published by the SEBI, 2013

2.4.3 Credit Rating Agencies

The credit rating agencies provide credit rating services in respect ofdebt instrumentsand initial public offering (IPOs). This rating agencies help issuers, investors, and lenders to take financing and investment decisions optimally. These agencies play a significant role in the development of capital market.

The credit rating agencies are regulated by the SEBI. A credit rating agency can be promoted by any of the following organization or combination thereof.

(a) Public financial institution as defined in section 4-A of the Companies Act of 2013

(b) Scheduled bank

(c) Foreign bank operating in India with the RBI approval.

(d) Foreign credit rating agency having at least five years experience in rating of financial instruments and

(e) Any company incorporated under the Companies Act or body corporate having continuous minimum networth of Rs. 100 crore as per its audited annual accounts for the previous five years prior to filing of the application with the SEBI for registration.

At present in India there are six credit rating agencies which rate debt instruments. The name of these rating agencies are given below:

1) Credit Rating Information Services of India (CRISIL Ltd)

2) Credit Analysis and Research (CARE) Ltd

3) Fitch Rating Agency

4) Brickwork ratings

5) Investment Information and Credit Rating Agency of India Ltd. (ICRA Ltd.)

6) SMERA Ratings Limited

2.4.4 Registrars to an Issue and Share Transfer Agents:

I) Registrars to an Issue

The registrarsare those entities which are selected by the issuer in consultation with a merchant banker. These entities perform following functions:

a) to finalize the basis of allotment in anissue

b) to finalize list of persons to whom securities are to be allotted

c) to process and send refund orders and allotmentletters etc.

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II) Share Transfer Agent

The Share Transfer Agents perform following functions.

a) to maintain the records of holders of financial instruments issued by registered companies.

b) Torecord all transactions pertaining to the transfer or redemption of financial securities.

According to the section 12 of SEBI Act, 1992 only those entities which are registered with the SEBI and having a certificate of registration are allowed to undertake the business of registrar to a public issue and act as a transfer agent.

The data about number of registrars to an issue and share transfer agents registered with the SEBI during 2007-08 to 2012-13 is given below :

Year	No. of Registrars to an Issue and Share Transfer Agents
2007-08	76
2008-09	71
2009-10	74
2010-11	73
2011-12	74
2012-13	72

Source : Handbook of Statistics on Indian Securities Market, Published by the SEBI, 2013

2.4.5 Bankers to a Public Issue

A scheduled bank as specified in the schedule II to the RBI Act 1934 is allowed to act as bankers to an Issue. It perform the following functions

a) to accept share applications with money

b) to accept allotment and calls money

c) to refund money in case shares are not allotted.

d) to pay dividend on behalf of companies.

With the help of bankers to a public issue it becomes easy to make funds available to issuers and to submit status report to the registrars.

2.5 Developments in the Financial System

Today's financial system is different from their status in the past. The following developments have brought significant changes in the financial system.

i) Use of Information Technology

Use of information technology has made a complete revolution in the financial system. The financial instruments are issued in demat form. The trading in securities is also in demat form and on line. This has led to the introduction of new products and innovations in the existing products. Apart from this, technology is used for processing of market data and settlement of transactions. This has resulted into increase in turnover in the various segments of financial markets.

ii) Deregulation of Markets

Most of the segments of financial markets are deregulated.This means price of a financial asset is determined not by the regulator but by the market forces i.e. demand and supply. For example, interest rates in call/notice/term are determined by the market forces (i.e. demand & supply). Similarly the securities in the Government debt market and equity market are issued under auction system. Therefore, the market participants decide about the price of the financial assets in the primary market. Further the price of financial assets in the secondary market also depends on market conditions which include demand and supply. The banks are also free to decide about pricing of deposit and loan products. It has led to the price discovery of financial assets. This has made various markets more efficient and transparent. However because of deregulation of markets, market participants are exposed to the market risk comprising interest rate risk and currency risk.

Hence market participants while participating in the financial markets require to focus on management of market risk in their business. In view of this, risk management has become in very relevant exercise in commercial organizations particularly in banks and other lending institutions.

iii) Integration of Markets

The various segments of financial markets are integrated with each others. For example changes in the yield on money market instruments affect the prices of securities market as well as exchange rates. Because of this, banks, financial institutions and companies have opted for integrated treasury which helps them to improve performance of treasury operations.

iv) Impact of Globalization

The Government has liberalized many economic policies and relaxes norms for participation of NRIs, foreign institutional investors and multinational companies in the domestic financial markets. This has made domestic markets more venerable to the investment decisions of FIIs, NRIs and Multinational companies. Further local banks and companies have been permitted to raise funds in international money and capital markets and bring those funds in the domestic market. Because of this, domestic markets are not only linked with international financial markets but have become much more volatile.

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2.6 Summary

The financial intermediary institutions like banks, NBFCs, Insurance companies act as agent between savers and borrowers.Capital market intermediaries play an important role in the development of a capital market. These intermediaries help the companies to issue financial instruments to raise short term as well as long term funds The financial markets in India have dynamic and vibrant due to deregulation, use of information technology, globalizations etc.The various segments of domestic financial markets are integrated with each other. Similarly domestic markets are also integrated with international markets.

2.7 Key Terms and List of Select Abbreviations

a) Key Terms

1) **Financial Intermediaries**

They mobilize savings from investors through sale of different financial products and make available funds to those who are in need of funds for productive purpose. Thus the financial intermediaries act as an agent between savers and borrowers.

2) Capital Market Intermediaries

The capital market intermediaries help the companies to issue securities so as to raise funds from the capital market.

3) Merchant Bankers

It is a registered entity with the SEBI which is allowed to carry on the activity of issue management and act as advisor, consultant, manager and underwriter to a public issue of various securities.

4) Deregulation of Markets

The various segments of financial markets are deregulated. This means prices of financial assets are determined by the market forces (i.e. demand and supply). For example securities in the Government securities market are issued under the auctions similarly interest rates in varioussegments of money market like call/notice/term money are determined by the market forces. Because of deregulation of markets, participants are exposed to price risk in respect of their financial assets.

5) Integration of Markets

The various segments of financial markets are integratedwith each other. For example changes in the yield on money market instrumentsinfluences prices of long term securities as well as exchange rates.

6) Credit Rating

Credit rating may be defined as an expression, through use

opinion about the quality of credit of the issuer of debt securities with reference to a particular instrument. As per the SEBI regulations, credit rating is nothing but as an opinion regarding securities expressed in the form of standard symbol or in any other standardized form assigned by a credit rating agency. The symbol given by rating agency for credit rating indicates a credit character of that particular security and thus it only facilitates to take a view on credit risk pertaining to that security.

7) Market Risk

Market risk refers to the risk or loss resulting from changes in market prices of financial assets and commodities like gold and foreign currency due to the changes in interest rates and foreign exchange rate. In simpler terms, it may be defined as the possibility of loss caused by changes in the equity and commodity prices

8) Underwriters

Underwriters are capital market intermediaries who undertake to subscribe to the securities which are offered by an issuer company in case these securities are not fully subscribed by the public, in case of an underwritten issue.

b) List of Select Abbreviations

1) NBFCs : Non –Banking Finance Companies

2) SEBI : Securities Exchange Board of India

3) FIIs : Foreign Institutional Investors

4) CRISIL : Credit Rating Information Services of India Ltd

5) CARE : Credit Analysis and Research Ltd

6) ICRA : Investment Information and Credit Rating Agency of India

2.8 Self -Assessment Questions

Q.1 State whether the following statements are true or false

1. Only banks are financial intermediary institutions in the financial markets.
2. Mutual funds are allowed to accept demand deposits from the public.
3. Credit rating agencies are not capital market intermediaries.
4. Capital market intermediaries are regulated by Securities Exchange Board of India.
5. All the NBFCs are regulated by the RBI.
6. Most of the markets are not deregulated.

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Q.2 Explain various functions of following capital market intermediaries

i) Merchant Bank

ii) Underwriter

iii) Credit Rating Agency

Q.3 Explain in brief the roll of following financial intermediaries in the financial system

i) Banks

iii) Financial Institutions

iii) Insurance Companies

iv) Mutual Funds

Q.4 Explain the impact of followings on financial markets

i) Use of information technology

ii) Deregulations

iii) Globalizations

2.9 Further Reading and References

1. Financial Institutions and Financial Markets in India, Functioning and Reforms, BhasinNiti, Published by New Century Publications, Latest Edition

2. Growth and Development in Emerging Market Economies by H Kohli, Published by Sage Publications, Latest Edition

3. India's Financial Markets: An Insider's Guide – How to markets work; Ajay Shah and Thomas Susan, Published by Elsevier, Noida, Latest Edition

4. Financial Markets and Exchanges Law by Blair Michel and Walker George, Oxford University Press, Latest Edition

5. Annual Reports of the RBI.

6. Website of RBI, SEBI, CCIL, FIMMDA

Unit 3 Indian Money Market-I: Features, Functions and Instruments

Structure

3.1 Introduction

3.2 Unit Objectives

3.3 Features and Functions of Money Market

3.4 Vagul Committee Report and its Recommendations

3.5 Money Market Instruments and Participants

3.5.1. Call and Notice Money Market

3.5.2. Term Money Market

3.5.3. Treasury Bills Market

3.5.4. Commercial Bills Market

3.5.5. Certificate of Deposits (CDs)

3.5.6. Commercial Papers (CPs)

3.5.7. Inter Bank Participation Certificate (IBPCs)

3.6 Summary

3.7 Key Terms and List of Select Abbreviations

3.8 Self Assessment Questions

3.9 Further Reading and References

3.1 Introduction

The money market is an important segment of financial markets which deals with money and short-term financial assets which are close substitutes for money. The short term financial assets are those which can be quickly converted into money with minimum transaction cost. In other words, the money market is a market for borrowing and lending of funds for short period i.e. up to 12 months or a year. In addition to the funds, short term financial instruments are also used to lend or borrow funds for a short period i.e. up to 12 months. This market acts as an equilibrating mechanism for evening out short term surplus and deficit. The money market in India is fully regulated by the Reserve Bank of India (RBI). In other words, the players, the instruments and other regulations are decided by the RBI. Further the RBI through its intervention in the money market brings out variations in liquidity profile in the economy. Along with the RBI, the Fixed Income

Money Market Derivatives Association of India (FIMMDA) a self regulatory organization also makes rules for market participants for executing transactions both in the primary and secondary money market. The various participants including banks, primary dealers and others undertake transactions in the money market in respect of various instruments with a view to manage liquidity and improve yield on short term instruments.

3.2 Unit Objectives

The objectives of this unit are as under :

(I) to know features of the money market and its functions

(ii) to study various money market instruments in terms of characteristics, participants, size and the RBI guidelines.

3.3 Features and Functions of the Money Market

The various features of the money market are as follows :

a. It is a wholesale market. The size of each transaction is very large like say, ` 5 crore, 50 crore and 100 crore, etc.

b. Large number of instruments are used in this market. This is mainly because the market is highly innovative and regulator also brings innovations in the existing money market instruments and introduce new instruments.

c. Since financial instruments are used to raise funds for very short period, this market provides high liquidity, low price risk and less degree of credit risk for such instruments.

d. The various segments of money market have very close inter-relationship as well as are substitutes for each other. Because of this, funds are freely transferred from one segment of the money market to another segment.

e. The transactions in the money market are short term in nature i.e. upto one year or less than one year.

f. The money market does not have a physical location but all participants are linked by a sophisticated network of telex, telephones, faxes and computers and transactions are carried out in electronic form through use of computer system.

g. This market is deregulated. Therefore, the interest rates on money market instruments are determined by the market forces (i.e. demand and supply).

Functions of Money Market :

The important functions of the money market are as follows:

1. It facilitates the transfer of large sums of money between institutions with surplus of funds and deficit of funds. Thus the money market provides mechanism by which surplus funds can be transferred from cash rich institutions to those institutions that require short term funds. Institutions like banks who are required to manage its liquidity on daily basis depend heavily on money market for the same.

2. This market helps the government and non government institutions to raise large amount of funds with out any difficulties to meet its current expenditure or working capital needs.

3. The RBI use money market to implement its monetary policy keeping in view available liquidity, existing inflation rate and current economic conditions.

4. The structure of short term interest rates in this market is determined by the market participants themselves based on demand for and supply of funds. Thus it provides information about yields on various money market instruments.

2.4 Vaghul Committee Report: Recommendations

In the backdrop of rigidities in the money market, the RBI recognised need to take necessary steps for the development of a healthy and active money market. Accordingly the RBI appointed a working group under the Chairmanship of Shri N Vaghul in September 1986 to undertake indepth study of the money market and to make recommendations for bringing desired changes in the money market.

The specific terms of reference of the Vaghul Committee were :

(i) To examine money market instruments and recommend specific measures for their development

(ii) To recommend the pattern of money market interest rates and to indicate whether these should be administered or determined by the market

(iii) To study the feasibility of increasing the participants in the money market

(iv) To assess the impact of changes in the cash credit system on the money market and to examine the need for developing institutions such as discount houses, and

(v) To consider any other issue having a bearing on the development of the money market.

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The Vaghul Committee submitted its report in 1987 and suggested the following course of action :

(i) To increase the number of participants to broaden the base of the money market

(ii) To activate the existing instruments and developing new ones so as to have a diversified mix of instrument

(iii) To move from administered interest rates to market determined interest rates, and

(iv) To create active secondary market though establishment of specialized institutions like discount houses or primary dealers.

The RBI accepted most of the recommendations of the Vaghul Committee and had taken a number of steps to develop the money market.

3.5 Money Market Instruments & Participants

As a part of the economic reform process, the RBI has brought about significant changes in the money market in order to make it more efficient and vibrant. All these changes have been effected in the context of instruments, participants and their participation in the primary as well as in the secondary markets. The list of various instruments and participants in the money market is given below.

Instruments	*Participants*
1. Call/Notice Money	1. Banks
2. Term Money Market	2. Primary Dealers
3. Treasury Bills	3. Financial Institutions
4. Repo (Repurchase Agreements)	4. Mutual Funds
5. Commercial Bills	5. Insurance Companies
6. Certificate of Deposits	6. Non-Banking Finance Companies and other Companies
7. Commercial Papers	7. Individual
8. Inter-Bank Participation Certificates	

The various features of the Indian money market can be studied in relation to the various instruments as well as participants or players. These features are discussed below :

Check your Progress

Q.1. State whether the following statements are true or false ?

(i) The money market is retail market.

(ii) The money market does have a physical location.

(iii) The money market is partially regulated by the RBI.

(iv) The fixed income Money Market Derivatives Association of India (FIMMDA) has nothing to do with money market.

(v) Money market instruments have high liquidity, low price risk and less degree of credit risk.

(vi) Vaghul committee on money market recommended to move from administrated interest rates to market determined interest rates.

Q.2 (i) What do you mean by the money market ?

(ii) Explain in brief various features of the money market.

(iii) What are the important functions of the money market ?

3.5.1 Call and Notice Money Market

The Call and notice money market is an important segment of the money market. In the call money market, the money is borrowed or lent for a day. It is also called as inter bank market or known as overnight money market. When money is borrowed or lent for more than a day but upto 14 days it is called "notice money". No collateral security is involved in such type of transactions. Participants use call money market to manage their day to day surpluses or deficits in their daily cash inflows and cash outflows.

The participants in the call and notice money market are banks and primary dealers. Both the banks and primary dealers are permitted to lend and borrow simultaneously. The primary dealers have been permitted to lend in call and notice money market upto 25 per cent of their Net Owned Funds (NOF) on a fortnightly average basis. State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) have been permitted to borrow from call and notice money market upto 2.0 per cent of their aggregate deposits as at the end of March of the previous financial year. The transactions done by the banks and primary dealers in call and notice money markets are being monitored on a daily basis by the RBI.

The screen based negotiated quote driven system (NDS-Call) was introduced in September 2006 in respect of dealings in call and notice money market. It does not require separate reporting. If the deals are not done through NDS-Call system then such deals must be reported within 15 minutes on Negotiated dealing system (NDS) screen. The interest rates in call and notice money market are determined by the market participants based on demand and supply of funds. The data relating to the weighted average call money rates during 2005-06 to 2013-14 is given in Table 3.1.

Year	High	Low	Average
2005-06	8.25	0.60	5.60
2006-07	80.00	1.90	7.22
2007-08	55.00	0.01	6.07
2008-09	23.00	1.00	7.06
2009-10	9.00	0.50	3.24
2010-11	12.00	0.25	5.75
2011-12	15.00	0.70	8.22
2012-13	18.00	5.00	8.09
2013-14	35.00	0.50	8.28

Source : RBI Publication on Hand book of Indian Economy Statistics

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3.5.2 Term Money Market

Funds are also borrowed or lent for a period beyond 14 days but upto 365 days by banks and primary dealers. Select financial institutions like SIDBI, EXIM and NABARD, etc., have been permitted to borrow funds from term money market for a period of 3 to 6 months. Like call and notice money market, transactions are carried out in term money market without having any collateral securities. Despite the initiative taken by the RBI, the term money market is not fully developed in India. Banks, primary dealers and other participants are not prepared to give quotes for lending in the term money market.

3.5.3 Treasury Bills Market

Treasury bills are short term securities issued by the Government of India to borrow from the money market. The RBI auctions T-bills at regular intervals. These treasury bills are issued at a discounted value and redeemed at par on maturity date. Therefore, it is also called zero coupon gilt security. The difference between the discounted value and redemption value constitute interest income for the investor. At present the RBI issues three types of T-bills having different maturities, namely, 91-day T-bills, 182 day T-bills and 364-day T-bills. These securities are issued under multiple price auctions. While participating in the bidding process, the bidder is required to indicate price and quantum of size to be subscribed.

Due to the market determined yields and the increased floating stock the secondary market for T-bills is very active. Banks and PDs are principal investors as well as traders in the T-bills market. Banks subscribe T-bills for maintenance of the Statutory Liquidity Ratio (SLR) and for better asset-liability management. Apart from banks and PDs, other institutions like insurance companies, mutual funds, financial institutions and NBFCs are active participants in T-bills market. The yield on various T Bills issued during 2011-12 to 2012-13 is shown in Table 3.2.

Table 3.2

Implicit yield at cut-off price on various Treasury Bills

Type of T-bills	Date of Auction	Yield at cut-off Price
2011-2012		
91 Day	January 2	8.5201
182 Day	January 4	8.4215
364 Day	January 11	8.2007
2012-13		
91 Day	April 4	8.8131
	July 4	8.2692
	December 19	8.1439
182 Day	April 11	8.5741
	July 4	8.2692
	December 19	8.1388
364 Day	April 4	8.3417
	July 11	8.0601
	December 12	8.6484

Source : RBI Publication on Handbook on Indian Economy

3.5.4 Commercial Bills Market

In order to develop commercial bills market, the RBI introduced an innovative instrument known as "Derivative Usance Promissory Notes" backed by such eligible commercial bills for required amounts and usance period (upto 90 days). The government has exempted stamp duty on derivative usance promissory notes. This has made commercial bills an active instrument in the secondary money market. The participants are banks, PDs, financial institutions and mutual funds. All participants in the call/notice money market can rediscount such commercial bills for which a minimum period is 15 days and maturity date of the bill is not more than 90 days from the date of rediscounting. The market for bills rediscounting registered a declining trend. At present this market is not active.

3.5.5 Certificate of Deposits (CDs)

The Certificate of Deposit as a money market instrument was introduced in 1989. The certificate of deposits are issued at a discount to face value as unsecured and negotiable promissory notes. The issuing bank is free to determine the discount rate. Banks and financial institutions have been permitted to issue CDs for a maturity of 7 days to 1 year and 1 year to 3 years respectively. Only scheduled commercial banks excluding RRBs and Local Area Banks have been allowed to issue CDs. There has been no restriction by the RBI on the amount to be raised by the banks through issue of CDs. Financial institutions are allowed to issue CDs within the overall combined limits (i.e. up to 100 per cent of net owned funds as per the latest audited balance sheet) fixed for issue of CDs along with other instruments like term money borrowing and term deposit etc. The issuer of CDs has freedom to decide a discount rate or interest rate. Such discount rate depend on various factors which include tenor, size, and prevailing yield on other comparable money market instruments, liquidity position of an issuer etc. The minimum size of CD is ` 1 lakh and it must be issued denomination of ` 1 lakh. This means it can be issued in multiples of ` 1 lakh. Such CDs can easily be traded in the secondary market by endorsement and delivery. With a view to providing flexibility and depth to the secondary market, restriction on the transferability period for CDs issued by banks and financial institutions was withdrawn. As a result of this, there is no restriction on transferability period. There is a need to rationalize the maturity structure of CDs and to bring variation to this instrument such as interest bearing CD and CD with floating rate. With a view to providing more flexibility for pricing of CDs and to give additional choice to both investors and issuers the RBI has allowed banks and financial institutions to issue CDs having floating rate basis provided the methodology of computing the floating rate is objective, transparent and market based. With effect from June 30, 2002, banks and financial institutions have been permitted to issue CDs in the dematerialised form.

