# A STUDY MATERIAL OF

# INDIAN FINANCIAL SYSTEMS AND SERVICES

(2ND SEMESTER MBA)

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# MODULE- I

# Indian Financial system

**Structure and Function of of Indian Financial System!**

Financial System is a set of institutional arrangements through which financial surpluses in the economy are mobilised from surplus units and transferred to deficit spenders.

The institutional arrangements include all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments of all kinds and the organisations as well as the manner of operations of financial markets and institutions of all descriptions.

**Thus, there are three main constituents of financial system:**

(a) Financial Assets

(b) Financial Markets, and

(c) Financial Institutions.

**Financial assets are subdivided under two heads:**

Primary securities and secondary securities. The former are financial claims against real-sector units, for example, bills, bonds, equities etc. They are created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending. The secondary securities are financial claims issued by financial institutions or intermediaries against themselves to raise funds from public. For examples, bank deposits, life insurance policies, UTI units, IDBI bonds etc.

## Functions of Financial System:

The financial system helps production, capital accumulation, and growth by (i) encouraging savings, (ii) mobilising them, and (iii) allocating them among alternative uses and users. Each of these functions is important and the efficiency of a given financial system depends on how well it performs each of these functions.

**(i) Encourage Savings:**

Financial system promotes savings by providing a wide array of financial assets as stores of value aided by the services of financial markets and intermediaries of various kinds. For wealth holders, all this offers ample choice of portfolios with attractive combinations of income, safety and yield.

With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is directly related to both financial assets and financial institutions. That is, financial progress generally insures larger savings out of the same level of real income.

As stores of value, financial assets command certain advantages over tangible assets (physical capital, inventories of goods, etc.) they are convenient to hold, or easily storable, more liquid, that is more easily encashable, more easily divisible, and less risky.

A very important property of financial assets is that they do not require regular management of the kind most tangible assets do. The financial assets have made possible the separation of ultimate ownership and management of tangible assets. The separation of savings from management has encouraged savings greatly.

Savings are done by households, businesses, and government. Following the official classification adopted by the Central Statistical Organization (CSO), Government of India, we reclassify savers into— household sector, domestic private corporate sector, and the public sector.

The household sector is defined to comprise individuals, non-Government, non-corporate entities in agriculture, trade and industry, and non-profit making organisations like trusts and charitable and religious institutions.

The public sector comprises Central and state governments, departmental and non departmental undertakings, the RBI, etc. The domestic private corporate sector comprises non-government public and private limited companies (whether financial or non-financial) and corrective institutions.

Of these three sectors, the dominant saver is the household sector, followed by the domestic private corporate sector. The contribution of the public sector to total net domestic savings is relatively small.

**(ii) Mobilisation of Savings:**

Financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instance, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings.

Other financial methods used are deductions at source of the contributions to provident fund and other savings schemes. More generally, mobilisation of savings taken place when savers move into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, bill, bonds, equity shares, etc.

**(iii) Allocation of Funds:**

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. With modem financial development and new financial assets, institutions and markets have come to be organised, which are replaying an increasingly important role in the provision of credit.

In the allocative functions of financial institutions lies their main source of power. By granting easy and cheap credit to particular firms, they can shift outward the resource constraint of these firms and make them grow faster.

On the other hand, by denying adequate credit on reasonable terms to other firms, financial institutions can restrict the growth or even normal working of these other firms substantially. Thus, the power of credit can be used highly discriminately to favour some and to hinder others.

## Structure of Indian Financial System:

Financial system operates through financial markets and institutions.

**The Indian Financial system (financial markets) is broadly divided under two heads:**

(i) Indian Money Market

(ii) Indian Capital Market

The Indian money market is the market in which short-term funds are borrowed and lent. The money market does not deal in cash, or money but in bills of exchange, grade bills and treasury bills and other instruments. The capital market in India on the other hand is the market for the medium term and long term funds

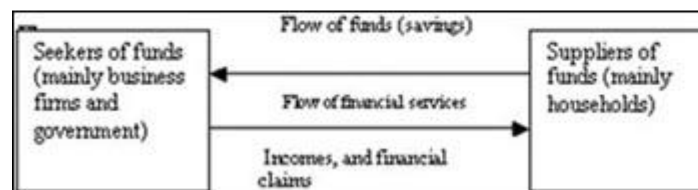
## Indian Financial System

**Introduction:**

Economic growth and development of any country depends upon a well-knit financial system. Financial system comprises, a set of sub-systems of financial institutions financial markets, financial instruments and services which help in the formation of capital. Thus a financial system provides a mechanism by which savings are transformed into investments and it can be said that financial system play an significant role in economic growth of the country by mobilizing surplus funds and utilizing them effectively for productive purpose.

The financial system is characterized by the presence of integrated, organized and regulated financial markets, and institutions that meet the short term and long term financial needs of both the household and corporate sector. Both financial markets and financial institutions play an important role in the financial system by rendering various financial services to the community. They  operate in close combination with each other.