Check your Progress

Q.1. State whether the following statements are true or false ?

(i) Only banks and primary dealers are allowed to participate in the call and notice money market.

(ii) The treasury bills are issued at a discounted value and redeemed at par value on maturity date.

Q.2. Define the following money market instruments ?

(i) Call and notice money market.

(ii) Term money market.

The main characteristics of CDs are as under

i) The CDs are issued in the form of usance promissory notes. Therefore such CDs are freely transferable by endorsement and delivery. There is no restriction on transferability period

ii) The CDs are subscribed by individuals, companies, trusts, mutual funds and NBFCs etc. The Non-Resident Indians (NRIs) are allowed to invest in CDs on non-repatriable basis.

iii) Banks and financial institutions are not permitted to buy-back their own CDs before maturity. Futher these lending institutions cannot lend against their own CDs.

The select data about issue of CDs during 2008-09 to 2013-14 is given in Table 3.3.

Table 3.3

Issue of Certificate of Deposits by Scheduled Commercial Banks

Fortnight Ended	Total Outstanding (Rs. In Crore)	Rate of Interest (%)
2008-09		
August 1	163546	8.92 – 11.05
January 16	162883	6.10 – 11.50
2009-10		
August 14	230198	3.75 – 8.00
January 15	264698	3.38 – 6.61
2010-11		
August 13	327582	6.25 – 7.90
January 14	371881	7.18 – 9.82
2011-12		
August 12	404743	8.70 – 9.92
January,13	374890	9.25 – 10.10
2012-13		
August 10	414630	8.44 – 9.30
January 11	338286	8.19 – 8.88
2013-14		
April 15	150355	7.80 —13.25
June 30	135588	7.58 — 12.71

Source : RBI Publication on Handbook on Indian Economy

3.5.6 Commercial Paper (CP)

The Commercial paper (CP) as a money market instrument was introduced in January 1990 with a view to enabling medium and large companies to raise short term funds for working capital purpose. In view of this, the companies can issue CP to raise funds from money market for working capital. In fact raising of funds through CP is considered as a substitute for working capital finance from banks. Further, issue of CP helps the companies to bring down cost of funds as it is issued at a lower rate than the lending rates of banks. Before issue of CP, the issuer Company has to comply with following conditions with respect to net owned funds and credit facilities from banks and financial institutions.

i) The tangible net worth of an issuer is not less than Rs.4 crore

ii) Lending institutions like banks and financial institution have appraised the borrower’s loan proposal and sanctioned working capital limit.

iii) The account is classified as standard asset by the financing bank and/ or All India Financial Institutions (AIFIs).

Such CPs are issued in the form of usance promissory notes, which are negotiable, by endorsement and delivery. Such CPs cannot be issued with put and call options. The issuer of CP has to appoint a scheduled commercial bank as an Issuing and Paying Agent (IPA) to raise funds through CP. The role of IPA is to act as a merchant banker and help the issuer to raise funds through CP. Since each issue of CP is required to be rated by a credit rating agency and subjected to a minimum rating of A3 given by any recognized rating agency, only well-rated companies can issue CPs. The minimum issue size of CP is ` 5 lakh. Such paper can be issued for a minimum period of 7 days and maximum period of 1 year. CPs have been subscribed by financial institutions, banks, mutual funds, insurance and other companies. Of these, the banks, financial institutions and PDs have been directed to make fresh investments and hold CPs in only dematerialized form with effect from June 30, 2001. Because of this, now-a-days CPs are issued in demat form. The secondary market for CP is active in India. The issuers are allowed to buy back of CPs from secondary market at prevailing market price. The select data about issue of commercial papers by companies is given in Table 3.4.

Table 3.4

Issue of Commercial papers by Companies & Non-Bank Finance Companies

Fortnight Ended 2008-09	Total Outstanding (` In Crore)	Rate of Discount (%) 2008-09
2008-09		
August 15	52831	9.54 – 12.50
January 15	40803	7.75 – 14.00
2009-10		
August 15	77352	3.43 – 9.20
January 15	92363	3.15 – 7.55
2010-11		
August 15	127271	4.65 – 9.10
January 15	98913	6.60 –11.95
2011-12		
April 15	105518	7.15 – 12.30
June 30	104689	8.35 – 13.50
2012-13		
April 13	110350	8.51 – 14.50
June 30	125811	8.24 – 15.25

Source: RBI Publication on Handbook on Indian Economy

3.5.7 Inter-Bank Participation Certificate (IBPC)

Such certificates are issued by a scheduled commercial bank to another bank against existing standard loan assets. The amount which is raised through issue of IBPC should not exceed 40 per cent of the outstanding advance at the time of issue. During the validity of participation certificate, the amount that is raised must be covered by an outstanding standard loan assets. If such certificates are to be issued without sharing of risk, the period should not exceed 90 days. If it is with risk participation, such certificates can be issued for a period of 91 to 180 days. The main features of IBPC are as under :

i) The IBPCs are not transferable and hence such instruments cannot be traded in the secondary market. Therefore, the secondary market does not exist for such instruments.

ii) Only the banks are allowed to issue IBPCs.

iii) Both the issuing and participating banks have to decide about interest rate on IBPCs. Thus on can conclude that rate of interest on such certificate is freely decided by the concerned parties

NOTES

Check your progress

Q. 1 State whether the following statements are true or false

(i) All type of banks have been permitted to issue certificate of deposits for a period up to 1 year.

(ii) The minimum size of commercial paper is of ` 1 Lakh.

(iii) Banks have been permitted to buy-back their Certificate of Deposits (CDs) before maturity date

(iv) The issuer of CP has to appoint a scheduled bank as an Issuing and Paying Agents (IPA) to raise funds through CP

(v) Banks and financial institutions are allowed to issue IBPCs

Q. 2 Explain main characteristics of certificate of deposits (CDs)

Q. 3

(i) Who can issue a commercial paper ?

(ii) For what purpose a commercial paper is issued ?

Q. 4 Explain various features of IBPCs.

iv) The IBPC is issued based on agreement between the issuing and participating bank.

3.6 Summary

The money market is an important segment of financial markets. This market has grown in terms of instruments, players and size of turnover. The banks and non-bank entities participate in the money market to manage liquidity. The RBI has taken a number of positive steps to make the money market more efficient and vibrant. This has resulted in the active secondary market for a variety of money market instruments. This has led to the development of their own markets for money market instruments like T-bills market and commercial paper market. The RBI regulates the money market. It intervenes in the market at appropriate time to ensure its stability and credibility.

3.7 Key Terms and List of Select Abbreviations

a) Key Terms

1) Money Market :

This is market for those instruments which are used to borrow or lend funds for a short period i.e. up to 12 months.

2) Call and Notice Money Market :

In call market money is borrowed or lent for a day i.e. 24 hours. Because of this, it is called as overnight money market. In notice money market money is borrowed or lent for more than 1 day but up to 14 days. The call and notice money market is also called as inter-bank market.

3) Term Money Market :

In this market money is borrowed or lent for a period beyond 14 d a y s but up to 365 days. The banks and primary dealers are allowed to borrow and lend in the term money market. The financial institutions like SIDBI, EXIM and NABARD are allowed to borrow from term money market for a period of 3 to 6 months.

4) Certificate of Deposits (CDs) :

The certificate of deposit, which is issued by a bank, is a money market instrument. It isissued in the form of promissory note that too in dematerialized form for a maturity of 7 days to 1 year. It is a tradable instrument. The banks mobilize financial resources through use of certificate of deposits to fund their business.

NOTES

5) Commercial papers (CPs) :

Non-bank entities like companies, NBFCs and primary dealers use commercial paper to raise short term funds for working capital. The commercial papers are issued in the form usance promissory notes which are negotiable by endorsement and delivery. The CPs are issued for a minimum period of 7 days and maximum period of 1 year. The minimum size of CP is ` 5 lakh

6) Interbank Participation Certificate (IBPC) :

It is a short term money market instrument. Such certificates are issued by scheduled commercial banks to another bank to raise funds against standard loan assets. The amount which is raised through issue of a certificate should not exceed 40 percent of outstanding advance at the time of issue. Such certificates are not transferable. Therefore there is no secondary market for such instrument.

7) Fixed Income Money Market Derivatives Association of India (FIMMDA) :

It is a self regulatory organization registered under section 25 of the companies act. This organization has been set up with a view to develop money, fixed income securities and interest rate derivatives markets in India. It is an association of the banks, financial institutions, primary dealers and insurance companies. It is recognized by the RBI.

8) Issuing and Paying Agent (IPA) :

A scheduled commercial bank is allowed to act as an issuing and paying agent (IPA) in the commercial paper market. The role of IPA is to act as a merchant banker and help the issuer to raise funds through issue of commercial paper.

9) Treasury Bills :

Treasury bills are short term instruments. The RBI issues three types of treasury bills having different maturities namely 91 day, 182 day and 364 day. These treasury bills are issued on behalf of the Government of India under multiple price auctions.

b) List of Select Abbreviations

1) **T-bills** : Treasury Bills

2) **CP** : Commercial Paper

3) **CD** : Certificate of Deposit

4) **IBPC** : Inter-Bank Participation Certificate

5) **AIFI** : All India Financial Institutions

6) **RBI** : Reserve Bank of India

3.8 Self-Assessment Questions

Q.1 State whether the following statements are true or false

(I) Only commercial banks are allowed to participate in the call and notice money market

(ii) Commercial papers are issued for 6 days also

(iii) CPs are issued as a discounted instruments

(iv) Commercial papers cannot be issued in dematerialization form (Demat)

(v) Treasury bills are issued under multiple price auctions.

(vi) Certificate of Deposits (CDs) issued by banks must be in dematerialized form only.

(vii) Financial Institutions cannot participate in the term money market.

Q. 2 (I) What do you mean by term money market?

(ii) Explain various features of Treasury Bills

(iii) Who regulates the money market?

Q. 3 Distinguish between commercial papers (CPs) and Certificate of Deposits (CDs)

4.4.2 4 Write Short Notes

Interbank Participation Certificate (IBPC)

Functions of Money Market

Inter-Bank Participation Certificate.

Q. 5 (i) Explain the concept of money market.

(ii) Describe various features of Money Market.

3.9 Further Reading and References

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UNIT 4 Indian Money Market-II : Repo Market, CBLO and Issues in Money Market

NOTES

Structure

4.1 Introduction
4.2 Unit Objectives
4.3 Repo Instrument
4.3.1 Why Repo Deals?
4.4 Report Market in India
4.4.1 Market Repo
4.4.2 Repo with RBI (Liquidity Adjustment Facility)
4.5 Collateralized Borrowing and Lending Obligations (CBLO)
4.6 Difference between Repo Deals and CBLO Transactions
4.7 Comparison of Repo Deals with call Money and CBLO Transactions
4.8 Issues in Money Market
4.9 Summary
4.10 Key Terms and List of Select Abbreviations
4.11 Self-Assessment Questions
4.12 Further Reading and References

4.1 Introduction

Repo and CBLO are an important money market instruments. These two instruments are extensively being used in Indian money market. Both these instruments are mainly used by institutional investors to manage liquidity in their own business. The RBI has taken a number of positive steps to develop repo market in India which has two components namely market repo and repo with the RBI. The CBLO product is introduced by the Cleaning Corporation of India Ltd. (CCIL) for those entities that cannot participate in the call, notice and term money market. The CCIL takes care of settlement of transactions both in market repo segment and CBLO segment of the Indian money market. In this unit, these two money market instruments along with issues in the Indian money market are discussed.

4.2 Unit objectives

- To know about repo and CBLO money market instruments and Liquidity Adjustment Facility (LAF).
- To understand the mechanism of repo and CBLO instrument.
- To analyze overall Repo Market in India.
- To understand various issues concerning with the money market.

4.3 Repo Instrument

Repo is a money market instrument which is predominantly used for managing Liquidity. In repo transactions, securities are sold for cash with an agreement to repurchase the same securities at a future date. The securities serve as collateral for a cash loan. On the opposite side of the repo transaction is the reverse repo transaction. In such transactions securities are purchased with an agreement to resell the same securities at a future date. Conversely the cash serves as collateral to obtain a specific security. Repo transaction is considered as an important technique for short term cash management. The several types of transactions such as standard repurchase agreements, sell and buy-back, etc. which have similar economic functions, are considered to be part of repo deals. All these types of deals are discussed below:

Repo deals are also known as repurchase agreements or ready forward deals

Standard Repo or Repurchase Agreement

In this transaction sale and repurchase price of a security is identical. In other words spot and forward price of a security is the same. This is also called as classic repo. The cost of transaction i.e. repo interest amount is calculated separately and hence shown in the profit and loss account. This repo interest is paid to the buyer of the security. Because of this, settlement value on maturity date is different from price of a security which is considered at the 1st leg transaction. The standard legal agreement is used to execute repo deals.

Sell and Buy back

In case of sale and buy-back arrangement, cost of transaction is included in the forward price. Because of this, forward price of a collateral security is different from spot price. No margin and standard legal agreement is used in such a type of transaction.

4.3.1. Why Repo Deals?

Both regulatory authorities like the RBI and participants in the money and securities markets have special interest in repo deals and thus in the development of repo market.

a) Utility of Repo instrument at micro level

Participants in the money and securities market use repo instrument for the following objectives:

1. to manage liquidity position in short term period,
2. to fund long positions in securities (i.e. purchase of security)
3. to manage short sale transaction in securities market
4. to adjust portfolio of securities keeping in view overall objectives of investment management.

Utility of Repo Instrument at Macro Level

1. The RBI uses repo as an integral part of its open market operations with the objective of injecting/withdrawing liquidity into and from the market and also to reduce volatility in short term market in particular in call money market. As repos are being used as short term money market instruments, repo market has strong linkages with inter-bank or call money market, term money market, securities market, derivatives market etc.

2. Increase in repo deals will help to increase in turnover in the money and securities market thereby improving liquidity and depth of such markets.

3. A large number of repo transactions for varying tenors will effectively result in a term interest rate structure and this will lead to the development of term money market.

4.4 Repo Market in India

In India, banks, primary dealers, and non-bank institutions etc., look upon the repo instrument l as a short term money market instrument. All them of have recognized the utility of the repo instrument for better funds management especially in the money market. The volume of repo deals has increased considerably in recent past. This market being a segment of the money market is fully regulated by the Reserve Bank of India (RBI). With the amendment to the section 16 of the Securities Contract Regulation Act, 1956 and notification dated March 1, 2000, the RBI has been authorized to regulate repo transactions and thus repo market in India. The RBI has published a report of the sub-group of Technical Advisory Committee on Government Securities Market on Repurchase Agreements in April 1999. The said committee had made certain recommendations in order to make the repo market more efficient and vibrant. Based on this committee’s recommendation, the RBI has taken a number of policy initiatives to make the repo market more active and vibrant. The repo market in India is comprised of two segments namely market repo and repo with the RBI. These two segments are discussed below :

4.4.1 Market Repo

a) Eligible Securities for Repo Deals in India

Initially, scheduled commercial banks in India were allowed to enter into repo transactions in Treasury Bills of all maturities issued by the Government of India (GOI) and in such dated securities of the Government of India, as approved by the Reserve Bank of India, in consultation with the Central Government, provided repo transactions were effected at Mumbai and, the deals were put through the Subsidiary General Ledger (SGL) account with the Reserve Bank of India (RBI).

Earlier, the RBI, in consultation with the GOI, selected few dated securities of the GOI for the purpose of repo deals. However, vide credit policy circular dated April 15, 1997, the RBI permitted to undertake repo deals in respect of all dated Central Government securities besides Treasury bills of all maturities. Further, vide circular (IDMC No. PDRS/10.02.01/99-2000) dated March 7, 2000, the RBI also allowed to undertake repo transactions in respect of securities issued by the State Governments. In view of this, repo deals are carried out in respect of treasury bills of varying maturities, the Government of India dated securities and securities issued by the state Governments.

Since March 1, 2010, the RBI has allowed to use listed corporate debt securities which are rated 'AA' or above by credit rating agency, that are held in the security accounts of the repo seller for executing market repo deals.

Above discussion clearly points that repo deals are carried out in respect of following securities which are used as collateral securities:

i) Treasury bills of varying maturities like 91 day, 182 day and 364 day

ii) Central Government dated securities

iii) State Government securities

iv) Corporate bonds, which are listed, having credit rating of AA or above and which are held in the security account of the repo seller in demat form.

In order to further develop the repo market, the RBI has permitted to execute repo transactions in other collateral securities such as CP, CD and Non Convertible Debentures of less than one year of original maturity. The minimum hair cut requirement in corporate debt repo has been brought down from existing 10 per cent,12 per cent, 15 per cent to 7.5 per cent, 8.5 per cent, 10 per cent respectively for AAA/AA+/AA rated corporate bonds.

Table 4.1: Instrument wise Settlement of Volumes for Repo Trades

(` in million)

Year	Central Govt. Securities		T-Bills		State Govt. Securities	
2002-03	4039710	(86.28per cent)	642380	(13.72per cent)	200	(0 per cent)
2003-04	8744380	(92.71per cent)	592210	(6.28per cent)	95300	(1.01per cent)
2004-05	12621494	(81.02per cent)	2869547	(18.42per cent)	88025	(0.57per cent)
2005-06	13694109	(80.81per cent)	2776870	(16.39per cent)	474108	(2.80per cent)
2006-07	21266336	(83.19per cent)	379647	(14.83per cent)	506768	(1.98per cent)
2007-08	3569960	(90.41per cent)	323984	(8.20per cent)	54807	(1.39per cent)
2008-09	3475348	(84.88per cent)	583335	(14.25per cent)	35603	(0.87per cent)
2009-10	5233295	(86.18per cent)	812587	(13.38per cent)	26996	(0.44per cent)
2010-11	3253965	(79.38per cent)	832632	(20.31per cent)	12688	(0.31per cent)
2011-12	2186877	(58.10 per cent)	1554121	(41.29 per cent)	22878	(0.61 per cent)
2012-13	2918337	(54.02 per cent)	2413144	(44.66 per cent)	71282	(1.32 per cent)
2013-14	3364069	(46.54 per cent)	3832478	(53.02 per cent)	31580	(0.44 per cent)

Source : Fact book – 2014 - Publication of Clearing Corporation of India Ltd., Mumbai.

Looking at the data given in Table 4.1 one can observe that in the past central government dated securities were most acceptable collateral securities in repo transactions. During the period 2008-09 to 20013-14 central Government dated securities were used as collateral securities along with treasury bills. After 2010-11, share of T-bills as collateral securities in total repo deals increased from 20.31 per cent in 2010-11 to 53.02 per cent in 2013-14. On the contrary, the state Government securities were used as collateral securities in less than 1 per cent of total repo transactions. The reason for this is that the state Government securities are perceived to be less liquid and hence no active secondary market. Hence, market participants are not prepared to accept the state Government securities as a collateral security for undertaking repo transactions. The market for repo deals in corporate bonds is not active. Very few deals have been reported so far.

b) Maturity for Repo Deals Transactions

Theoretically speaking, repo deals can be transacted for any length of time or period. However in practice, the period is usually short - generally from one day (an overnight repo) to several months. In India, market rapo deals are executed for a minimum period of one day. Though there is no restriction on the maximum period for which banks and others can undertake repo transaction, normally in India, banks and others including primary dealers enter into repo deals for a period upto 14 days. This is so because in India, rapo instrument is considered as a short term money market instrument.

Banks and other participants enter into a repo deal for a single day. Further as per the RBI's guidelines repo-transactions in corporate/ debt securities shall be for a minimum period of one day and a maximum period of one year.

The data about repo term analysis is given in Table 4.2. This data highlights that almost 66 per cent of total trades in the repo market were carried out for a one day period (i.e. overnight) during 2013-2014. In the same year 28 per cent of total trades in the repo market were carried out for a period of 2 to 3 days. Only around 5 per cent of total trades in the repo market were carried out for 4-7 days. As against this during 2003-04 to 2013-14, less than 1 per cent of total repo trades were carried out for a period beyond 8 days. This analysis clearly brings out the fact that by and large market participants execute repo deals for 1 day period.

Table 4.2 : Repo Term Analysis

(Per cent)

	Trades	Value	Trades	Value	Trades	Value	Trades	Value	Trades	Value
2002-03	50.05	50.15	30.96	31.01	15.46	15.95	2.26	1.78	1.27	1.11
2003-04	53.00	52.29	32.68	32.94	13.63	14.37	0.58	0.34	0.11	0.06
2004-05	68.29	69.29	26.30	24.23	5.30	6.35	0.09	0.11	0.02	0.02
2005-06	70.93	72.06	25.73	25.11	3.06	2.71	0.19	0.08	0.08	0.04
2006-07	73.68	75.19	21.58	21.06	4.32	3.57	0.12	0.07	0.31	0.11
2007-08	74.00	73.97	22.86	23.25	2.80	2.69	0.03	0.01	0.30	0.09
2008-09	68.24	68.19	27.17	27.04	4.35	4.17	0.07	0.03	0.17	0.07
2009-10	70.42	69.51	23.07	24.25	6.23	6.00	0.19	0.23	0.09	0.02
2010-11	68.51	65.99	27.94	31.12	2.56	2.68	0.27	0.08	0.32	0.13
2011-12	67.46	65.94	26.27	28.53	5.17	5.24	0.39	0.11	0.72	0.18
2012-13	69.06	67.82	27.13	27.75	3.49	4.16	0.14	0.21	0.18	0.05
2013-14	66.29	65.24	27.73	28.34	5.60	6.17	0.16	0.18	0.23	0.07

Source: Fact Book - 2014, Publication of Clearing Corporation of India Ltd. Mumbai

c) Who Can Participate in the Repo Market?

The following entities have been permitted to participate in the market repo segment.

1. Banks
2. Primary Dealers
3. Financial Institutions
4. Insurance Companies registered with IRDA
5. Non-Banking Finance Companies Registered with IRDA
6. Housing Finance Companies Registered with NHB

The data about share of major participants in repo market in terms of repo

settlement value is given in Table 4.3. This data reveals that banks are major players in the repo market. Amongst the various categories of banks, private sector banks and foreign banks are major players in the repo market. The share of foreign banks increased from 8.27 per cent in 2004-05 to 43.74 per cent in 2013-14. The share of public sector banks and co-operative banks in the repo market was 7.38 per cent and 1.68 per cent in the year 2013-14 respectively. The share of primary dealers in the repo market was above 25 per cent in 2013-14. In view of this, it can be observed that banks and primary dealers have been major players in the repo market. The reasons for this are obvious. Banks look upon investment in the Government securities for maintenance of statutory liquidity ratio (SLR) and as a source of liquidity. The primary dealers, being wholesale traders and market makers, in the Government Securities, have a substantial portfolio of such securities. As against this, mutual funds, financial institutions and Insurance Companies do not participate in the repo market.

Table 4.3 : Share of Major Participants in Repo Settlement Value

(Figures are in Percentage)

Year	Public Sector Banks	Private Sector Banks	Foreign Banks	Co-operative Banks	All the Banks Together	Mutual Funds	FIs & Insurance	Primary Dealers	Others
2002-03	14.83	41.86	11.58	1.26	69.53	0.00	0.19	30.24	0.04
2003-04	14.26	38.06	16.80	2.84	71.96	0.08	0.17	27.79	0.00
2004-05	20.90	32.50	8.27	0.04	61.71	0.08	0.64	37.57	0.00
2005-06	11.00	29.26	13.97	0.08	54.31	0.00	0.08	45.16	0.02
2006-07	1.96	18.64	40.14	0.18	60.92	0.00	0.00	39.08	0.00
2007-08	3.02	24.89	46.58	0.07	74.56	0.00	0.00	25.44	0.00
2008-09	2.99	40.78	34.59	0.03	78.39	0.00	0.00	21.61	0.00
2009-10	1.01	62.37	22.30	0.02	85.70	0.00	0.00	14.30	0.00
2010-11	8-71	29.47	32.51	2.30	73.00	0.00	0.00	27.00	0.00
2011-12	6.04	23.73	29.82	1.85	61.44	0.00	0.00	38.56	0.00
2012-13	1.97	8.17	49.99	1.07	61.20	0.00	0.00	37.60	1.20
2013-14	7.38	13.38	43.74	1.68	66.28	0.00	0.00	26.03	7.79

Source : Fact Book – 2014, Publication of Clearing Corporation of India Ltd., Mumbai

d) Determination of a Repo-Rate

The following factor affects market repo rate.

i) The quality of collateral security : If the quality in terms of credit worthiness is not good, the repo-rate will be relatively high.

ii) The repo-rate is likely to be higher when the market in the particular collateral security is less liquid. This is so because, the buyer can early realize less amount as compared to the value of the collateral in the event of default.

iii) Repo tenor: If the repo period is longer say 30 days or 60 days, then repo rate is likely to be more as compared to repo rate for overnight or 1 day period.

e) Settlement of Repo Deals

The repo deals in the Government securities are settled through the Clearing Corporation of India Ltd (CCIL) which ensures guaranteed settlement and therefore there is no credit or default risk. The CCIL has introduced Clearing Repo Order Matching System (CROMS). Around 79 per cent of total market repo transactions, where government securities are used as collateral securities, are done through CROMS. The salient features of this system are as follows.

a) It is anonymous STP enabled dealing system with CCIL acting as central counter party

b) It is based on order matching on best repo rate which provides time priority.

c) Such transactions are not needed to report on the RBI's PDO – NDS platform.

d) It facilitates special and basket repos as well as market repo in STRIPS instrument.

As mentioned earlier, there are two types of CROMS transactions namely special and basket. In case of special CROMS, the security is identified and disclosed to the counter party. As against this, in case of CROMS Basket the CCIL identifies a group of select securities and these are considered as a collateral securities for repo transactions. The securities are not disclosed to the counter party. The share of repos under CROMS in total market repo transactions increased from 0.45 per cent in January 09 to 90.29 per cent in 2013-14.

The participants have been permitted to enter into repo transactions in corporate debt securities in the OTC market. Therefore such deals are settled in the same manner as outright OTC trades in corporate debt securities. The security acquired under repo cannot not be sold by the repo buyer. All repo trades in the corporate debt securities must be reported within 15 minutes of the trade on the FIMMDA's reporting platform. The details of corporate debt securities lent or acquired under repo or reverse repo transactions must be disclosed in the Notes on Account to the Balance Sheet.

NOTES

4.4.3 Repo Transactions with the RBI under Liquidity Adjustment Facility (LAF)

As a part of open market operations, the RBI is carried out regularly repo transactions in the Government Securities. The main objectives behind repo transactions under LAF are to ensure adequate liquidity in the system and to transmit interest rate signals to the market. Thus the LAF is used as an instrument for implementing effective monetary policy.

Only banks and primary dealers have been permitted to avail liquidity support from the RBI under LAF. The current repo rate and reverse rate are 7.25 per cent and 6.25 per cent respectively. In other words under repo transactions banks and PDs are permitted to borrow funds from the RBI against their own investment in Government securities at 7.25 per cent interest. Similarly under reverse repo transactions banks and PDS can lend funds to the RBI at 6.25 per cent interest rate. The LAF offers various benefits. The few of these benefits are mentioned below :-

1. It has helped the RBI to shift from direct instruments of monetary policy to indirect instruments
2. It has provided the RBI much more flexibility in determining both the quantum of adjustment in the availability of Liquidity as well as in the repo and reverse repo rates
3. It helps the RBI to control supply of funds on a daily basis to meet day-to-day liquidity mismatches in case of individual banks and primary dealers
4. It enables the RBI to bring desire changes in the demand for funds through changes in repo and reverse repo rates.

Thus LAF is an important tool of monetary policy and enable the RBI to transmit interest rate signals to the market. Operation of LAF through repos by means of daily auctions has provided the benchmark for collateralized lending and borrowing in the money market. The call rate is expected to be largely within a corridor set by repo and reverse repo rates. This mechanism has helped in providing liquidity to the government securities market as well as imparting grater stability in the financial markets.

Check Your Progress

Q 1: State whether the following statements are true or false:

a) Under reverse repo transaction funds are borrowed against Government security.

b) Market repo deals are executed in respect of Government securities only.

c) Repo transactions are executed mainly for liquidity purpose.

d) Only banks and primary dealers are allowed to participate in the market repo segment.

e) Repo transactions in corporate debt securities are settled through the Clearing Corporation of India Ltd.

Q 2:

a) What do you mean by repo instrument?

b) Explain the utility of repo instrument at micro level.

Q 3: Distinguish between market repo and repo with the RBI under liquidity adjustment facility (LAF)

Q 4: Who are allowed to enter into repo transactions with the RBI?

4.5 Collateralized Borrowing and Lending Obligation (CBLO)

The CBLO product is introduced by the CCIL especially for those participants who have not been to participate in the call and notice money market. It is a discounted instrument which is issued in electronic book form (e.g. .demat form). As per the RBI guidelines, this instrument can be made available up to one year. However, in practice this instrument is considered for the maturity period ranging from 1 day to 90 days.

Meaning of CBLO

- It is an obligation on the part of borrower to repay the money borrowed at its face value at a specified future date.
- It is an authority on the part of the lender to receive money at a specified future date. The lender has option or privilege to transfer the authority to receive money to another lender for value received.
- A charge is created on the collateral securities held in account with the CCIL for the amount borrowed or lent.

Features

- The CCIL ensures fully guaranteed settlement of CBLO transactions.
- The CBLO, which is issued in electronic form, is not subjected to stamp duty.
- It is traded at discount to face value.
- Along with banks and primary dealers, other institutions such as financial institutions, insurance companies, mutual funds, NBFCs, provident funds and companies are allowed to use CBLO product for their liquidity purpose.
- The borrowers who do not have SGL account with the RBI/CCIL are required to open constituent SGL account with CCIL and deposit securities offered as collateral.
- The securities, which are offered as collateral, are not transferred in the name of lender but lender's interest in the underlying securities blocked by CCIL is recognized by documentation.
- The Government of India dated securities and treasury bills of various maturities are considered as collateral securities for undertaking CBLO transactions.

The volume in the CBLO market has increased over the years especially after the phasing out of the non-bank's entities from the inter-bank market. The daily average volume in this market which was only Rs. 6 crore in January 2003 is now over Rs.50,000 crore.

4.6 Difference between Repo Deals and CBLO Transactions

As discussed earlier, repo deals are executed mainly for one day period. Similarly CBLO transactions are also executed for one day period. Further like market repo transactions, the CCIL also ensures fully guaranteed settlement of CBLO transactions. Because of this, CBLO transaction appears to be similar to that of repo transaction. However, there are few points of differences between these two transactions or instruments which are stated below :

1) Companies cannot participate in the repo market however they are allowed to participate in the CBLO market.

2) Along with gilt securities, corporate bonds with minimum credit rating of AA or above are allowed to use collateral securities in repo market. However, only treasury bills of varying maturities and the Government of India dated securities are eligible instruments as collateral securities in CBLO transactions.

3) In case of market repo transactions, securities are sold or purchased and thus legal title is transferred to the buyer of security. By virtue of this, banks who purchases the Government security under reverse repo transaction are entitled to use this security for maintenance of SLR. However, in case of CBLO transaction, the borrower is allowed to hold the securities on behalf of counter party and thus lender do not get ownership as well as possession of the security. Therefore, if a lender is a bank then it cannot use this security for maintenance of SLR.

4) A security which is acquired under reverse repo cannot be sold except for executing short selling transaction. However, in case of CBLO, lender has an option or privilege to transfer CBLO product for value received.

5) Repo deals in market repo segment are executed at market determined interest rates which are called as repo rates. In case of repo with RBI, such deals are executed at a repo rate i. e. 7.25 per cent which is fixed by the RBI. The CBLO product is a discounted instrument and hence interest rate is not attached to this instrument.

4.7 Comparative analysis of repo deals with call money and CBLO transactions

The comparative analysis of repo deals with call money and CBLO transactions is made in Table 4.4.

The data given in Table 4.4 reveals that the proportion of call money transactions in total money market operations (i.e. for 1 day period) declined from 45.83 per cent in 2004-05 to 15.17 per cent in 2013-14. The proportion of repo transactions in total money market operations more or less has remained in the range 22 per cent to 25 per cent. As against this the proportion of CBLO transactions increased from 20 per cent in2004–05 to around 60 per cent in 2013-14. This analysis clearly indicates that size of CBLO market is much more as compared to the size of repo as well as call money market. Many reasons can be explained for this phenomenon. The most important reason is that non-bank entities mainly companies, who otherwise cannot participate either in repo market or in call money market, are allowed to participate in the CBLO market.

Table 4.4 : Comparison of Repo Deals with Call Money Transaction and CBLO Transactions

(Value in ` crore)

	Value	**%**	**Value**	**%**	**Value**	**%**
2004-05	2146247	45.83	1560116	33.31	976789	20.86
2005-06	3020846	39.39	1694509	22.1	2953132	38.51
2006-07	3654936	33.4	2556501	23.36	4732272	43.24
2007-08	3455931	22.27	3948741	25.45	8110828	52.28
2008-09	3657632	22.06	4094286	24.7	8824784	53.24
2009-10	2489975	10.33	6072829	25.19	15541378	64.48
2010-11	2908906	15.1	4099284	21.27	12259715	63.63
2011-12	4013031	21.20	3763877	19.88	11155428	58.92
2012-13	4677777	21.16	5402766	24.44	12028040	54.40
2013-14	4427358	15.17	7228126	24.77	17526192	60.06

Source : Fact book – 2014, publication of The Clearing Corporation of India Ltd., Mumbai

4.8 Issues in Indian Money Market

In order to make the money market more efficient and vibrant, the RBI has to address following issues and take appropriate policy initiatives.

i) Term money market is not developed in India. Due to lack of interest rate term structure and yield curve; the banks are not prepared to lend in the term money market. Further non-bank entities other than financial institutions cannot participate in this market.

ii) By and large market participants are entered into repo transactions for a one day period. Occasionally participants enter into repo transaction for a period up to 3 to 7 days. Therefore, repo market is not developed for various short term maturity tenors.

iii) Because of lack of bill culture, bills of exchanges are not drawn by the sellers on their customers. In view of this, bills of exchanges are not being discounted with the commercial banks. Therefore, the market for rediscounting of bills of exchange is not developed in India.

NOTES

4.9 Summary

Repo is used as a short term money market instrument. In India, repo market is comprised of market repo and repo with the RBI under liquidity adjustment facility. Of the various eligible securities, the Government of India dated securities and treasury bills of various maturities are most acceptable collateral securities in the market repo segment. Banks and primary dealers have been permitted to borrow at repo rate of 7.25 per cent from the RBI under liquidity adjustment facility. The RBI use this instrument for implementing effective monetary policy. The market participants use repo & CBLO products to manage their liquidity. The volume in the CBLO market have increased over the years specially after the phasing of the non-bank entities from the inter-bank market. The daily average volume in this market was over 47,000 crore in 2013-14. The RBI has taken a number of positive steps to make money market more efficient and vibrant. This has resulted in the active secondary market for a variety of money market instruments. This has led to the development of their own markets for money market instruments like repo market and CBLO market, etc.

4.10 Key Terms and List of Select Abbreviations

A) Key Terms

a) Repo Transaction (i.e. Repurchase Agreement)

Repo instrument is used as a short term money market instrument. In repo transaction funds are borrowed against sale of a security to meet temporary liquidity needs with an agreement to re-purchase the same security at the end of repo period.

b) Reverse repo transaction

Under reverse repo transaction funds are made available to the borrowers against purchase of a security with an agreement to resell the same security to the same country party at the end of repo period.

c) Market Repo

Market repo transaction is carried out between two market participants. A repo transaction between a bank like Bank of Baroda and a primary dealer like PNB Gilts ltd is considered as market repo transaction.

d) Repo with the RBI

It is repo transaction between market participants like bank or primary dealer and the RBI. Banks or primary dealers are allowed to borrow from the RBI at repo rate of 7.25 per cent under Liquidity Adjustment Facility.

e) Collateralized Borrowing and Lending Obligation (CBLO)

It is a discounted instrument which is issued in electronic book

tradableinstrument and is traded at discount to face value. The borrower is allowed to borrow from CBLO market against the Government Securities like Government dated securities and treasury bills. The Clearing Corporation of India Ltd ensures fully guaranteedsettlement of CBLO transactions.

f) Term Money Market: In this market money is borrowed or lent for a period beyond 14 days but up to 365 days. Banks and primary dealers are allowed to borrow and lend in the term money market. Financial institutions like SIDBI, EXIM and NABARD are allowed to borrow from term money market for a period of 3 to 6 months.

B) List of Select Abbreviations

1) CBLO : Collateralized Borrowing and Lending Obligation
2) LAF : Liquidity Adjustment Facility
3) CCIL : Cleaning Corporation of India Ltd.
4) REPO : Repurchase Agreement
5) OTC : Over the Counter
6) NABARD : National Bank for Agriculture and Rural Development
7) SIDBI : Small Industries Development Bank of India

4.11 Self-Assessment Questions

Q 1. State whether the following statements are true or false ?

a) The transactions in repo market are settled through CCIL.

b) The minimum period for undertaking repo transaction is of 3 days.

c) All types of corporate bonds are eligible as a collateral security for executing repo transaction.

d) Financial institutions are allowed to avail liquidity support under LAF from the RBI.

e) CBLO is a discounted instrument which is issued in electronic book form

Q 2. Give correct answers

a) RBI's Repo Rate under LAF is

a) 7.50 per cent

b) 7.00 per cent

c) 7.25 per cent

d) None of the above

b) Which securities are not eligible as collateral securities for undertaking market repo transactions

a) GOI Dated Securities

b) Treasury Bill of various maturities

c) Corporate Bonds with AAA or AA credit rating

d) Equity Shares

Q 3. Write Short Notes :

a) Liquidity Adjustment Facility (LAF) of RBI

b) Utility of repo instrument

c) Features of Indian Repo Market

Q 4. (i) What do you mean by repo instrument and repo market?

(ii) Who are the major participants' in the repo-market?

Q 5. Explain the followings in the context of market repo deals :

(i) Eligible securities.

(ii) Period of deals.

Q. 6

(i) What do you mean by CBLO product?

(ii) Who can participate in the CBLO market?

Q. 7 What are the main issues in Indian money market ?

4.12 List of Select Books and References

1) Report of a Working established by the Committee on the Global Financial System of the Central Bank of the Group of Ten Countries on "Indications of Repo Market for Central Banks", Bank for International Settlements, Basle, March 9, 1999.

2) Report of the Sub-Group of the Technical Advisory Committee on Government Securities Market on "Repurchase Agreements" (Repos), IDM Cell, Central Office, RBI, Mumbai, April 1999.

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4) International Securities Market Association (ISMA) - The Repo Market in Euro : Making it Work, Switzerland, Zurich, 1997.

5) Siva Kumar, Sowmya - Repositioning the repo market. Business Standard, Mar 11, 1999, p.6.

6) Kuvalekar S. V, Monograph on Emerging Money Market in India: Instruments, Participants and Regulatory Framework, Published by NIBM, Pune, 2007.

7) RBI's Latest Circular on the Guidelines for Uniform Accounting for Repo/ Reverse Repo Transactions.

8) Annual Reports of RBI 2011-12, and 2912-13, RBI, Mumbai.

9) Fact Book of Clearing Corporation of India Ltd. For 2008, 2009, 2010, 2011 and 2014

10) Monetary and Credit Policy of RBI.

UNIT 5 Indian Debt Market I: Debt Instruments and Government Debt Market

5.1 Introduction

5.2 Unit Objectives

5.3 Types of Debt Instruments

5.4 Government Debt Market

5.4.1 Role of the RBI

5.4.2 Policy Initiatives and Reforms

5.4.3 Types of Government Debt Securities

5.4.4 Primary Market

5.4.5 Secondary Market

5.4.6 Participants

5.5 Issues Concerned with Government Debt Market

5.6 Summary

5.7 Key Termsand List of Select Abbreviations

5.8 Self-AssessmentQuestions

5.9 Further Reading and References

5.1 Introduction

The debt market is one of the largest segments of Indian financial markets. This market is comprised of the Government securities and corporate debt securities. The Government debt securities market is the most dominant segment of the Indian debt market. Of the combined debt market, the Government debt securities market accounts for more than 60 per cent of the total primary market for debt securities. Nearly more than 95 per cent of the total trades in the secondary debt market are in respect of Government Securities.

5.2 Unit Objectives

The objectivities of this unit are as under:

(i) to understand various types of debt instruments.

(ii) to know the structure of Government securities market in terms of instruments, participants and size, etc.

(iii) to understand reforms in the primary and secondary market of Government securities market

5.3 Types of Debt Instruments

The various types of debt instruments are seen in Indian debt market. These instruments are discussed below :

5.3.1 Fixed and Floating Rate Instruments

Debt instruments are issued either at a fixed or floating rate of interest. In case of fixed rate debt instruments, interest rate is fixed and paid periodically (semiannually or annually). The fixed rate of interest, which is always stated on the annual basis, is called the coupon rate and the payment itself is called the coupon. The coupon rate of the instrument is fixed at the time of issuance which remains constant throughout the tenor of the instrument. For example, issue of 10 per cent bond by a public company for 10 years. Here 10 per cent interest is fixed and remains the same throughout the tenor of a bond. Such bonds are called as simple or plain vanilla bonds or simply fixed coupon bond. The coupon is determined by a number of factors which includes the credit rating of instrument, tax benefits, the collateral securities offered to secure the issue, overall interest rate scenario in the market and special features offered to the investors. Debt instruments are also issued at a floating interest rate. In such case the floating interest rate is periodically changed reflecting changes in market conditions particularly changes in rate of interest payable on the gilt securities or changes in the base rate. The interest rate on such instruments is linked with benchmark or base rate such as primary market cut-off yield of the 91-day-Treasury bills or 182 day Treasury-bills. Such instruments are also known as adjustable rate or variable interest rate debt instruments.