**Financial System;**




The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy.  The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation

**Role/ Functions of Financial System:**

A financial system performs the following functions:

* It serves as a link between savers and investors. It helps in utilizing the mobilized savings of scattered savers in more efficient and effective manner. It channelises flow of saving into productive investment.
* It assists in the selection of the projects to be financed and also reviews the performance of such projects periodically.
* It provides payment mechanism for exchange of goods and services.
* It provides a mechanism for the transfer of resources across geographic boundaries.
* It provides a mechanism for managing and controlling the risk involved in mobilizing savings and allocating credit.
* It promotes the process of capital formation by bringing together the supply of saving and the demand for investible funds.
* It helps in lowering the cost of transaction and increase returns. Reduce cost motives people to save more.
* It provides you detailed information to the operators/ players in the market such as individuals, business houses, Governments etc.

**Components/ Constituents of Indian Financial system**:

The following are the four main components of Indian Financial system

1. Financial institutions
2. Financial Markets
3. Financial Instruments/Assets/Securities
4. Financial Services.

**Financial institutions:**

Financial institutions are the intermediaries who facilitates smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in

productive activities promising a better rate of return. Financial institutions also provide services to entities seeking advises on various issues ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets elsewhere. Financial institutions act as ***financial intermediaries*** because they act as middlemen between savers and borrowers. Were these financial institutions may be of Banking or Non-Banking institutions.

**Financial Markets:**

Finance is a prerequisite for modern business and financial institutions play a vital role in economic system. It's through financial markets the financial system of an economy works. The main functions of financial markets are:

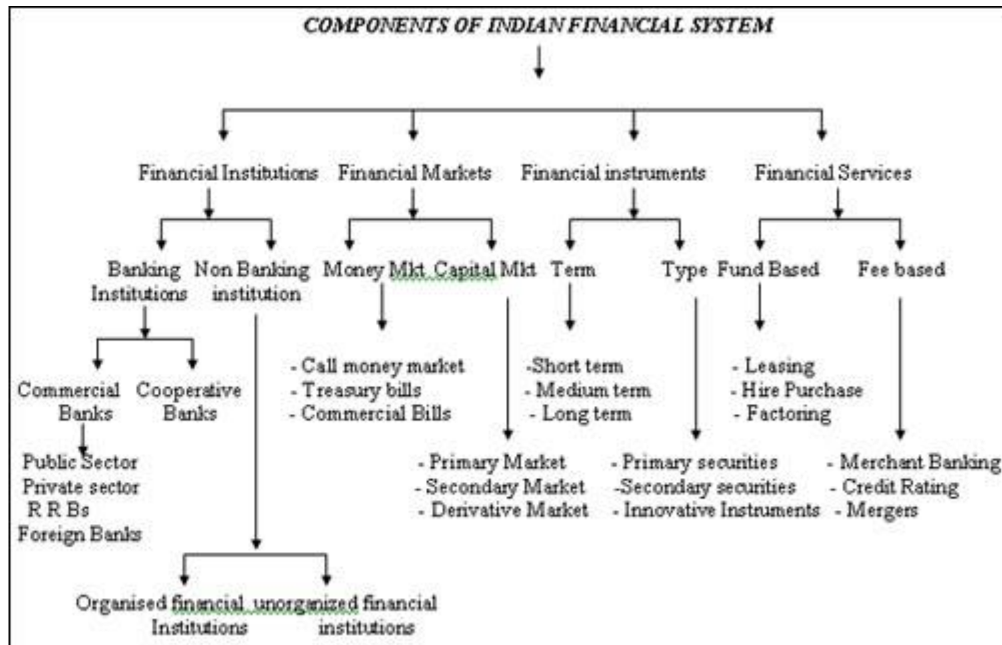
1. to facilitate creation and allocation of credit and liquidity;
2. to serve as intermediaries for mobilization of savings;
3. to assist process of balanced economic growth;
4. to provide financial convenience

**Financial Instruments**

Another important constituent of financial system is financial instruments. They represent a claim against the future income and wealth of others. It will be a claim against a person or an institutions, for the payment of the some of the money at a specified future date.

**Financial Services:**

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as "activites, benefits and satisfaction connected with sale of money, that offers to users and customers, financial related value".




## Reforms in Indian Financial System

It was in this backdrop that wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s with a view to improving the macroeconomic performance of the economy. The reforms in the financial sector focused on creating efficient and stable financial institutions and markets. The approach to financial sector reforms in India was one of gradual and non-disruptive progress through a consultative process. The Reserve Bank has been consistently working towards setting an enabling regulatory framework with prompt and effective supervision, development of technological and institutional infrastructure, as well as changing the interface with the market participants through a consultative process. Persistent efforts have been made towards adoption of international benchmarks as appropriate to Indian conditions. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards.