5.3.2 Debt Instruments with Call and Put Option

Nowadays debt instruments are issued with call and put option. A call option allows the bond issuer to call back the bonds and repay them at a predetermined price before maturity. The issuer exercises call option when general interest rates are lower than the coupon or interest rate on the existing debt instruments thereby retiring existing expensive debt instrument and refinancing at a lower interest rate. As against this, put option allows the bond holder or investor to sell the bonds to the issuer at a predetermined price before maturity

date. The holder of such debt instrument will exercise the put option when prevailing interest rates on new issue of bonds are higher than the coupon on the existing debt instruments.

5.3.3 Zero Coupon Debt Instruments

Such instruments are issued or sold at its discounted value and accordingly have zero interest rate. The best example is of treasury bills which are issued at discounted value. For example, 91 dayTreasury bill with a face value of ` 100 is issued at ` 98.50. Therefore such instruments have no coupons or interest rates at all. The difference between the discounted value and face value of the instrument is the gain or income for the investors. In other words, investors are not entitled to any interest income and thus are entitled to receive only repayment of face value of the security on the maturity date. The zero interest debt instruments are beneficial both to the issuers because of the deferred payment of interest and to the investors because of the lucrative yield and absence of reinvestment risk.

5.3.4 Non-Convertible v/s Convertible Debt Instruments

A debt instrument can be issued either with non-convertible clause or with convertible clause. A non-convertible debt instrument is that instrument which cannot be converted into equity at all. This means non-convertible debt instrument remains as a debt instrument throughout its tenor. The holder of convertible debt instrument can exercise the right to convert whole of debt instrument or its portion into equity. On conversion of debt instrument into equity, the investors will receive equity shares in place of existing convertible bonds. Once this is done then the investors will receive dividend income instead of interest Such instruments are issued either as fully convertible or partly convertible debt instruments.

5.3.5 Irredeemable and Redeemable Debt Instruments

Debt instruments can be classified according to its irredeemable and redeemable characteristics. The irredeemable debt instruments are those which can be redeemed only at the time of liquidation of an issuer entity. The redeemable debt instruments are those which are issued for a specified period and thus are redeemed once that period gets over. The common practice is to issue debt instruments as redeemable debt instruments. Under the company law provisions companies are not allowed to issue irredeemable debt instruments. They are allowed to issue debt instruments like debentures as redeemable debt instrument with a maximum period of 10 years. A company engaged in the setting up of infrastructure projects like road, power, etc. is allowed to issue secured debentures up to thirty years. This means such debentures cannot be issued as irredeemable debentures.

5.3.6 Secured Debentures v/s Unsecured Debentures

The secured debentures are those that are secured by a charge on the fixed assets belonging to the issuing company. In view of this, even if the issuer

fails to return money to the debenture holders on maturity, the issuer's assets on which charge is created can be sold to repay dues of the debenture holders. The unsecured debentures are those where if payment is not made to the debenture holders on maturity, then their dues are considered along with other unsecured creditors of the issuing company.

5.4 Government Debt Market

This market is comprised of debt instruments issued by the Government of India (GOI) and various State Governments. This is also called as the Government Securities Market.

Definition of Government Securities

The "Government security" means a security created and issued by the Government or for any other purpose as may be notified by the Government in the Official Gazette and having one of the forms mentioned below :

(i) A Government promissory note payable to or to the order of a certain persons; or

(ii) a bearer bond payable to bearer; or

(iii) a stock;[1] or

(iv) a bond held in a bond ledger account.

5.4.2 Role of the RBI

The Government debt market is regulated by the Reserve Bank of India (RBI). It manages the public debt issue (i.e. issue of Government securities) on behalf of the Central and State Governments. As a result of this, the cost of borrowing (i.e. interest rate), timing of issue and framework (i.e. other terms and conditions) of raising of loans by the Governments are decided by the RBI. The Government debt Securities are issued on the basis of liquidity conditions in the market, the proposed Government borrowings programme and expectations of the market. The RBI being a Central Bank of the Country has a special interest in the development of the Government securities market. The regulation of this market helps the RBI to manage its monetary policy more efficiently and effectively. Therefore the objective before the RBI is to ensure better coordination between monetary policy and debt management. In order to achieve this objective, the RBI, as per the provision in the Fiscal Responsibility and Budget Management (FRBM) Act 2003, is not allowed to subscribe Government Securities in the primary market. Hence the RBI cannot participate in the primary market of Government securities.

5.4.2 Policy Initiatives and Reforms

Recognizing the importance of the government debt market, the RBI, in consultation with the Government of India, introduced wide ranging reforms to develop this market. The major objectives of reforms were to (I) grant operational autonomy to the RBI; (ii) improve institutional infrastructure; (iii) impart liquidity and increase the depth of the market; (iv) deregulate the market; (v) create a sound legal and regulatory framework; (vi) increase transparency in deals and (vii) make market more broad based in terms of instruments and participants. Keeping these objectives in view, reforms were introduced to strengthen both primary and secondary segments of the government debt market. In the primary segment, measures were taken to raise resources from the market in a cost effective manner, particularly in the light of the transition to market related interest rate structure from the administered interest rate regime. In the secondary segment, measures were initiated to improve liquidity in the market. Suitable policy measures were also initiated to improve the trading systems, clearing and settlement infrastructure and the risk management framework. The main reforms introduced by the RBI since 1992 in the Government debt market are given in Table 5.1

TABLE 5.1: List of Major Policy Initiatives/Reforms introduced by the RBI in Government Securities Market

	Initiations/Reforms	
1992	Introduction of auction system for issues of Treasury bills and Government of India dated Securities	To deregulateGovernment Securities market and ensure price discovery
1994	Zero Coupon Bonds, & Floating Rate Bonds were introduced	To introduce innovative Government debt Securities in the market more broad based in terms of instruments.
1995	The Primary Dealer system was introduced. Banks, FIs, NBFCs were allowed to float their own subsidiaries to take up primary dealership business	To support Government borrowing programme thus strengthen the primary market through underwriting support. To make secondary market more active and liquid.
1997	Fixed Income Money Market Derivatives Association of India (FIMMDA) was set up.	(I) To adopt international standards & practices for the participants in the Govt. Securities Market. (ii) To undertake activities like introduction of bench mark, valuation norms and standard sets of documents to develop Government debt market.
1997	Foreign Institution Investors (FIIs) who were registered with SEBI/RBI were allowed to invest in Government securities.	To make the Government securities market more broad-based in terms of participants and institutional investors

2002	Clearing Corporation of India Ltd. (CCIL) was established	To establish a safe institutional structure for the clearing and settlement of trades in the Government securities.
2003	Trading of the Government securities allowed on BSE/NSE	To facilitate retail trading, easy access & wider participation
2005	The Negotiated Dealing System Order Matching (NDS-OM), an anonymous order matching system which allows straight-through processing (STP) was established.	To provide the NDS members with a more efficient trading platform.
2006	Initially Intra-day short selling was permitted. Later on it was	To improve liquidity in the Government securities market, rates scenarios.
2006	Introduction of 'When Issued' market/trading in respect of the Government dated securities.	To facilitate efficient price discovery and distribution of auctioned stock.
2006	The Government Securities Act, 2006 passed by the Parliament, GOI.	To facilitate wider participation in the government securities market and issue of Separately Traded Registered Interest and principal Securities (STRIPS).
2008-09	Introduction of STRIPS	To develop secondary market for the Government securities & thus to create liquidity for illiquid Government securities.
2011-12	The period of short sale was extended from five days to three months from February 1, 2012.	To have price discovery, promote liquidity and better risk management.
2011-12	Direct access to NDS-OM was extended to licensed urban co-operative banks.	To facilitate wider participation of urban co-operative banks in the second market of government securities.
2012-13	Migration of the secondary market reporting of OTC trades in Government securities (outright and repo) from PDO-NDS to NDS-OM and CROMS respectively.	To ensure that participants use NDS-OM and CROMS for executing OTC trades in Government securities.

5.4.3 Types of Government debt Securities

As mentioned earlier, the Government debtsecurities are sovereign debt instruments. These securities are issued by the RBI on behalf of Central as well as state Governments to finance their deficit budgets, undertake social expenditures and provide financial support to business enterprises in the public sector. The following types of securities are issued by the RBI on behalf of Government of India & State Governments.

(i) Treasury bill of 91 day, 182 day and 364 day.

(ii) Government of India dated securities.

(iii) State Government securities

5.4.4 Primary Market

Issue of Treasury Bills

The treasury bills are issued as discounted instruments. At present there are three types of treasury bills namely 91 day, 182 day and 364 day. Such instruments are issued under multiple price auctions. The auctions for issue of 91 day treasury bills is held on every Wednesday. The auctions for issue of 182 day & 364 day treasury bills are held on alternate Wednesday(once in a fortnight.)

Issue of Government of India Dated Securities

Such securities may be issued for various tenors ranging from two to thirty years or even for more than 30 years. However, in practice, such securities are issued for a minimum period of five years. The RBI publishes calendar for issue of GOI dated securities after every six months (twice in a year.) These securities are issued either at a fixed interest rate or floating interest rate. The coupon is paid semiannually. The coupons offered on dated Government securities are either pre-determined by RBI or arrived through competitive bidding or auction process. As mentioned earlier, the RBI has issued variety of dated Government securities such as fixed coupon bonds, bonds with put and call options, zero coupon bonds, floating rate bonds, etc.

Issue of State Government Securities

State Government securities are nothing but State Government loans. Such securities by and large are issued for a minimum period of four years and maximum period of ten years at fixed coupon. The state Government debt securities are issued by the RBI on behalf of various State Governments. Such securities like dated Government securities are issued either through auctions or with pre-announced coupon rates. There has been significant increase in the market borrowings by the State governments.

Some State Governments like West Bengal, Andhra Pradesh, Kerala and Tamilnadu raised funds from the market more frequently. The increase in the market borrowings of the State Governments has been mainly on account of additional allocation of funds for various projects, higher fiscal deficit and inadequate collection of tax revenues.

When Issued Market

The RBI has introduced the system of When Issued Market (WIM) in the Government securities market. The main characteristic of this market is that those who submit bids under auction system to acquire securities are allowed to sale before its allotment on date of auction. This policy is expected to facilitate price discovery and reduce uncertainty surrounding auctions. The main features of this

system are as under:

- Period relates to between the date of announcement of auction and date of allotment
- Only members having connectivity for NDS are allowed to participate in the When Issued Market. This means banks, PDs, financial institutions, insurance companies, etc. are allowed to participate in this market.
- All trades must have a Primary Dealer (PD) as a counter party. The primary dealers are allowed to take both long as well as short positions.
- Entities other than Primary Dealers are allowed to take only long positions
- If auction is cancelled on any day, then all the trades in When Issued Market automatically will get cancelled

5.4.5 Secondary Market

Most of the deals in the secondary market of Government debt securities are negotiated between market participants like banks, PDs, having SGL accounts with the RBI. Such deals are negotiated directly by participants themselves or negotiated through brokers. The RBI has introduced Negotiated Dealing System (NDS) and accordingly members of NDS have been provided connectivity. Negotiated Dealing System (NDS) is an electronic platform for facilitating deals in the Government securities and other money market instruments. If the members of NDS have executed deals outside NDS system (i.e. over telephone or through brokers) then such deals have to be reported on NDS within 15 minutes of concluding such deals. Thus NDS is also used to report transactions in the secondary market of Government securities. The Negotiation Dealing System – Order Matching (NDS) – OM) System was introduced bythe RBI in August 2005 with a view to provide NDS members with a more efficient trading platform.The NDS-OM is an electronic, screen based anonymous order driven trading platform to facilitate trading in government securities. The participants in the market have the option of using the NDS or the NDS-OM for their trading operations. The settlement of both types of transactions is however, integrated. There are types of participants in NDS-OM namely direct and indirect.

Direct members are permitted to open current and SGL accounts with RBI and hence can directly settle their trades on NDS-OM electronic platform. At present, direct members include banks, primary dealers (PDS), insurance companies, mutual funds and large provident funds. These entities have current and SGL accounts with the RBI and therefore can directly trade on NGS-OM electronic trading system.

Indirect members are those who do not have current and SGL accounts with the RBI and hence such members cannot trade directly on NDS-OM trading system. Such members are NBFCs, smaller provident funds, pension funds, co-operative banks, Regional Rural Banks (RRBs), companies and foreign institutional investors (FIIs). These entities can trade on NDS-OM electronic trading system through direct members like banks and primary dealers (PDs) who have current and SGL accounts with the RBI.At present, more than 130 institutions

banks and PDs directly settle their trades on NDS-OM trading system. More than 80 per cent of the total trades in Government securities are done through NDS-OM trading system.' Therefore one can observe that the NDS-OM mode is being extensively used by the market participates to trade in Government securities market.

The system of NDS-OM has helped to bring efficient price discovery, reduce bid-ask spread and intraday price volatility. Once a trade is done on NDS-OM system, it is settled through Clearing Corporation of India (CCIL) and subsequently through NDS gets reflected in SGL as well as current account with the RBI. The settlement of trade is as per Delivery Versus Payment (DVP) (III) mechanism. This was introduced in March 2005. Under the DVP III mechanism, the securities and funds are settled on net basis.

The standardized lot size of each trade is of `5 crore and in multiples of ` 5 crore.

The trades include outright sale and purchase of Government securities, repo and reverse repo transactions where Government securities are used as collateral securities (other than repo with RBI). The settlement of these trades is donethrough CCIL Cleaning Corporation of India Ltd. (CCIL). The settlement is on T (Trade date) +1 basis.

To encourage retail investors to trade in Government securities a separate segment for smaller lot sizes has been created in the NDS-OM platform with a minimum trading lot of ` 10,000/-. This will help retail investors as well as institutional investors who have smaller investment in Government securities to trade in lot sizes which are less than 5 crore.

Trade on stock Exchange.

Both National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) through their Wholesale Debt Market (WDM) segment have introduced trading in Government securities. (All Government securities and Treasury bills are deemed to be listed automatically as and when they are issued.) Trades on the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) are anonymous, order driven and screen based. Since this is a part of wholesale trading, investors like banks, PDs can participate in such trading. The trading system is market driven and order matching and therefore participants require to quote price and quantity. The settlement is on T (Trade date) + 1 basis. The transactions in Government securities through stock exchanges are settled through NDS-CCIL platform.

5.4.6 Participants

Banks and Primary Dealers (PDs) are major holders of Government securities and thus are main participants in the Government securities market. The Government securities are approved securities for the maintenance of Statutory Liquidity Ratio (SLR) by banks. As against Statutory Liquidity Ratio (SLR) of 21.5 per cent of Net Demand and Time Liabilities (NDTL), it is estimated that these banks still have investments in Government securities around 23 to 26 per cent of their NDTL. As per the RBI's guidelines, banks are required to keep their

additional investment portfolio in Government securities (beyond 21.5 per cent of NDTL) in the form of Held for Trading (HFT) and/ or Available for Sale (AF) category. Such securities are identified for sale in the secondary market. In view of this, by and large commercial banks are active participants in the secondary market of Government securities. Their primary objective is to earn sizable trading profit from trading in Government securities in the secondary market. The share of commercial banks in the outright market for Government securities seems to be around 70 per cent. This can be seen from date given in Table 5.2. Along with commercial banks, co-operative banks and regional rural banks also invest in Government securities for various reasons. .

The primary dealers are wholesale traders in the Government securities market. They are active participants both in the primary as well as in the secondary market. They require to achieve a minimum success ratio of 40 per cent for both dated Government securities and treasury bills vis-à-vis bidding commitment and provide underwriting support to the auctions of Government securities. As mentioned earlier, they are essentially wholesale traders in the Government securities market. Their total portfolio is in the nature of trading portfolio. As they are market makers in the Government securities market, they require to provide two way quotes at least in respect of few Government securities in the secondary market. At present 21 primary dealers including bank's own PDs have been operating in this market.

Along with banks and primary dealers, mutual funds, financial institutions, insurance companies and Foreign Institutional Investors (FIIs) are also active participants in the secondary market of government securities. Other investors include charitable trusts, NBFCs, manufacturing companies and individuals.

The category wise share of various institutional and other investors in the outright market for government securities is given in Table 5.2.

TABLE 5.2: Category wise Share of Various Institutional and Other Investors in the Outright Market

(Figures are in percentage)

Participants	2013-14	2012-13	2011-12	2010-11	2009-10	2008-09
Public Sector Banks	19.00	21.39	18.33	17.18	21.33	21.12
Private Sector Banks	15.81	17.95	15.42	16.12	8.07	17.24
Foreign Banks	31.33	32.06	29.30	34.14	27.70	27.68
Primary Dealers	17.82	16.42	26.35	8.98	15.84	18.77
Mutual Funds	09.86	05.81	04.75	8.67	10.94	07.64
Co-operative Banks	02.87	02.85	03.05	2.53	2.75	03.75
Financial Institutions and Insurance Companies	01.97	02.10	01.99	1.59	1.30	01.80
Others	01.35	01.43	0.80	0.79	10.07	02.00
	100.00	100.00	100.00	100.00	100.00	100.00

Source : Clearing Corporation of India Limited; Fact Book 2014, 2011 and 2010.

5.5 Issues Concerned with Government Debt Market

The Government securities market in India is well developed. However, there are certain issues which need to be addressed to make this market more active and efficient. These issues are discussed below

5.5.1 Lack of Liquidity in respect of many Debt Instruments in the Secondary Market

Though the size of the government debt market in India is reasonably large, the market relatively lacks liquidity. Only few Government dated securities and treasury bills are marketable hence liquid securities in the market. Therefore, there is need to create active secondary market for other long term Government dated Securities. The Primary dealers have to become a market maker in respect of large number of Government dated securities and state government securities. The problem of illiquid securities in the Government securities market can be resolved through buyback of such securities and reissue of other securities which are likely to be perceived by investors as liquid securities.

5.5.2 Increasing the Number of Participants

Increasing the number of players in the market will result in participants being available on both sides of the market and will also boost volumes. Various institutional investors need to be encouraged to participate in the secondary market. FIIs also will have to be encouraged to invest in Government debt securities. The Pension funds, provident funds and charitable funds, etc., need to be encouraged to participate in the market. For this, suitable tax benefits can be offered to the investors.

5.5.3 Need for Change in Attitude of Retail Investors

There is a need to encourage retail investors ti invest in Government securities t. In order to provide liquidity in respect of Government securities, the RBI has allowed trading in gilt securities on stock exchanges. The retail investors do not trade in the Government securities in the secondary market. The normal tendency is to invest in and hold Government securities till maturity. This attitude needs to be changed.

5.6 Summary

The debt market is an important segment of financial markets in India. One can find various types of debt instruments in the debt market. With the growing demand for funds and inadequate tax collection both the Central and State governments have to raise more funds through issue of government securities. In this regard Government Security market has an important role to play in the

economy. This market is fully regulated by the RBI. It has introduced many reforms in the Government securities market to make it more efficient, liquid and vibrant. Banks and primary dealers are dominant participants in the Government securities market.

5.7 Key Terms and List of Select Abbreviations

A) Key Terms

1) Fixed Rate Debt Instrument

In case of such instrument interest rate or coupon is fixed and remains constant throughout the tenor of the instrument. The principal amount is paid on maturity date. This is also called as plain vanilla or simple debt instrument or straight bonds.

2) Floating Rate Debt Instrument

In case of such debt instrument interest rate or coupon is not fixed. The interest rate is periodically changed so as to reflect changes in market conditions particularly changes in rate of interest on gilt securities or changes in base rate. The interest rate which is floating is linked with bench mark or base rate such as primary market cut off yield of 91 days treasury bills or 182 days treasury bills. Such debt instruments are also known as adjustable rate or variable interest rate debt instruments.

3) Debt instrument with call option

A call option allows the issuer of debt instrument to call back the bonds and repay them at a predetermined price before maturity date. The issuer may like to exercise call option when interest rates in the market are lower than the coupon or interest rate on the existing debt instruments thereby retiring expensive debt instruments and refinancing them at a lower interest rate.

4) Debt instrument with Put option

A put option allows the bond holder or investor to sell the bonds to the issuer at a predetermined price before maturity or redemption date. The holder of such a debt instrument may like to exercise put option when interest rates in the market are higher than the coupon or interest rates on the existing debt instruments.

5) Zero Coupon Debt Instrument

Such instrument is issued or sold at discounted value and redeemed at par value. Hence, it does not have coupon. Example of this instrument is that of treasury bills which are issued at discounted value and redeemed at par. The difference between the discounted value and face value of the instrument is the gain or income to the investors.

6) Convertible Debt Instrument

A debt instrument is issued with convertible clause. The holder of such instrument can exercise the right to convert debt instrument either fully or partially into equity. On conversion of debt instrument into equity, the investors will receive equity shares. Once this is done then the investors will be paid dividend but not interest.

7) Redeemable Debt Instrument

Redeemable debt instrument is that instrument which is issued for a specified period and thus is redeemed once the period gets over. Under the company law provisions the companies are allowed to issue debt instrument like debentures for a maximum period of 10 years. A company which is engaged in the setting up of infrastructure project is permitted to issue debentures for thirty years.

8) Primary Dealers

The primary dealers are wholesale traders in the Government securities market. They are market makers and hence provide liquidity in respect of the Government securities. The primary dealers are active participants in the money and Government securities markets. At present in all there are 21 primary dealers in India.

9) Short Sale

Short sale is defined as sale of securities one does not own. (I.e. a security which is not part of portfolio at the time of sale of security). The scheduled commercial banks and primary dealers are allowed to execute short sale transactions in the Government of India dated securities subject to the short sale position being covered within a maximum period of 3 months including the date of trade.

10) Negotiated Dealing System - Order Matching (NDS-OM)

The Negotiated Dealing System - order matching (NDS-OM) System is an anonymous electronic matching platform owned by the RBI. This system was launched on August 1, 2005. This system facilitates trading in all kinds of Government dated securities, State Government securities and treasury bills in the secondary market. This system is hosted and maintained by the Clearing Corporation of India Ltd (CCIL) for and on behalf of the RBI.

11) Subsidized General Ledger (SGL) account

It is the securities account that is maintained by banks and primary dealers with the RBI for holding their investment in Government securities Banks and PDs are allowed to hold their own securities (i. e. proprietary holdings) in the SGL account.

12) Multiple Price Auction

Under this auction, once a cut-off price is determined, all the successful bidders are allotted securities at prices quoted by them (i. e. either at cut-off price or above). All types of treasury bills are issued under multiple price auction.

13)Separately Traded Registered Interest and Principal Security (STRIPS)

Under STRIPS series of zero coupon securities are created from the cash flows of a coupon bearing Government security. Such securities are created separately in respect of cash flows arising on account of coupon payment and principal payment. Stripping of a security result in coupon STRIPS for all outstanding coupon payments and one Principal STRIP for the redemption of face or par value. Each STRIP accordingly becomes a zero coupon bond since it has only one cash flow at maturity. Each STRIP is considered as a distinct Government security.

B) List of Select Abbreviations

1) NBFCs : Non-banking Finance Companies

2) FIMMDA : Fixed Income Money Market Derivatives Association of India.

3) NDS : Negotiated Dealing System

4) NDS-OM : Negotiated Dealing System-Order Matching

5) STRIPS : Separately Traded Registered Interest and Principal Security

6) CCIL : Clearing Corporation of India Ltd.

7) SLR : Statutory Liquidity Ratio

8) NDTL : Net Demand and Time Liabilities.

9) FIIs : Foreign Institutional Investors

5.8 Self-AssessmentQuestions

Question 1 : State whether the following statements are true or false.

(i) Treasury bills are issued as discounted instruments.

(ii) The market for Government debt securities is regulated by the SEBI.

(iii) Primary dealers are wholesale traders in the Government Securities Market

(iv) Banks are major institutional investors in the Government securities market.

(v) All trades in Government securities are settled through the Cleaning Corporation of India Ltd.

Question 2 : Define the following type's debt instruments.

(i) Floating Rate Bonds

(ii) Zero-coupon Bond

(iii) Convertible Debentures

(iv) Bonds with put and call options.

Question 3 : Define following key term in the context of Government debt market

(i) Primary Dealers

(ii) Short Sale

(iii) When Issue market

Question 4 : (a) Define the Government security.

(b) What is the role of the RBI in issue of Government securities.

Question 5 : Who are the major participants in the Government securities market?

5.9 Further Reading and References

A. Annual reports of the RBI for the period 2008-09 to 2012-13

B. RBI's Circulars on Secondary Market Transactions in Government Securities – Short Selling and on STRIPS

C. Relevant Provisionsof the RBI Act, Government Securities Act and Fiscal Responsibility and Budget Management Act 2003.

D. Relevant materials available on Website of FIMMDA, RBI, NSE and CCIL

E. Bond & Money Markets, Taxman Publications Pvt. Ltd., Mumbai (Latest Publication)

F. Fact Book 2010, 2011and 2014 of Clearing Corporation of India Limited; Mumbai

G Government Securities Market in India - A Premier, Published by the Internal Debt Management Department, RBI, February 2010.

Unit 6 Indian Debt Market-II : Corporate Debt Market

Structure

6.1 Introduction

6.2 Unit Objectives

6.3 Issues of Bonds

6.3.1 Bonds Issued by Public Sector Undertakings

6.3.2 Bonds Issued by Financial Institutions

6.3.3 Corporate Debentures

6.4 Primary Market

6.5 Secondary Market

6.6 Issues concerned with Indian Corporate Debt Market

6.6.1 Lack of Liquidity in respect of many Debt Instruments in the Secondary Market

6.6.2 Increasing the Number of Players

6.6.3 Need for Change in Attitude of Retail Investors

6.6.4 Innovative Instruments

6.6.5 Greater Disclosure in Respect of Privately Placed Debt Instruments

6.7 Summary

6.8 Key Terms and List of Select Abbreviations

6.9 Self Assessment Questions

6.10 Further Reading and References

6.1 Introduction

The corporate debt market is an important segment of the overall debt market in India. The market for corporate bond is regulated by the Securities Exchange Board of India (SEBI). It is responsible for the development of primary as well as secondary market for corporate debt instruments. Banks, Financial Institutions, NBFCs, Public sector undertakings and private companies borrow long term funds from the capital markets through issue of various debt instruments having different maturities. For example private companies raise funds for longer period say 5 years or 10 years through issue of a typical long-term debt instruments.

NOTES

As discussed in Para no. of Unit no. 5 a company registered under the Companies Act, 2013, cannot issue debentures for more than ten years. A company which is engaged in infrastructure projects is allowed to issue debentures for a period exceeding ten years but not beyond thirty years. The corporate debt market has assumed a special place in the financial markets due to its support to provide long term funds. In the process this market helps to achieve following objectives

(i) to diffuse stress on banks by diversifying credit risk across the economy .among various investors.

(ii) to supply long term investment products for long term investors.

(iii) to reduce funding cost for corporate and others by eliminating agency or disinter median cost.

(iv) to ensure that capital is allocated more efficiently among various enterprises.

6.2 Objectives of the Unit

The objectives of this unit are as under:

(i) to know the structure of corporate debt market in terms of instruments, participants and size, etc.

(ii) to understand reforms in the primary and secondary segment of corporate debit market

(iii) to study various issues relating to the Indian corporate debt market

6.3 Issuers of Corporate Bonds

Public sector undertakings (PSUs), banks, financial Institutions, private corporate enterprises and non banking finance companies (NBFCs) have issued various types of debt instruments to raise funds from the debt market. These bonds can be grouped into following categories :

i) Fixed Rate v/s Floating Rate Bonds

ii) Convertible Bonds v/s Non Convertible Bonds

iii) Credit Rated Bonds v/s Unrated Bonds

iv) Coupon Bearing Bonds v/s Deep Discount Bonds

v) Tax free v/s Taxable Bonds

vi) Bonds with Put and Call Options

6.3.1 Bonds Issued by Public Sector Undertakings (PSUs)

Several central as well as state level public sector undertakings (PSUs) entered the market for the first time in 1985-86 to raise funds through debt instruments. Since then, many such public sector undertakings have raised funds through tax free as well as taxable bonds. The gradual withdrawal of budgetary support to PSUs by the Government has forced many PSUs to depend heavily on the bond market for mobilizing long term resources. Even though these bonds does not have any Government guarantee nevertheless bonds have become attractive mainly because of the tax exempt status and the high coupon rates. The PSUs did not issue tax free bonds during 2003-04 to 2008-09. This can be seen from data given in Table 6.1. This data reveals that size of taxable bonds issued by PSUs has been much more as compared to the size of tax free bond issues The bonds issued by PSUs have been subscribed by banks, insurance companies, mutual funds and other institutions as well as retail investors. The investors prefer to invest in tax free bonds issued by PSUs because the interest income from these bonds is completely exempt from income tax.

[1] Any person including firm, corporate body, institution, State Government, provident fund, trust, non-resident Indians (NRI), Foreign Institutions Investors (FIIs) registered with SEBI and approved by RBI can submit offers including in electronic form for purchase of Government securities.

Table 6.1 : Bonds Issued By Public Sector Undertakings*

(Rupees in Billion)

1	**2**	**3**	**4**
1995-96	5.47	17.44	22.91
1996-97	0.67	33.27	33.94
1997-98	5.70	24.12	29.83
1998-99	4.06	39.57	43.63
1999-00	4.00	82.97	86.97
2000-01	6.62	159.69	166.32
2001-02	2.74	141.62	144.36
2002-03	2.86	72.43	75.29
2003-04	-	54.43	54.43
2004-05	-	75.91	75.91
2005-06	-	48.46	48.46
2006-07	-	103.25	103.25
2007-08	-	134.04	134.04
2008-09	-	205.46	205.46
2009-10	19.26	464.83	484.09
2010-11	16.42	587.91	604.33
2011-12	230.82	599.83	880.65
2012-13	148.60	378.57	527.17

Note : Data include both public issues of bonds and privately placed bonds. **Source :** RBI's website (Data on Indian Economy)

NOTES

6.3.2 Bonds Issued by Financial Institutions (FIs)

Financial institutions which cannot accept demand deposits comprising of savings and current deposits depend on bond instruments to raise funds from the bond market. Because of higher rating from rating agency, these institutions issue bonds at lower interest rates. In the past many financial institutions like SIDBI, NABARD, IFCI, raised funds through various bonds such as capital gain bonds, deep discount bonds, floating rate bonds, etc. Total resources mobilized by the All India Financial Institutions in the year 2011-12 in the form of bonds and debentures were considerably higher than in the previous year. These institutions raised Rs. 961 billon though issue of bonds and debentures, in 2011-12. In 2012-13 all these institutions mobilized Rs. 490 billion from markets through issue of bonds and debentures. This can be seen from data given in Table 6.2.

Table 6.2 : Resources Raised by way of Bonds/Debentures by Select All India Financial Institutions (FIs)

(` In billion)

	2010-11	**2011-12**	**2012-13**	**2010-11**	**2011-12**	**2012-13**
EXIM Bank	111	88	111	3.4	9.0	9.0
NABARD	97	179	174	7.0	7.2	9.3
NHB	75	555	87	7.1	9.5	7.7
SIDBI	100	139	98	7.2	8.3	7.6
Total	383	961	490	N. A.	N.A.	N. A.

Source : RBI's Report on Trend and Progress of Banking in India, 2011-12 and 2012-13

Along with financial institutions, banks have also raised funds through issue of subordinate debts to raise funds to maintain Capital Risk Asset Ratio (CRAR) as per the prudential norm prescribed by the RBI.

6.3.3 Corporate Debentures

The private corporate enterprises issue debentures to raise funds for longer period. However, the companies cannot issue any debentures carrying voting rights. Further, the companies have to issue secured debentures. In recent past the Companies have issued various types of debentures such as convertible debentures, debentures with put and call options, floating rate debentures etc., a very large proportion of such debts instruments have been issued to the institutional investors such as banks, mutual funds, insurance companies, etc., through private placement. The companies also issues debentures through public offer to the institutional as well as retail investors.

6.4 Primary Market

The companies are free to issue debt instrument either through private placement or through public offer. Over the last five years, the companies have shown a distinct preference for private placements over public issues for issue of debt securities. The dominance of private placement over public issue can be attributed to a number of factors which are mentioned below:

a) The cost of issue of debt securities through public issue is considerably higher than those for a private placement.

b) Public issue requires disclosure about company's information and financial data. This forces the companies to opt for the private placement route.

c) Larger amount can be easily raised through private placement rather than through a public issue.

d) Certain debt instrument like commercial paper (CPs) has to be issued through private placement only.

The issuer may list its debt securities issued through private placement on a recognized stock exchange subject to the following conditions.

- Debt securities are issued in compliance with the provisions of the Companies Act of 2013.
- Credit rating has been obtained in respect of such debt securities from at least one credit rating agency registered with the SEBI
- Debt securities are issued in demat form.
- The disclosure as provided in regulation with respect to the listing agreement has been made.

6.4.1 Issue of Debt Instrument through Private Placement

The issuers take the help of merchant bankers to place debt instruments with institutional investors like banks, insurance companies and mutual funds, etc. As banks and financial institutions as per the RBI guidelines require to invest only in rated debt instruments, the issuers are forced to obtain credit rating in case of issue of debt instrument through private placement from a recognized credit rating agency. Further, the issuers have to issue debt instruments in demat form. For taking help of a merchant banker for private placement issuer pays commission for the same.

6.4.2 Issue of Debt Instrument through Public Issue

The Companies also have been permitted by the SEBI to issue debt securities through public issue. The salient features as well as conditions of such issues are as follows:

9) Issuer has to make an application to one or more recognized stock exchanges for listing of such debt securities and it has received in principle approval from the stock exchange / s for listing of its debt securities.

10) Issuer has obtained credit rating from at least one credit rating agency registered with the SEBI and the same is disclosed in the offer document. If the issuer has obtained credit rating from more than one credit rating agencies then all the credit ratings including unaccepted ratings must be disclosed in the offer document.

11) Issuer has entered into an arrangement with a depository registered with the SEBI for the dematerialization of the debt securities which have proposed to be issued.

12) Issuer has to appoint one or more merchant bankers registered with the SEBI at least one of whom shall be a lead merchant banker.

13) Issuer has to appoint one or more debenture trustees in accordance with the provisions of the section 71 (5) of Companies Act of 2013 and the SEBI (Debenture Trustee) Regulations, 1993 before the issue of prospectus or letter of offer for subscription.

14) In order to facilitate issuance of below investment grade bonds (i.e. below BBB) to suit the risk-return appetite of investors, the stipulation that debt instruments shall be of at least investment grade has been removed.

15) Issuer is free to structure debt instruments without any restrictions with respect to put and call option, conversion clause, etc. However, in case of issue of convertible debt instruments issuer has to comply with guidelines issued by the SEBI in this regard.

16) A draft offer document needs to be filed with the designated stock exchange through a SEBI registered lead merchant banker who shall be responsible for due diligence exercise in the issue process.

6.5 Secondary Market

The secondary market for corporate debt securities consist of over the counter (OTC) as well as stock exchange. Deals in respect of privately placed debt instruments (which are not listed on a stock exchange) are executed in the OTC market. In case of listed debt instruments, trades are executed according to the guidelines of stock exchange. Therefore, participants have a choice of platform. They may trade in OTC or on a stock exchange trading platform where debt instruments are listed. Existing stock exchanges provide facilities for trading of listed corporate debt securities. Both National stock exchange (NSE) and Bombay stock exchange (BSE) have been permitted to provide trading platform for this purpose.

Trading in Corporate Debt Securities

The National Stock Exchange (NSE) provides a distinct platform for trading in debt securities and has created a separate segment for the same, which is called as Wholesale Debt Market (WDM) segment. This segment commenced operations on June 30, 1994. This segment caters to large players in the market, like banks, institutions, etc.

The NSE-WDM segment provides a trading platform for trading in various debt securities such as PSU bonds, corporate debentures, bonds issued by financial institutions, etc. Trades in debt securities are executed through the National Exchange for Automated Trading (NEAT) system which is an automatic system that provides trading and reporting facilities. NSE's trading platform has a screen based, order driven and automated order matching system.

The Bombay Stock Exchange (BSE) has introduced trading in all types of debt instruments in the Wholesale Debt Market (WDM) segment through GILT System. This system is an automatic online trading system. Trading members and participants have identified as entities in the system. Trading members (brokers) are admitted on the exchange with trading rights. Trading members execute trades on GILT system for entities like banks, financial institutions, mutual funds, statutory corporations, etc. Even individuals can also transact in corporate debt securities through the members of BSE who have been permitted to undertake deals in debt securities.

6.5.1 Reporting and settlement of Trade in Debt Securities

In April 2007, the SEBI permitted both the BSE and the NSE to put in place corporate bond trading platforms to enable efficient price discovery and reliable clearing and settlement facility having following characteristics:

a) Trade matching platform shall be order driven with essential features of OTC market.

b) System of anonymous order.

In August 2007, the SEBI granted approval to the Fixed Income Money Market Derivatives Association (FIMMDA) for starting corporate bond trade reporting system. Accordingly in September 2007, the FIMMDAs reporting platform became operational as the third reporting platform after BSE and NSE. For reporting of OTC trades, the concerned parties are free to opt for reporting their trades on any one of the three reporting platforms. The trades in corporate bonds in OTC market are settled through the clearing corporation of stock exchanges i.e. the Indian Clearing Corporation Limited (ICCL) and the National Securities Clearing Corporation Ltd. (NSCCL). All trades in corporate bonds which are executed in demat mode and reported on any of the specified reporting platform like FIMMDA and NSE-WDM can be settled through the NSCCL. To facilitate this, buyers and sellers in corporate bond market are required to indicate their intention to settle such deals through the NSCCL.

6.5.2 Additional Disclosure as per the SEBI Guidelines

With effect from August 2007 the SEBI has made mandatory that the companies issuing debentures and the respective debenture trustees as well as stock exchanges shall disclose all information regarding the debentures to the investors and general public by issuing a press release and also displaying the details on their respective websites with respect to the followings:

i) Default by Issuer Company to pay interest on debentures or redemption of principal amount.

ii) Failure to create a charge on the assets.

iii) Revision of rating assigned to the debentures.

6.5.3 Trading Data

The number of trades as reposted on NSE and BSE in corporate bonds increased from 32,662 in 2010-11 to 47,135 in 2013-14. The amount of settlement of trades as reported on NSE and BSE increased from Rs. 450123.15 crore in 2010-11 to Rs. 618899.44 crore in 2012-13. Of the total deals on both the exchanges, around 90 per cent deals in corporate bonds were reported on NSE. This can be seen from data given in Table 6.3.

Table 6.3 : Settlement of Corporate Bonds

(` In Crore)

	No. of trades	**Amount**	**No. of trades**	**Amount**	**No. of trades**	**Amount**
2010-11	30948	432631.65	1714	17491.50	32662	450123.15
2011-12	34697	391120.43	2916	10679.87	37613	401800.30
2012-13	36902	435113.77	7415	42976.58	44317	478090.35
2013-14	39695	654681.68	7440	64217.76	47135	618899.44

Source : Data on Trading in Corporate Bonds, SEBI Website.

6.6 Issues Concerned with Indian Debt Market

The corporate debt market in India is yet to be fully developed. Despite various reforms in the corporate debt market, still there are certain issues which need to be addressed and changes will have to be made in the existing policy framework. These issues are discussed below.

Check Your Progress

Q 1. State whether the following statements are true or false ?

1. The public sector undertakings (PSUs) raise long term funds through issue of taxable bonds only.
2. The cost of issue of debt securities through public issue is considerably higher than those for a private placement.
3. The corporate debt securities are issued in physical form.
4. In case of public issue of debt securities, the issuer has to obtain credit rating from at least one credit rating agency registered with the SEBI.
5. The secondary market for corporate debt securities is only in the nature of over the counter (OTC) market.

Q 2. Explain in brief various conditions for issue of debt instruments through public issue.

Q 3. (i) What do you mean by private placement of debt instruments ?

(ii) Mention any two reasond for issue of debt instruments through private placement.

Q 4. Discuss in brief the secondary market for corporate debt securities.

6.6.1 Lack of Liquidity in respect of many Debt Instruments in the Secondary Market

The secondary market for corporate debt instruments is illiquid. In the absence of active secondary market, investors have difficulties to sale debt instruments in the secondary market. The concept of Primary dealers need to be introduced in respect of corporate debt segment to create secondary market in respect of large number of corporate debt securities which are not listed on stock exchanges.

6.6.2 Increasing the Number of Participants

Increasing the number of players in the market will result in participants being available on both sides of the market and will also boost volumes. Various institutional investors need to be encouraged to participate in the secondary market. FIIs also will have to be encouraged to invest in corporate debt securities. The Pension funds, provident funds and charitable funds, etc., need to be encouraged to participate in the market. For this, suitable tax benefits can be offered to the investors.

6.6.3 Need for Change in Attitude of Retail Investors

There is a need to encourage participation of retail investors in the corporate debt market. The retail investors do not trade in the corporate debt securities in the secondary market. The normal tendency is to invest in and hold corporate debt securities till maturity. This attitude needs to be changed. The retail investors will have to be encouraged to trade in corporate debt securities in the secondary market. The primary dealers can play a significant role in this regard. They have to offer two way quotes in respect of large number of debt securities.

6.6.4 Need for Innovative Instruments

There is no point in offering only plain Vanilla debt securities. In order to encourage savings from small investors and attract investment from institutional investors, there is a need to bring innovations in the issue of debt instruments. The debt securities having features such as monthly interest payment, deep discount bonds, bonds with put and call options and floating rate bonds etc., are likely to be subscribed by both institutions as well as retail investors. Therefore more variety of debt instruments needs to be offered to the retail and institutional investors.

6.6.5 Greater Disclosure in Respect of Privately Placed Debt Instruments

A larger portion of the corporate debt securities is privately placed. In view of this, various issues relating to the private placements need to be addressed. In this context, it is essential to ensure greater transparency, adequate disclosures, minimum credit rating and proper accounting standards. This will enhance the confidence of investors in the debentures issued by private corporate entities.

Credit rating agencies will require to take utmost care while rating of debt instruments which are privately placed.

6.7 Summary

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Even though the corporate debt market has been in existence in India for long time, it has remained underdeveloped and inefficient. With the reforms in economy, increasing activities of manufacturing companies, opening of insurance sector to the private sector, and focus on investment in infrastructure sector, demand for long term debt securities is bound to increase further. In this regard, corporate debt market will have an important role to play in the economy. The companies have been raising funds through issue of various debt instruments mainly through private placement. Several measures have been taken by the SEBI to develop the corporate debt market in India. It includes reporting and trading platform at BSE, NSE & FIMMDA, simplification of the debt issue process and dissemination of all the information about corporate debt to the investors on the website of the issuer, stock exchanges etc. Many more reforms are needed to make both primary and secondary market for corporate debt securities vibrant. In this regard the regulators and the Government will require to take various policy initiatives to make corporate debt market broader based and thus efficient in India.

6.8 Key Terms and List of Select Abbreviations

a) Key Terms

1) Fixed Rate Debt Instrument

In case of such instrument interest rate or coupon is fixed and remains constant throughout the tenor of the instrument. The principal amount is paid on maturity date. This is also called as plain vanilla or simple debt instrument or straight bonds.

2) Floating Rate Debt Instrument

In case of such debt instrument interest rate or coupon is not fixed. The interest rate is periodically changed so as to reflect changes in market conditions particularly changes in rate of interest on gilt securities or changes in base rate. The interest rate which is floating is linked with bench mark or base rate such as primary market cut off yield of 91 days treasury bills or 182 days treasury bills. Such debt instruments are also known as adjustable rate or variable interest rate debt instruments.

3) Debt instrument with call option

A call option allows the issuer of debt instrument to call back the bonds and repay them at a predetermined price before maturity date. The issuer may like to exercise call option when interest rates in the market are lower than the coupon or interest rate on the existing debt instruments thereby retiring

instruments and refinancing them at a lower interest rate.

4) Debt instrument with Put option

A put option allows the bond holder or investor to sell the bonds to the issuer at a predetermined price before maturity or redemption date. The holder of such a debt instrument may like to exercise put option when interest rates in the market are higher than the coupon or interest rates on the existing debt instruments.

5) Zero Coupon Debt Instrument

Such instrument is issued or sold at discounted value and redeemed at par value. Hence, it does not have coupon. Example of this instrument is that of treasury bills which are issued at discounted value and redeemed at par. The difference between the discounted value and face value of the instrument is the gain or income to the investors.

6) Convertible Debt Instrument

A debt instrument is issued with convertible clause. The holder of such instrument can exercise the right to convert debt instrument either fully or partially into equity. On conversion of debt instrument into equity, the investors will receive equity shares. Once this is done then the investors will be paid dividend but not interest.

7) Non Convertible Bond

Such bond cannot be converted into equity. Therefore such bond remains bond till it is redeemed.

8) Credit Rated Bond

Such bond is rated by a recognized rating agency. The rating symbols are AAA, AA, A and BBB etc. In case of a public issue of bonds credit rating is mandatory.

9) Redeemable Debt Instrument

Redeemable debt instrument is that instrument which is issued for a specified period and thus is redeemed once the period gets over. Under the company law provisions the companies are allowed to issue debt instrument like debentures for a maximum period of 10 years. A company which is engaged in the setting up of infrastructure project is permitted to issue debentures for thirty years.

10) Tax Free Bond

Interest income from these bonds is completely exempt from income tax

11) Private Placement

It is a method for issue of securities like debt instruments. Under this method offer is made privately to a small chosen number of investors (say less than fifty investors) to subscribe debt instruments or other securities.

12) Public Issue

It is nothing but offer or invitation by an issuer to the public at large to subscribe to the debt and other securities. This method is used to issue shares of public limited companies subject to the company law provisions and guidelines issued by the Securities Exchange Board of India (SEBI).

b) List of Select Abbreviations

i) PSUs : Public sector undertakings

ii) OTC : Over the Counter

iii) NSCCL : National Securities Clearing Corporation Ltd.

iv) ICCL : Indian Clearing Corporation Limited

v) WDM : Wholesale Debt Market

vi) NEAT : National Exchange for Automated Trading

vii) FIMMDA : Fixed Income Money Market Derivatives Association

(i) Self-Assessment Questions

Question 1 : State whether the following statements are true or false.

(i) The market for corporate debt market is regulated by the SEBI.

(ii) The reporting of corporate bond deals in OTC market must be made only to the reporting platform of National Stock Exchange (NSE).

(iii) The securities in corporate debt market are issued only through private placement.

Question 2 :

(a) Define the Government security.

(b) What is the role of RBI in issue of Government securities ?

Question 3 :

Who are the major participants in the corporate debt market ?

Question 4 :

Write short notes

(a) Private placement of corporate debt.

(b) Primary market for corporate debt securities.

(c) Trading in Corporate Debt Securities.

6.10 Further Reading and References

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7. The Bond and Money Markets: Strategy, Trading and Analysis, Oxford, Butterworth - Heinemann (Latest edition)

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9. The Corporate Debt Market in India, BIS paper written by Sharma V K and Sinhala C (2000) (Available on BIS website)

10. Fact Book for the years 2013, 2012 & 2011 published by CCIL, Mumbai

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Unit 7 Indian Equity Market-I: Primary Market

Structure

7.1 Introduction

7.2 Unit Objectives

7.3 Types of Shares

7.3.1 Equity Shares

7.3.2 Non-voting Shares

7.3.3 Sweat Equity Shares

7.3.4 Preference Shares

7.4 Issue of Shares at Par, Discount and Premium

7.5 Primary Market

7.6 Initial Public Offering through Book Building Method

7.7 Difference between Book Building and Normal Public Issue

7.8 Resources mobilized from Primary Market

7.9 Summary

7.10 Key Terms and List of Select Abbreviations.

7.11 Self Assessment Questions

7.12 Further reading and References

NOTES

7.1 Introduction

Equity market is an important segment of the financial markets. This market helps the corporate to raise funds with long and indefinite maturity and this facilitates the capital formation in the country. The funds raised through issue of equity shares are used mainly for purchase of fixed assets. The investors invest their surplus funds in equity shares for better return and capital appreciation. The economic growth of a country largely depends on the growth in equity market. Equity along with debt market forms an integral part of the capital market which offers a number of investment avenues to the investors. This market is comprised of primary and secondary market. While issuing shares in the primary market, companies are required to comply with company law provisions and guidelines issued by the SEBI. The various aspects of the primary equity market are discussed in this unit.

7.2 Unit Objectives

The objectives of this unit are as follows:

(i) **to know various types of shares with reference to its features and legal provisions.**

(ii) to have proper understanding of primary market where shares are issued.

(iii) to study various methods for issue of shares in primary market.

7.3 Types of Shares

In India the company can issue under the Company Law provisions, two types of shares namely equity shares as well as preference shares.

7.3.1 Equity Shares

Equity shareholders are owners of the company and they undertake maximum risk in the business. Because of this the equity capital is called as risk capital. The relevant provisions of the Companies Act and guidelines issued by the SEBI regarding equity shares are considered by the companies while issuing equity shares. These shares are also called as ordinary shares.

The various advantages and disadvantages of raising funds through issue of equity shares are as follows:

Advantages

- It is a permanent source of funds and therefore capital base of the company remains in tact.
- The issue of the new equity shares increases flexibility of the company in terms of raising of additional debt capital.
- There is no mandatory dividend payment to the shareholders of equity shares in the form of return on equity. In other words, dividend is paid only if the company has earned profit or adequate reserves and therefore, there is no legal obligation to pay dividends on equity shares. However, once, dividend on equity shares is approved by Board and members in Annual General Meeting, and then it becomes a liability of a company.

Disadvantages

1. As dividend which is paid or payable on equity capital, is not allowed as deduction for computation of tax liability. In view of this, after taking into account income tax effect cost of equity is always more than the cost of debt funds.
2. Issue of additional shares to the new investors for the purpose of increasing share capital dilutes share of promoters in the share capital

loss of control for the existing promoters or management.

7.3.2 Non-Voting Shares

The Public Limited Company can issue non-voting shares. Such shares have to be listed by listed companies separately on the stock exchanges. The investors holding of such shares are entitled to receive dividends and bonus shares in the same proportion as that being offered to equity shareholders with voting rights.

In case dividend on non-voting shares remains unpaid for a certain period despite dividend declared by the company, the shareholders holding such shares will have voting rights as in the case of preference shares.

By issuing non-voting shares, the company will be able to mobilize additional equity capital and thus to strengthen the net worth without dilution of control of existing management.

7.3.3 Sweat Equity Shares

Public Limited Company has been permitted under Section 54 of Companies Act of 2013, to issue sweat equity shares of a class of shares already issued. The sweat equity shares are issued to the directors of a company and long time employees of the company. These shares are issued at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights. The sweat equity shares are issued subject to the following conditions.

i) the issue of shares is authorized by a resolution passed by the company in the general meeting.

ii) the resolution specifies the number of shares, the current market price and the class or classes of directors or employees to whom such equity shares are to be issued.

iii) not less than one year has at the date of issue elapsed since the date on which the company was entitled to commerce business and

iv) where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the SEBI in this behalf and if they are not listed the sweat equity shares are issued in accordance with the rules made in this behalf by the Government of India [i. e. Companies (Share Capital & Debenture Rules) 2014].

7.3.4 Preference Shares

Shareholders of preference shares enjoy preferential treatment both as regard to the payment of a fixed amount of dividend and repayment of capital on winding up of the company. Long term funds can be raised through issue of preference shares. Such preference shares carries a fixed dividend say 10 per

cent which is paid annually. These shares can be classified into the following categories :

1. Cumulative preference shares v/s non-cumulative preference shares

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The holders of cumulative preference shares have the right to demand or receive unpaid dividend for any year, in the succeeding year or years when the sufficient profits are available for distribution of dividend. In view of this, dividends which are not paid in any year are accumulated and are paid when the profits are available. Thus arrears of dividend for any year or years are paid in subsequent years. As against this, holders of non – cumulative preference shares are entitled to receive dividend provided there is profit in that year. This means arrears of preference dividend are not carried forward in the subsequent years.

2. Irredeemable v/s redeemable preference shares

Irredeemable preference shares are those shares which are redeemed at the time of liquidation or insolvency of the company. As against this, redeemable preference shares are redeemed after completion of specified period. For example 10 per cent preference shares are issued for 10 years. These are called redeemable preference shares because such shares are to be redeemed after expiry of 10 years.

3. Cumulative convertible preference shares

Cumulative convertible preference shares are converted into equity shares. On conversion preference shareholders become equity shareholders and enjoy the rights of equity shareholders. The cumulative convertible preference shares can be either partially convertible or fully convertible.

4. Participating v/s non-participating preference shares

The holders of participating preference shares are paid dividend at a fixed rate with the right to participate further in the profits either along with or after payment of certain dividend to the equity shareholders. As against this, holders of non – participating preference shares do not have right to share in the profits of the company after the preference dividend at a fixed rate is paid.

In the absence of any specific details such shares are normally presumed to be cumulative preference shares. In India the companies can not issue irredeemable preference shares. As per the Section 55 of the companies' act of 2013, no company can issue preference shares which are irredeemable. This section further provides that a company can issue preference shares which are liable to be redeemed within a period of twenty years from the date of its issue. However a company having infrastructure projects may issue preference shares for a period exceeding 20 years but not exceeding thirty years.

The advantages of issuing preference shares for the companies are as under :

- No dilution in earnings per share (EPS) on enlarged capital base. (If equity shares are issued, it reduces EPS).
- It provides leverage benefit as it carries a fixed dividend.
- There is no risk of take over.
- There is no dilution of managerial control.

- Preference shares can be redeemed after a specified period. (No need to have such capital as a permanent one).

The major disadvantage of issue of preference shares is lack of tax benefit. Like equity shares, dividend paid or payable on preference shares is not allowed as admissible expense for tax purpose. In view of this, effective cost of preference shares (i.e. post tax) of the company is far greater than the cost of borrowed funds.

7.4 Issues of Shares at Par, Discount and Premium

The companies can issue a share with a face value of Re. 1 or Rs. 2 or 10 or Rs. 100. If a share is issued at a price below face value then it is called issue of shares at a discount. Similarly, if a share is issued at a price above the face value then it is known as issue of shares at a premium. For example, a share with a face value of Rs. 10/- is issued at premium of Rs. 5/-, then price will be Rs. 15/-.

As per the SEBI guidelines, the companies which have not completed 12 months of commercial operations, and whose audited operation results i.e. financial statements are not available and which are promoted by entrepreneurs without a track record, must issue shares at par or face value. This means such companies cannot issue shares at premium.

7.4.1 Issue of Shares at Discount

As per the section 53 of Companies Act of 2013, the companies cannot issue shares at a discount except sweat equity shares. Any shares issued by a company at a discount become void and hence the company is liable to pay penalty as per the company law provision.

7.4.2 Issue of Shares at Premium

The Companies Act, 2013, does not specify any condition for issue of shares by a company at a premium. However, as per the SEBI guidelines new companies promoted by existing companies can offer shares to the public at a premium provided :

1. the existing companies have a five year consistent track record of profitable performance.
2. the promoters have agreed to take up at least 50 per cent of the shares in the issue.
3. all parties applying to the issue should be offered the same instrument at the same terms especially regarding the premium.
4. the prospectus should provide justification for the proposed premium.

The above mentioned restrictions are not applicable in case of existing companies. Therefore such companies can issue shares with premium without any restrictions.

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Check Your Progress

Q 1. State whether the following statements are true or false ?

(i) The funds raised through issue of equity shares are used mainly to purchase fixed assets.

(ii) Equity capital is called as risk capital

(iii) It is mandatory for the company to pay dividend on equity shares

(iv) The sweat equity shares are issued to the public at large.

(v) The dividend, which is paid or payable on preference shares, is allowed as an admissible expense for tax benefits.

(vi) The companies are allowed to issue irredeemable preference shares.

Q.2. (i) What do you mean by sweat equity shares?

(ii) What are the advantages of issuing preference shares for the companies?

Q.3. Distinguish between equity shares and preference shares?

Q.4. (i) What do you mean by cumulative convertible preference shares?

(ii) Distinguish between redeemable and irredeemable preference shares.

The securities premium account can be used only for the following purposes as lay down by the section 52 (2) of the Companies Act of 2013.

(i) to issue fully paid bonus shares to the extent not exceeding unissued share capital of the company.

(ii) to write off preliminary expenses of the company

(iii) to write off the expenses of or commission paid or discount allowed on any of the shares or debentures issued earlier

(iv) to pay premium on the redemption of preference shares or debentures of the company.

(v) To purchase its own shares under Section 68 of The Companies Act, 2013.

The existing companies prefer to issue shares with premium as it helps them to increase the book value.

NOTES

Check Your Progress

Q 1. State whether the following statements are true or false ?

(i) If a share is issued at a price below its face value then it is called issue of shares at a premium

(ii) The companies are allowed to issue shares at a discount

(iii) The securities premium account is used to write off all the deferred revenue expenditures

(iv) The existing companies are free to issue shares with premium without any restrictions

(v) New companies, irrespective of their promoters, have to issue shares at par

Q.2. For what purposes securities premium account can be used ?

7.5 Primary Market

The equity market can be divided into two segments namely primary as well as secondary market.

A primary market is a market where new securities are brought and sold for the first time. It is called as the New Issues Market (NIM) or the Initial Public Issue (IPI) market. In other words the first public offering of equity shares or convertible securities (like convertible debentures) by a company, which is followed by the listing of company's shares on a stock exchange, is known as Initial Public Offering (IPO). The primary market also includes issue of further capital by existing companies whose shares are already listed on the stock exchange. Therefore, the companies, which intend to raise equity capital in the primary market, can be classified into three broad categories namely (I) new, (II) existing private/ closely held and unlisted and (III) existing listed. Such companies can issue equity shares either at par or premium subject to the compliance with the guidelines issued by the SEBI.

In a primary market a corporate can raise equity capital by using any one of the following methods:

7.5.1 Public issue

When shares are offered to the public or new investors through issue of offer document then it is called a public issue. As per the provision of companies Act of 2013; issue becomes public if offer to subscribe to the securities is made to 50 or more persons. Such issue can be further categorized into initial public offer (IPO) and further public offer. In case of initial public offer, shares are offered first time to the public. Such offer is made by an unlisted company. Initial public offer can be at fixed price or at a price which is determined through book building process. In case of issue of shares at fixed price, issuer in consultation with a merchant banker decides about the price which is fixed and accordingly
are invited from the prospective investors, through offer document

as prospectus. This method is used when the company intends to issue shares at a fixed price. The issuer company has to prepare prospectus based on the SEBI Guidelines and provisions contained in the Companies Act of 2013. As against this, equity shares can be offered through book building method. Under this method share are not issued at fixed price. Instead, floor price or minimum price is fixed and accordingly price band (where cap or maximum price should not be more than 120 per cent of the floor price) is fixed. In this method, offers or bids are invited from the public stating the price as well as numbers of shares to be purchased. The cutoff price is calculated by using uniform price auction. As per the SEBI guidelines, a public issue is required to keep open as per the following norms :

i) For fixed price public issue : 3-10 working days

ii) For book built public issues : 3-7 working days extendable by 3 days in case of a revision in the price band

The public issue made by an infrastructure company may be kept open for a maximum period of 21 working days.

Further Public Offer

When existing listed company issues or offers new shares to the public then it is called as further public issue.

The company cannot offer shares to the public through public issue unless it enters into an agreement with a depository for dematerialization of shares already issued or proposed to be issued to the public.

7.5.2 Offer for sales

Instead of offering shares to the public at large, companies sell securities to the merchant bankers, who will offer such securities subsequently for sale to the institutional or retail investors. The difference between the issue price fixed by the issuer and offer price by the merchant banker is the gain for the merchant bankers. The unlisted companies use this method for raising of funds through issue of shares. The public sector undertakings (PSUs) use this method for selling of part of equity to the investors through disinvestment process.

7.5.3 Issue through private placement

In this case, the issuing company does not offer shares through public issue or rights issue, to the investors. Instead, issuer offers shares to the select group of investors. In this case, shares are offered to less than 50 investors. It is called a private placement. Both listed and unlisted companies can issue shares through private placement. For this, issuer approaches a merchant banker for assistance. Listed company can allot new shares through private placement under following options :

(i) Preferential Allotment

A listed company may like to issue shares to a select group of persons keeping in view provisions of Chapter VII of SEBI (ICDR) Regulations, 2009. The issuer has to comply with various norms relating to the pricing, disclosures, lock-in-period, etc.

(ii) Qualified Institutional Placement

A listed company is allowed to issue new shares to the qualified institutional buyers in terms of provisions of Chapter VIII of SEBI (ICDR) Regulations, 2009

(iii) Institutional Placement Programme (IPP)

A listed company may like to make public offer of new shares to the qualified institutional buyers in terms of Chapter VIII of SEBI (ICDR) regulations 2009 to achieve minimum public shareholding.

Unlisted company may also like to offer new shares through private placement. In this case, the SEBI Guidelines are not applicable. Therefore, terms and conditions of an issue are agreed between issuer and institutional investors.

7.5.4 Rights issue

It is nothing but offering of new shares by the existing companies to their existing shareholders. Such shares are offered on pro-rata basis in a particular ratio to the existing shareholders. Such shares are issued as per the company law provisions.

7.6 Initial Public Offering through Book Building Method

An initial public offer is nothing but selling of securities to the investors in the primary market. As discussed in para 7.5.1, shares are offered through fixed price method or book building method or combination of both. In developed countries like USA and UK, companies raise capital with the help of merchant bankers through book building method. In India book building method for public issue of securities is relatively a new concept. In India, book building method was introduced by the SEBI in 1995 based on the recommendations of the Malegam Committee which was appointed to review the (then) existing disclosure requirements in offer documents. Accordingly, the SEBI introduced in November 1995 the book building method for issue of securities in the primary market. In Indian market if the issuer decides to issue securities through the book building process the issuer has to follow the guidelines issued by the SEBI on book building. As per the existing guidelines of the SEBI, an issuer company can issue securities in the following manner:

(a) Hundred per cent (100%) of the net offer to the public through the book building route.

(b) Seventy five per cent (75%) of the net offer to the public through the book building process and 25 per cent (25%) through the fixed price portion.

The SEBI has given permission to the company to go in for initial public offers through the Stock Exchange On-Line (e-IPO) system. In this regard, such companies are required to comply with the guidelines of SEBI.

7.6.1 Book Building Concept

Book building is essentially a capital issuance process to be used in Initial Public Offer (IPO) which facilitates to discover an appropriate price and demand from the market.

As per the SEBI guidelines, the book building method can be defined as under :

"Book building is a process undertaken by which a demand for the securities proposed to be issued by a corporate body is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document."

The book building method is looked upon as an aid for price discovery in respect of issue of new securities. The issuer with the help of merchant banker sets a floor or base price and a price band within which the investor is allowed to bid for shares. The investor has to submit a bid for a quantum of share which he intends to subscribe at a price which falls within the price band. The spread between the floor price and cap of the price band shall not be more than 20 per cent. In other words, the cap price cannot be more than 120 per cent of the floor price.

While using book building method for issue of securities, the issuing company has to appoint a merchant banker who will manage the public issue and thus will act as a book running lead manager (BRLM). The order book which is maintained by a merchant banker is built around investor's bid for number of the securities along with a quoted price (which happens to be within a price band). Thus in other words, a book runner on receipt of offers records the price and quantity of shares to which the investors are willing to subscribe at that price.

7.6.2 Features & Process of Book Building

The features of book building method are as follows:

a) Book building method is used by companies for issue of securities to raise large amount (i.e. mega issues).

b) Price for issue of securities is arrived on the basis of bids submitted by various investors. By and large uniform price method is followed in this regard. The price band is worked out and accordingly bids are invited from prospective retail as well as institutional investors.

c) The entire book building process is managed by one of the lead manager (Merchant Banker). He is also called as ‘book runner’. He is selected and nominated for this by the issuer company.

d) In case of book building method, red herring prospectus is prepared. It includes only floor price or price band but does not include the final price at which securities are allotted. Once a cut-off price is finalized; the final prospectus with all the details including the final issue price and issue size is filed with ROC.

e) The issuer as well as merchant banker has to follow book building method for issue of securities as per the guidelines issued by the SEBI.

Process

- The issuer, who has planned IPO issue, has to appoint a lead manager (i.e. merchant banker) to act as a book runner.

- The issuer in consultation with the lead manager decides about the number of securities to be issued and the price band for orders.

- The issuer in consultation with the lead manager appoints syndicate members with whom orders can be placed by the investors. Syndicate members are those intermediaries who are registered with the SEBI and who are permitted to carry on activity as an underwriter.

- Investors place their order with a syndicate member who enters the same into the ‘electronic book’. This process is called bidding or auction. Investors cannot submit the bids at a price less than the floor price. Such bids can be revised by the bidder before the issue closes.

- The bid should be open for at least 3 working days and not more than 7 working days which may be extended to 10 working days in case the price band is revised. At the end of each day of the bidding period, the demand should be shown graphically on the terminals for information of the syndicate members/ investors.

On the close of the book building period the book runner (i.e. lead manager) evaluates the bids on the basis of the evaluation criteria which may include (i) quoted price, (ii) type of investor and (iii) timely response from the investors.

- The book runner and the issuer have to decide about the final price at which securities will be issued.

- Issuer will allot the share to the successful bidders in consultation with lead manager and registrar to the public issue.

7.6.3 Underwriting Support

In case of issue of shares to the public through book building method, it is essential to have entire net offer underwritten by the syndicate members and book runners. The syndicate members must enter into an underwriting agreement with the book runner(s) indicating the number of shares that they would subscribe at the pre-determined price. The book runner(s) should, in turn,

underwriting agreement with the issuer company. In the event of shortfalls or inadequate response

from investors, syndicate members who have provided underwriting support will be asked to subscribe remaining portions. If syndicate members fail to fulfill their underwriting obligations, the book runner(s) would be responsible for subscribing devolved portions.

7.6.4 Price Band and Cut-off Price

As discussed in para no. 7.6, the issuer has to decide about the price and price band in consultation with the merchant banker. The regulator like SEBI has no role in setting the price or price band. Once the floor price is fixed, the upper price of the band can be a maximum of 1.2 times of the floor price which is the maximum price at which bids can be made. The investors are required to submit their bids for purchase of shares within this price band. It is not possible to enter bids at a price less than floor price because the system automatically rejects the bids if price is less than floor price. Similarly, bidder is not supposed to bid at a price beyond the upper price as fixed under the price band formula fixed by the SEBI. The issuer has to disclose about the basis of issue price in the offer document. It is required to disclose in detail about the qualitative and quantitative factors justifying the issue price.

The issuer has an option to revise price band during the bidding period. The maximum revision on either side cannot be more than 20 per cent. In other words, revise floor price of the price band can be reduced or can be increased to the extent of 20 per cent of existing floor price and accordingly price band also needs to be revised which cannot be more than 20 per cent of the revised floor price. In case the issuer has decided to revise price band, it must be communicated to the stock exchange and to the investors through press release, change on the relevant website. In this case, bidding period will be extended by 3 days.

Once the issue is over and the book has been built, the lead manager in consultation with the issuer arrives at a cut off price based on Dutch auction (i.e. Uniform Price Auction). This is the price discovered by the market. The shares are allotted to the prospective investors at the cut-off price. The bids submitted by the investor at a price below the cut-off price will be ignored. In view of this, those investors, who submit bids at a price higher than cut-off price, will get shares of a company.

The cut-off price is arrived at by using uniform price auction system. The example is given below:

Suppose ABC Ltd. has decided to issue 100,000 shares. The floor price for one share of face value ` 100 is fixed at ` 200 and price band is ` 200 and ` 240. The lead manager, who has maintained the book, has received the following bids.

NOTES

Sr. No.	No. of Shares	Quoted Price
1.	25,000	220
2.	20.000	230
3.	60,000	225
4.	40,000	210
5.	80,000	240
6.	60,000	215

The bids will be arranged according to descending order in terms of price.

Sr.No.	No. of Shares	Price (from highest to lowest price)
1.	80,000	240
2.	20,000	230

The cut price is set at ` 230. All one lakh shares will be issued at cut-off price of ` 230/-Those investors, who have submitted bids at ` 240/- will receive shares at ` 230/-. The extra money paid by these investors will be returned to them along with allotment letter.

7.6.5 Types of Investors

There are three kinds of investors which are normally found in book building process. They are as under:

(i) Retail individual investors (RII).

(ii) Non-institutional investors (NII).

(iii) Qualified institutional buyers (QIB).

Retail individual investor is an investor who applies for shares for a value not exceeding ` 2,00,000. As per the SEBI guidelines, only retail individual investors have an option of applying at cut-off price. Any bid or offer exceeding this amount is considered in the non-institutions investor category. Such category is comprised of high-net worth individuals. The Qualified Institutions Buyers (QIB) are institutional investors who possess the expertise and have large financial resources to invest in the securities market. Various institutional investors like commercial banks, insurance companies, financial institutions, mutual funds and provident fund, etc., belong to the group of Qualified Institutional Buyers (QIB). Each of these categories is allocated a certain percentage of the total issue. In case an issuer company makes an issue of 100 per cent of the net offer to public through book building process then, the total allotment to the Retail Individual Investor (RII) group has to be at least 35 per cent of the net offer to the public Non-Institutional Investors (NIIs) are to be given at least 15 per cent of the net offer to the public. The Qualified Institutional Buyers (QIB) are to be issued not more than 50 per cent of the net offer to the public. Once the shares are allotted, the same must be issued in demat mode. If an investor intends to have securities in demat mode,

then he has to indicate name of the depository and also of the depository participant with whom an account is maintained. It is appropriate on the part of the investors to hold securities in demat form as physical securities carry the risk of being fake, forged or stolen. For this, there is a need to open a demat account with depository participant like a bank. This will facilitate to carry our transactions like sale and purchase of shares.

7.6.6 IPO Grading

The SEBI has issued guidelines for grading of the IPO by the rating agencies. The IPO grading has been introduced with a view to provide additional information about IPOs to the investors so as to facilitate proper assessment about IPOs before applying for subscription. The IPO grading is nothing but the grade given by the recognized credit rating agency to the initial public offer (IPO) of equity shares or any other security which may be converted into equity at a later date. Such grading is generally assigned on a five point scale which is as under:

IPO Grade 1: Poor Fundamentals

IPO Grade 2: Below Average Fundamentals

IPO Grade 3: Average Fundamentals.

IPO Grade 4: Above Average Fundamentals

IPO Grade 5: Strong Fundamentals

Earlier IPO Grading was made mandatory. But now it is optional. Any issuer who decides to offer shares through an IPO may like to obtain a grade for the same from at least one recognized credit rating agency. The IPO grading can be done either before filing the draft offer documents with the SEBI or thereafter. However, the grades given to the IPO by credit rating agencies may be disclosed in the prospectus or red herring prospectus as the case may be.

7.7 Difference between Book Building Issue and Normal Public Issue

The company can offer shares either through book building process or through normal public issue. Therefore both the methods are different from each other. The following points can be considered to find out difference between these two methods:

(i) In case of normal public issue, the price at which the shares are offered or allotted is known in advance to the investor. In case of book building process, price at which shares are offered or allotted is not known in advance to the investor. Only an indicative price range (i.e. price band) is known to the investor.

(ii) In case of normal public issue, demand for the shares offered is known only after the closure of the issue. However, in case of book building method, the demand can be known everyday as the book is built or maintained by a lead

manager (merchant banker) of a public issue on daily basis.

(iii) In case of normal public issue, payment for subscription is made at the time of submission of application form. The refund if any, for non-allotment of shares is made after allotment of shares. In case of book building method, institutional investors are required to pay 10 per cent of subscription amount at the time of submission of bid. However, retail investors are required to make full payment at the time of submission of application.

7.8 Resources mobilized from Primary Market

The data pertaining to the resources mobilized by the companies from the primary market is given in Table 7.1. Looking at this table it is observed that during 2005-06 to 2012-13, numbers of public issues were much higher as compared to the right issues. During 2010-11 to 2012-13 primary market witnessed a large number of IPOs as compared to the public issue by listed companies. During the year 2012-13, 45 public issues were at premium as compared to 4 issues at par. During 2008-09 to 2011-12 there was only one issue of cumulative convertible preference shares in each year. Therefore one can observe that preference shares are not popular as a source of capital for the companies. During the year 2012-13 public issue of equities were 49 as compared to 20 issues of bonds.

Year	Total	Category-wise				issuer Type							
		Public		Rights		Listed		IPOs		Equities			
										At Par		At Premium	
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**
2005-06	27,382	103	23,294	36	4,088	60	16,446	79	10,936	10	372	128	27,000
2006-07	33,508	85	29,796	39	3,710	47	5,002	77	28,504	2	12	119	32,889
2007-08	87,029	92	54,511	32	32,518	39	44,434	85	42,595	7	387	113	79,352
2008-09	16,220	22	3,582	25	12,638	26	14,138	21	2,082	5	96	40	14,176
2009-10	57,555	47	49,236	29	8,319	37	32,859	39	24,696	1	9	71	54,866
2010-11	67,609	68	58,105	23	9,503	38	32,049	53	35,559	2	50	78	57,617
2011-12	48,468	55	46,093	16	2,375	17	6,953	54	41,515	4	104	47	12,753
2012-13	32,455	53	23,510	15	6,945	36	25,926	33	6528	4	571	45	14,902

Table 7.1 : Resources Mobilized from the Primary Market (Amt. in Rs. crore)

Source : Handbook of Statistics on Indian Securities Market, Published by the SEBI, 2009, 2010, 2011 and 2013

NOTES

7.9 Summary

Equity market is an important segment of the financial market. This market helps corporate to raise capital for long term investment like purchase of fixed assets and setting up of a new plant etc. The companies prefer to issue equity shares as compared to preference shares. The companies issue shares in the primary market through book building method. Barring few exceptions, the companies are allowed to issue equity shares at premium. On account of deregulation of equity market, the price of public issue is decided by the market participants through submission of bids under the auction system. The secondary market for equity is nothing but stock exchange, which helps to have price discovery and liquidity in respect of listed equity securities. The equity market is regulated by the SEBI. Therefore, participants in the primary and secondary market require to undertake transactions keeping in view, the guidelines issued by the SEBI, Company Law Provisions, stock exchange guidelines etc. The equity securities are issued in dematerialized or in electronic form. This has helped to facilitate on line trading, have transparency and increase speed and accuracy in respect of trading in equity shares. The SEBI has brought significant reforms in equity market to make it more efficient and vibrant.

7.10 Key Terms and List of Select Abbreviations

a) Key Terms

1) **Equity Shares :** Such shares are called as ordinary shares. The investors holding such shares are owners of the company and receive dividend on such shares if the company has earned profit or adequate reserves. Such share holders have voting rights.

2) **Sweat Equity Shares :** Such shares are issued to the directors of a company and employees have long term service with the company at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights.

3) **Cumulative Preference Shares :** The holders of cumulative preference shares have the right to receive unpaid dividend for past year/s in the succeeding year or year when the sufficient profits are available for distribution of dividend.

4) **Irredeemable Preference Shares : The i**rredeemable preference shares are those shares which are redeemed at the time of liquidation or insolvency of the company. Such preference shares are not issued in India.

5) **Redeemable Preference Shares :** The redeemable preference shares are redeemed after completion of a period for which such shares are issued. Normally such preference shares are issued for a period upto 20 years. However subject to certain conditions infrastructure companies are allowed to issue irredeemable preference shares beyond 20 years.

NOTES

6) **Participating Preference Shares :** The holders of such preference shares are paiddividend at a fixed rate with a right to participate further in the profits either along With or after payment of certain dividends to the equity shareholders.

7) **Issues of Shares at Premium :** If a share is issued at a price above face value then if is called as issue of shares at a premium. Such premium is credited to the securities premium account.

8) **Primary market :** A primary market is a market where new equity and preferences shares are brought and sold for the first time. It is called as a New Issue Market (NIM) or Initial Public Issue (IPI) market. It includes issue of new shares by the existing companies.

9) **Public Issue at Fixed Price :** It is nothing but inviting offers from the public at large to subscribe the shares through issue of offer document at a fixed price. In case of such issue, the issuer in consultation with a merchant banker decides about the fixed price of a share.

10) **Book Building Method :** Under this method shares are not issued at fixed price. Instead floor or minimum price is arrived at and price band is decided. (Here maximum price of a share cannot be more than 120 per cent of the floor price). Under this method bids are invited from prospective investors who have to state the price as well as numbers of shares to be purchased. In this method cut off price is decided through use of uniform price sanction.

11) **IPO Grading :** IPO grading is the grade given by a credit rating agency to the IPOs of equity shares. Such grading is assigned on a five point scales with IPO Grade I with poor fundamentals and IPO grade 5 with strong fundamentals.

12) **Qualified Institutional Buyers :** Qualified Institutional buyers are those institutional investors who are generally perceived to possess expertise and the financial muscle to evaluate and invest in the capital markets. In terms of clause 2.2.2 B (v) of DIP guidelines, a 'Qualified Institutional Buyer' shall mean :

a) public financial institution as defined in section of the Companies Act, 2013;

b) scheduled commercial banks;

c) mutual funds registered with SEBI;

d) foreign institutional investor registered with SEBI;

e) multilateral and bilateral development financial institutions;

f) venture capital funds registered with SEBI

g) foreign venture capital investors registered with SEBI

h) state Industrial Development Corporations

i) Insurance companies registered with the Insurance Regulatory and Development Authority (IRDA)

j) provident funds with minimum corpus of Rs. 25 crore

k) pension funds with minimum corpus of Rs. 25 crore.

l) insurance funds set up and managed by army, navy or air force of the Union of India.

m) insurance funds set-up and managed by the Development of Posts etc

NOTES

13) Prospectus

It is a document which is used to invite offers from the public for the subscription or purchase of shares of a registered company.

14) Red Herring Prospectus : In case of book building method, red herring prospectus is prepared. It includes floor price or price band but does not include the final price at which securities are allotted. Once a cut-off price is finalized; the final prospectus with all the details including the final issue price and issue size is filed with ROC.

15) Uniform Price Auction : Under this method all successful bidders or applicants are allotted shares at cut-off price which is uniform irrespective of prices quoted by them.

16) Initial Public Offering (IPO) : The first or initial public issue by a public limited company

17) Book Runner : A lead merchant banker who is appointed by the issuer company to maintain the book under book building method. The name of the book running lead merchant banker is mentioned in the red herring prospectus prepared by the issuer company.

18) Bonus Shares : Issue of additional shares by the companies to their shareholders without any cash or other considerations by capitalizing existing reserves, securities premium accounts and credit balance in profit and loss account.

b) List of Select Abbreviations :

1) SEBI : Securities Exchange Board of India.

2) EPS : Earnings Per Share

3) IPO : Initial Public Offer

4) ICDR : Issue of Capital and Disclosure Requirements

5) BRLM : Book Running Lead Manager.

6) QIB : Qualified Institutional Buyer

7) NII : Non Institutional Investors

8) RII : Retail Individual Investor.

NOTES

7.11 Self Assessment Questions

Q.1 State whether the following statement is true or false

i) A company has to pay dividend on equity capital irrespective of its profits.

ii) The companies are allowed to issue irredeemable preference shares.

iii) Equity shares are issued only through public offer.

iv) Sweat equity shares are issued to the public at large.

v) All the companies irrespective of their financial performance are allowed to issue shares at premium.

Q. 2

i) What do you mean by preference shares?

ii) Explain various advantages of issuing preference shares.

iii) Distinguish between equity shares and preference shares.

Q.3

i) What do you mean by the primary equity market.

Q.4 Write short notes

i) IPO Grading

ii) Book Building Method for Issue of Shares.

iii) Issue of Shares at Premium.

Q. 5 Distinguish between Book Building Issue and Normal Public Issue.

7.12 Further Reading and References

1) Handbook on Statistics on the Indian Securities Market, 2013, Published by SEBI.

2) Dr V A Avadhani, Capital market Management, Himalaya Publishing House, (Latest Edition).

3) Website of SEBI, RBI, NSE Ltd. and BSE Ltd.

4) Relevant Provisions of the Companies Act of 2013.

5) Manual of Indian Capital Market by Sanjeev Agarwal, Published by Bharat Law House (Hand Book), Latest Edition.

Unit 8 Indian Equity Market-II: Market Composition and Secondary Market

NOTES

Structure

8.1 Introduction
8.2 Unit Objectives
8.3 Market Composition
8.4 Secondary Market
8.5 Difference between Primary Market & Secondary Market
8.6 Trading in Equity Shares
8.7 Measures Taken by the Government of India (GOI) and SEBI to make Equity Market more Efficient
8.8 Summary
8.9 Key Terms and List of Select Abbreviations
8.10 Self-Assessment Questions.
8.11 Further reading and References

8.1 Introduction

The equity market is comprised of various participants such as issuers, investors, capital market intermediaries, stock exchanges and regulatory body like the SEBI. The secondary market provides a place for trading in shares. As far as listed shares are concerned, the secondary market is nothing but a stock exchange. The unlisted shares are traded in the over the counter (OTC) market. The secondary market for equity shares is different from primary market. There is a close relationship between primary and secondary market. The primary market is likely to be active and vibrant provided secondary market is also active and vibrant. The SEBI, being a regulatory body for equity market, has initiated several measures to make equity capital more efficient and vibrant. All these aspects of equity market are discussed in this unit.

8.2 Unit Objectives

The objectives of this unit are as follows:

(i) to know about equity market composition in terms of various participants.

(ii) to have understanding of secondary market for shares.

(iii) to study various measures taken by the SEBI to make equity market more efficient and vibrant.

8.3 Market Composition in Terms of Participants

The equity market is comprised of investors, issuers, intermediaries, stock exchanges and regulatory body. These are explained below :

1) Investors : Both retail investors like individuals and institutional investors invest in equity shares and trade in equity securities on the stock exchange. Institutional investors include banks, insurance companies, mutual funds, financial institutions, non-banking finance companies, provident funds, foreign institutional investors etc. In case of listed shares, investors are required to trade in such shares through brokers and sub-brokers on stock exchange. Investors look for profit from trading in shares.

2) Issuers : Large, medium and small scale manufacturing and non manufacturing enterprises participate in the primary market to raise long term funds for the business. These issuers take the help of merchant bankers to issue shares in the primary market.

3) Capital market intermediaries like merchant bankers, underwriters, portfolio managers, credit rating agencies, brokers, and bankers to issue, registrars are important participants in the equity market. They provide variety of services both to the issuers and investors to facilitate transfer of savings from investors to those companies which are in need of long term funds. These intermediaries are registered with the SEBI and function under the regulations and guidelines of the SEBI. As on March 31, 2013 numbers of intermediaries in capital market registered with the SEBI were as follows :

As on March 31, 2013

1.	Stock Exchanges	20
2.	Brokers (Individuals) & cash segment firms)	10128
3.	Brokers (corporate) and (cash segment)	4713
4.	Foreign Institutional Investors	1757
5.	Custodians	19
6.	Depositories	2
7.	Depository Participants	865
8.	Merchant Bankers	198
9.	Bankers to the Issue	57
10.	UnderwritersPortfolio	3
11.	Managers	241

Source : Handbook on Statistics on the Indian Securities Market, 2013, Published by the SEBI. Page no. 3

1) The depositories and Depository participants. The depositories are institutions which hold securities like equity shares in demat or in electronic form on behalf of investors. They transfer securities between accounts on the instructions of the account holders and facilitate transfer of securities. Depository participants provide depository services to the investors who maintain depository accounts with them. There are two depositories in India namely the National Securities Depository Ltd (NSDL) and the Central Depository Services Ltd. (CDSL). As on March 31, 2013, there were 865 depository participants.

2) The Securities Exchange Board of India (SEBI) an autonomous and statutory body is regulatory body of equity market in India. Its main function is to regulate and develop equity market in India. The SEBI also protects interest of small investors and accordingly looks into investors complaints against companies.

3) Stock exchanges: The stock exchange is place where shares are listed and trading takes place in listed securities. It provides a transparent and safe mechanism for executing transactions of sale and purchase in listed securities which includes shares. It provides liquidity and fair value in respect of listed shares. As on March 31, 2013, there were 20 stock exchanges.

NOTES

8.4 Secondary Market

The secondary market is a place where shares which are already issued are bought and sold. Such shares are traded on a stock exchange. Therefore, stock exchanges are an integral part of the secondary market. A stock exchange means anybody of individuals which is incorporated for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. Stock exchanges have to be organized and managed keeping in view its overall role and importance in the economy. Such exchanges thus act as a barometer of the state of health of the nations economy by constantly measuring its progress or otherwise.

8.4.1 Functions of Stock Exchanges

The stock exchanges perform three important functions in the orderly growth of capital formation. These are as under:

1. ***Channelization of savings into investment*****:** This takes place through issue of new shares and sale of existing shares to the investors having surplus funds in an orderly and systematic manner. The trading members of stock exchanges also assist in the sale of new shares by acting (i) as brokers (i.e. to procure subscription from investors spread all over the country and (ii) as underwriters.

2. ***Market place*****:** A stock exchange provide a market place for the purchase and sale of listed securities including shares thereby enabling free transferability from one investor to another one. Thus it provides liquidity to the listed shares.

3. ***Continuous price* formation:** A stock exchange helps to get a price for the listed shares. The collective judgement of many participants in the market reflects in the price of a share on the stock exchange. In view of this, it is possible to get a true value of a share which can be used in the valuation of firm for the purpose amalgamation, merger and take over of the company. In view of a continuous transactions on stock exchange it will not allow to have a distortion in the prices of shares.

Section 19 of the Securities Contracts (Regulations) Act, 1956, prohibits formation of a stock exchange unless it is recognized by the Central Government. A stock exchange becomes a recognized stock exchange on its being granted a recognition by the Central Government under Section 4 of the Securities Contracts (Regulations) Act, 1956. The Central Government has delegated the power to recognize the stock exchange to the SEBI. The trading members of stock exchange are essentially the middlemen who transact in shares on behalf of investors for a commission or on their own behalf. The corporate membership of stock exchanges has also been introduced. In view of shortcomings of existing stock exchanges which were established as mutual organizations, the Government of India has taken a policy decision for corporatization of stock exchanges by which ownership, management and trading membership of stock exchanges would be segregated

from each others. This arrangement will help to bring transparency in trade deals and will not allow brokers to have an access to sensitive financial information about listed companies. In view of segregation of management from trading membership, stock brokers will not be able to misuse their positions for their own benefits

There were 20 stock exchanges with cash segment in India on March 31, 2013. Of these the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) are main stock exchanges which operates at National level.

BSE Stock Ltd

The BSE Ltd. was set up in 1875. It is the oldest stock exchange in India. In 1957, the Government of India granted permanent recognition to BSE as a stock exchange under Securities Contracts (Regulation) Act (SCRA). The BSE which was set up in the form of mutual association was incorporated as a limited company under existing companies Act. It became a corporate entity on August 19, 2005. The SEBI issued notification on June 29, 2007 for recognizing BSE Ltd as a corporatization and demutualization stock exchange. It has broad shareholders base that includes global stock exchanges like Deutsche Bourse and Singapore exchange. Besides providing efficient and transparent trading in listed securities like equity, debt, derivatives etc., it also provides a platform for trading in equity shares issued by small and medium size enterprises. The shares of more than 5500 companies are listed on the BSE Ltd. It has established Central Depository Services Ltd. to provide depository services to the investors. The BSE's popular equity index- the S & P BSE Sensex is India's most widely watched and reported stock market benchmark index.

NSE Ltd.

The National Stock Exchange (NSE) was established in 1992 with the following objectives :

1. to establish a nationwide trading for equities and debt instruments
2. to provide a fair, efficient and transparent securities market and
3. to meet the international standards of securities market.

The NSE is completely professionally managed. It is owned by financial institutions and banks and therefore not by brokers. Initially the NSE had set up two segments i.e. the Wholesale Debt Market (WDM) and the Capital Market Segment. The WDM segment deals with pure debt instruments such as Government securities, treasury bills, public sector bonds, corporate debentures, commercial papers, institutional bonds, certificate of deposits, etc. The capital market segment deals with equities, convertible debentures, warrants, units of mutual funds etc. The NSE introduced trading and settlement of deals in dematerialized securities in 1996. It had set up National Securities Clearing Corporation Ltd (NSCCL) to carry out the clearing and settlement of trades executed in the equity, and other securities including derivatives segments of the NSE. Trading system of the NSE known as NEAT (National Stock Exchange for

NOTES

Automated Trading) is a fully automated screen based trading system. This system supports to develop order driven market. In addition to having capital market segment and WDM segment, the NSE has introduced third segment namely for derivative products like futures and options. At present more than 1300 securities are traded on the NSE.

It launched CNX NIFTY index in 1996. This is a well-diversified 50 stock index. As on June 22, 2015 CNX NIFTY was closed at 8353.10

The NSE has captured a big chunk of the market. This has been made possible primarily because of the fact that the NSE is much better equipped technologically as compared to the BSE and other regional stock exchanges.

All stock exchanges in India have been permitted by the SEBI to open trading terminals anywhere in India.

8.4.2 Listing of Shares on Stock Exchanges

Listing of shares is nothing but registration of shares on the stock exchange. A company who has decided to list its shares on the stock exchange must apply to the concerned executive of the stock exchange providing required details of shares and other information along with listing fees. Such companies have to comply with the guidelines on listing of shares issued by the SEBI as well as the stock exchange. A public limited company, which has made public issue of shares must apply to the stock exchange for listing of its shares.

The following companies are not required to have their shares listed on the stock exchange

(i) A private limited company.

(ii) A public limited company who has not issued its shares to the public.

If a listed company makes a fresh issue of shares to public then the fresh shares will also have to be listed on the stock exchange. If a company is listed on NSE or BSE, it need not be registered with any other regional stock exchange for listing of its shares.

Advantages of Listing

Listing is advantageous both to the company as well as to the investors. In this regard the following points may be considered.

- To provide ready marketability and impart liquidity (listed shares can be easily sold in stock market through a stock broker at a market determined price). The prices of listed securities are determined on the basis of demand and supply, market perception on true value of securities.
- To ensure proper supervision and control of dealings therein.
- To protect the interests of shareholders and of general investing public.
- It helps the listed companies to mobilize more resources from

shareholders through rights issue or from market for expansion of existing business or undertake new projects without depending on banks and financial institutions for line of credit. It helps companies to enjoy tax concession under the Income Tax Act as the listed companies are subject to lower income tax rate.

- Listed securities can be used to obtain loans from lending institutions like banks and non-banking finance companies. The investors having investment in listed shares can obtain credit facilities from lending institutions.

- The listing agreement between a company and stock exchange ensures that the listed company will disclose its full financial information that include dividend, issue of bonus and right shares, buy-back of shares, quarterly financial results. This brings transparency and improves corporate governance practices in listed securities.

Delisting of shares

The shares of a listed company can be removed from a stock exchange. This is known as delisting of shares. As a consequence of delisting, shares of such a company cannot be traded on stock exchange. The companies like to delist their shares from the stock exchange due to certain reasons. Few of these reasons are given below :

i) The cost associated with listing of shares which includes listing fee is very high.

ii) The promoters want to increase their stake in the capital of listed company so as to acquire complete control over the company's business.

iii) Poor or lack of trading in shares of listed company; or the trading in such shares is suspended or cancelled by the stock exchange due to certain reasons such as violation of provisions in the listing agreement; non-submission of financial and other information to the stock exchange, etc.

The SEBI through its notification dated March 21, 2015, has issued new regulations relating to the delisting of equity shares.

8.5 Differences between Primary Market and Secondary Markets

1. Nature of Securities

The primary market deals with issue of new shares i.e. shares which are offered to the investing public for the first time. These are new block of shares for public subscription.

The secondary market for shares is nothing but a stock exchange. It is a market for existing listed shares and therefore quoted values for such shares are

(ii)

Trading in equity on the stock exchange is screen based. The brokers are required to trade during trading hours fixed by the management of stock exchange. Settlement is done through stock exchange on T + 2 basis. The management of stock exchange exercises control over trading in market so that speculation is either eliminated or remained under control.

The BSE Sensex is comprised of thirty large company's shares. This is calculated using the free float capitalization methodology. This is also referred to as index construction methodology. Free float market capitalization method considers only those shares issued by the company that are readily available for trading in the market. It generally excludes promoters holding, government holding, strategic holding and other locked in shares that will not come to the market for trading in the normal course. In other words the market capitalization of each company in a free float index is reduced to the extent of its readily

organizationally physical existence and is located in a particular geographical area. However, both NSE and BSE have been permitted to open trading terminals at different places.

8.6 Trading in Equity Shares

The trading in equity shares is done on a stock exchange through a broker (trading member of stock exchange) or sub-broker who is registered with the SEBI. Anyone who intends to sell or buy equity security through a broker or sub-broker, it is necessary to enter into a broker-client agreement and file a client registration form. Once an investor books an order for sale or purchase of equity security with a broker, he will get a contract note which is legally enforceable document.

shares in the market.

The data about S&P BSE Sensex is given in Table 8.1.

TABLE 8.1: Year wise S&P BSE Sensex Data

2001	3991	4462	2595	3262
2002	3262	3758	2828	3377
2003	3384	5921	2904	5839
2004	5872	6617	4228	6603
2005	6626	9443	6069	9398
2006	9422	9423	14035	8799
2007	13828	20948	12316	20237
2008	20325	21207	7697	9647
2009	9721	17531	8047	17465
2010	17473	21109	15652	20509
2011	20622	20665	15136	15455
2012	15535	19612	15358	19426
2013	19513	21483	17448	21170
2014	21222	28822	19963	27499

Source : BSE Data (BSE website)

The S&P BSE Sensex increased from 3262 in 2001 to 20237 in 2007. Due to the financial crisis in the USA, sale of equity shares by Foreign Institutional Investors (FII) and negative market sentiment the Sensex declined to 9647 in 2008. However, on account of growth in the economy, good performance of companies and fresh investment of FIIs the Sensex increased to 20509 in 2010. It increased to 21170 in 2013. Due to change in the Central Government and its economic policies and high expectation from domestic and foreign investors BSE Sensex further increased to 27499 in 2014.

8.7 Measures taken by the SEBI to make Equity Market more Efficient

The SEBI have taken several measures to make equity market more efficient and vibrant. Few of these measures are given below:

8.7.1 Corporatization and Computerization of Stock Exchanges

The SEBI has decided to have stock exchanges in the form of Joint Stock Company. Accordingly the BSE stock exchange was converted into a corporate entity with Limited Liability. New stock exchanges were formed as Joint Stock Company registered under companies Act. This has made stock exchanges to have two types of members namely shareholders and trading members. The trading members have been permitted to trade in the listed securities on stock exchange. But they are not allowed to participate in the administration of stock exchanges. This policy has helped to eliminate the possibility of having inside trading in the listed securities. Further the SEBI has directed all stock exchanges to have all operations including trading fully computerized. Accordingly all stock exchanges have opted for full computerization of their operations. This has helped to introduce on line trading in electronic form and to display market information on line basis. This has resulted into increase in turnover and speedy settlement of transactions.

8.7.2 Expansion of Trading Terminals of Stock Exchanges

The SEBI has permitted stock exchanges like BSE Ltd. and NSE Ltd. to open their trading terminals at different places in the country. Because of this, it has become possible for investors and traders to trade in various listed securities through using trading terminals at different places.

8.7.3 Trading in Demat form

In the past trading in securities was in physical form. Now a days trading in securities is done in demat or in electronic form. The financial instruments like equity shares are issued in demat form. The investors use depository services to facilitate holding and trading of such securities in electronic form. It provides following advantages:

a) It eliminates various drawbacks of holding and trading of physical security such as bad delivery, fake certificate etc.

b) It does not involve postal charges and stamp duty.

c) It ensures that securities are held in safe and are transferred immediately.

d) It involves minimum paper work.

e) The payment of dividend and interest as well as other benefits like issue of

bonus shares are credited directly to the investors depository account with depository participant.

8.7.4 Buy back of shares

Under the section of 68, of the Companies Act of 2013, companies are allowed to buy back their own shares from the open market. The companies opt for buy back of shares for the following reasons.

(a) To increase earning per share (EPS): thus to improve the intrinsic value of shares by virtue of the reduced level of floating stock.

(b) To safeguard interest of promotes against hostile take over by increasing promoters holdings.

The companies are free to buy-back of its own shares subject to the following conditions:

(i) The buy-back of shares is authorized by its articles.

(ii) The shares are fully paid and not partly paid.

(iii) Every buy back shall be completed within 12 months from the date of passing special resolution or resolution passed by the board.

(iv) The time gap between two buy back offers must be at least 365 days.

(v) The buy-back shall not exceed 25 per cent of the total paid up capital and free reserves of the company.

(vi) The buy-back of equity shares in any financial year shall not exceed 25 per cent of the total paid-up equity capital in that financial year.

(vii) After buy-back the ratio of debt owed (Covering secured and unsecured) shall not be more than twice the paid up capital and its free reserves.

8.7.5 Publication of financial results of listed companies

Every listed company under clause 41 of the Listing Agreement is required to furnish either audited or unaudited quarterly financial results in prescribed format on a quarterly basis to the concerned stock exchanges within forty five days of the end of the quarter. The listed companies are allowed to publish audited quarterly financial results on quarterly basis along with audit report. The objective behind this is to ensure transparency by bringing the adequate information on company's financial performance in public domain.

8.7.6 Introduction of Derivative Trading in stock linked derivative products on stock exchanges

In order to develop the secondary market for equity shares and help investors for managing price risk in their equity portfolio; the SEBI has introduced equity linked derivative products like stock option, stock future and stock index futures

etc. All these derivative products have been designed by stock exchanges. Therefore, these derivative products are called exchange traded derivative products. As on March 31, 2013, only two exchanges namely BSE & NSE were allowed to offer equity linked derivative products. Institutional investors like mutual funds, financial institutions, insurance companies and retail investors are quite active participants in equity linked derivatives market. The participants in this market use such products both for hedging as well as for speculative purposes. The size of derivative segment in equity market is much more as compared to the size of cash segment.

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8.7.7 Focus on Corporate Governance for Listed Companies

The SEBI has emphasized on corporate governance in the listed companies. In order to achieve this; necessary provisions are made by the GOI in the Companies Act of 2013, appropriate clauses are inserted in the listing Agreement with stock exchange and guidelines are issued by the SEBI. In this regard the following points may be considered:

1. As per the section 134 of companies Act of 2013, a company is required to include a director's responsibility statement in the report of the Board of Directors which should affirm the following

- Annual accounts have been prepared in accordance with applicable accounting standards.
- The selection and application of accounting policies by Directors is consistent and prudent so as to give a true and fair view of the state of affairs of the company.
- The annual accounts of the company are prepared on a going concern basis and
- Proper and sufficient care has been taken by the Directors for maintenance of adequate accounting records for safeguarding the assets of the company and for prevention and detention of frauds and irregularities.

2. The Section 177 of the companies Act of 2013 requires every listed company to constitute an audit committee at the Board level. The audit committee is mandated to review the annual financial statements before submission to the Board for its approval. This committee has to oversee company's financial position and disclosure of the same.

3. As per the provision in the listing agreement with a stock exchange, the listed company has to ensure that half of the members of Board of Directors are independent directors.

Check Your Progress

Q.1. State whether the following statements are true or false?

(i) The SEBI protects interest of small investors and accordingly looks into investors complaints against companies.

(ii) The depositories hold securities like equity shares in demat or in electronic form on behalf of investors.

(iii) The BSE sensex is comprised of forty large company's shares

(iv) The stock exchanges have two types of members namely trading members and shareholders.

(v) The trading on stock exchange in securities like shares is done both in physical form as well as in demat form

Q.2. (i) What do you mean by trading in demat form

(ii) What are the advantages of having trading of shares in demat form?

Q.3. (i) What do you mean by buy-back of shares?

(ii) Mention various conditions subject to which the companies are allowed to purchase its own shares

Q.4 Explain various measures taken by the GOI and SEBI to make the equity market for Shares more efficient and vibrant.

8.8 Summary

The equity market is comprised of investors, issuers, capital market intermediaries and regulatory body. The capital market intermediaries help issuers to raise funds through issue of shares. The secondary market for trading in shares is nothing but a stock exchange. These shares are listed on stock exchange to have proper valuation and facilitate trading. The BSE Ltd. and The NSE Ltd. are main stock exchanges in India which operates at national level. A stock exchange in India function as a corporate entity and hence it has two types of members namely, trading members and shareholders. Trading in shares is done on a stock exchange through its trading members, The Bombay Stock Exchange's S & P BSE Sensex is India's most widely known and reported stock market benchmark index. The SEBI has taken several measures to make equity market more efficient and vibrant. It includes corporatization and computerization of stock exchanges, trading in demat form, buy back of shares by companies, introduction of equity derivative trading and introducing norms for corporate governance in the listed companies.

8.9 Key Terms and List of Select Abbreviations

a) Key Terms

1) **Secondary Market:** The secondary market is a place where existing or old shares are purchased and sold. Such a market is nothing but a stock exchange.

2) **Listing of shares on Stock Exchanges:** Listing of shares is nothing but registration of shares on the stock exchange for trading purpose

3) **Depositories**: These are institutions which hold securities like equity shares in demat or electronic form on behalf of investors.

4) **Depository Participants**: These are representatives of the investors in the depository system. Depository participants allow investors to open depository account which is used to trade in securities. According to THE SEBI guidelines, financial institutions, banks, custodians, stock brokers, etc. can become depository participants in the depository system.

5) **Cash Segment**: It is segment or division of a stock exchange which deals with trading in the listed securities like shares, debentures, etc.

6) **Derivative Segment**: This segment or division of a stock exchange deals with trading in derivative products.

7) **Corporatization of stock exchange**: It is nothing but setting up of a stock exchange as a joint stock company with limited liability under the existing Companies Act.

8) **Buy back of shares**: It is nothing but purchase of shares from open market. The companies are allowed, under the section 68 of Companies Act, 2013, to

purchase its own shares.

17) Trading in Demat form: Trading in dematerialization or in electronic form. This is possible because shares are issued in demant form. The SEBI has made it mandatory to have trading in shares in demat but not in physical form.

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18) Delisting of shares: Permanent removal of securities like shares of a listed company from a stock exchange. Because of this, such shares cannot be traded on stock exchange.

19) Dematerialize: The process of converting securities held in physical form into electronic form through a depository participant.

20) Listing Agreement: It is an agreement between companies which intend to have listing of shares on a stock exchange and the management of stock exchange. As a part of this agreement, listed companies are required to provide or disclose all the financial and other information as per the provisions to the stock exchange authorities.

21) Derivative Transaction: Derivative transactions are financial contracts. The value of such contracts depend on value of an underlying assets such as value of shares.

b) List of Select Abbreviations

1) SEBI : Securities Exchange Board of India.

2) NSDL : National Securities Depository Ltd.

3) CDSL : Central Depository Services Ltd.

4) SCRA : Securities Contract Regulation Act.

5) NEAT : National Stock Exchange for Automated Trading

6) NSCCL : National Securities Clearing Corporation Ltd

8.10 Self Assessment Questions

Q.1 State whether the following statements are true or false ?

i) Listing of shares is mandatory in case of issue of shares through private placement.

ii) Public limited companies have to list their shares on both NSE Ltd and BSE Ltd.

iii) The NSE Ltd. is oldest stock exchange in India.

iv) The RBI is regulatory body of equity market in India.

v) The companies are allowed to purchase (i.e. buy-back) its own both fully paid and partly paid shares..

Q.2 i) What do you mean by secondary market.

ii) Explain various functions of a stock exchange.

Q.3 Distinguish between primary & secondary markets.

Q.4 Discuss in brief various measures taken by the SEBI to make equity market more effective and vibrant.

Q.5 Write short notes:

i) Advantages of listing of shares

ii) Trading in Equity Shares.

iii) Buy-back of shares

8.11 Further Reading and References

1. Handbook on Statistics on the Indian Securities Market, 2013, Published by the SEBI.
2. Dr V A Avadhani, Capital market Management, Himalaya Publishing House, (Latest Edition).
3. Website of the SEBI, NSE Ltd. and BSE Ltd.
4. Relevant Provisions of the Companies Act of 2013.
5. Manual of Indian Capital Market by Sanjeev Agarwal, Published by Bharat Law House (Hand Book), Latest Edition.