The reform of the interest regime constitutes an integral part of the financial sector reform. With the onset of financial sector reforms, the interest rate regime has been largely deregulated with a view towards better price discovery and efficient resource allocation. Initially, steps were taken to develop the domestic money market and freeing of the money market rates. The interest rates offered on Government securities were progressively raised so that the Government borrowing could be carried out at market-related rates. In respect of banks, a major effort was undertaken to simplify the administered structure of interest rates. Banks

now have sufficient flexibility to decide their deposit and lending rate structures and manage their assets and liabilities accordingly. At present, apart from savings account and NRE deposit on the deposit side and export credit and small loans on the lending side, all other interest rates are deregulated. Indian banking system operated for a long time with high reserve requirements both in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). This was a consequence of the high fiscal deficit and a high degree of monetisation of fiscal deficit. The efforts in the recent period have been to lower both the CRR and SLR. The statutory minimum of 25 per cent for SLR has already been reached, and while the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, the CRR of SCBs is currently placed at 5.0 per cent of NDTL.

As part of the reforms programme, due attention has been given to diversification of ownership leading to greater market accountability and improved efficiency. Initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. This was followed by a reduction in the Government shareholding in public sector banks to 51 per cent. Consequently, the share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in2004. With a view to enhancing efficiency and productivity through competition, guidelines were laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

The Indian financial system has undergone structural transformation over the past decade. The financial sector has acquired strength, efficiency and stability by the combined effect of competition, regulatory measures, and policy environment. While competition, consolidation and convergence have been recognized as the key drivers of the banking sector in the coming years.

# Indian Banking Systems

## Definition of Banks

The term bank has originated from the term 'Banchi'. In olden days, the traders of Italy who performed the job of exchanging money were known as Banchi or Bancheri because the table which they used for making payment was called a Banchi. According to some people, the term bank is derived from the Greek word 'Banque.'

A bank deals in money in the same way as a businessman deals in goods. Banks are business enterprises which deal in money, financial instruments and provide financial services for a price called interest, discount, commission etc.

**Following are cited some prominent definitions of bank:**

(1) "Banking is the business of accepting for the purpose of lending or investment, of deposits of money from the public repayable on demand or otherwise and withdraw-able by cheque, draft, and order or otherwise." Indian Banking Regulation Act, 1949

(2) "A bank is an organisation whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure."-R.P. Kent

## Structure and Types of Banks in India

### Structure of Banking Sector in India

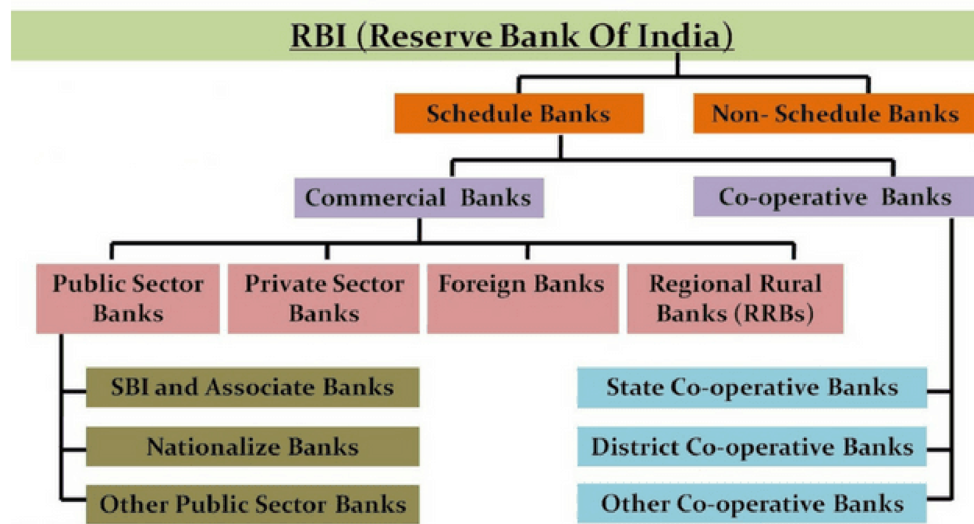
Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 under the RBI Act of 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions. As of now 26 public sector banks in India out of which 21 are Nationalised banks and 5 are State Bank of India and its associate banks. There are total 92 commercial banks in India. Public sector banks hold near about 75% of the total bank deposits in India.

Indian Banks are classified into commercial banks and Co-operative banks. Commercial banks comprise: (1) Schedule Commercial Banks (SCBs) and non-scheduled commercial banks. SCBs are further classified into private, public, foreign banks and Regional Rural Banks (RRBs); and (2) Co-operative banks which include urban and rural Co-operative banks.

**The Indian banking industry has its foundations in the 18th century**, and has had a varied evolutionary experience since then. The initial banks in India were primarily traders' banks engaged only in financing activities. Banking industry in the pre-independence era developed with the Presidency Banks, which were transformed into the Imperial Bank of India and subsequently into the State Bank of India.

The initial days of the industry saw a majority private ownership and a highly volatile work environment. Major strides towards public ownership and accountability were made with **Nationalisation in 1969 and 1980 which transformed the face of banking in India**. The industry in recent times has recognized the importance of private and foreign players in a competitive scenario and has moved towards greater liberalization.

**Structure of Indian Banking System is as Follows:**




In the evolution of this strategic industry spanning over two centuries, immense developments have been made in terms of the regulations governing it, the ownership structure, products and services offered and the technology deployed. The entire evolution can be classified into four distinct phases.

**1. Phase I**- Pre-Nationalisation Phase (prior to 1955)

**2. Phase II-** Era of Nationalisation and Consolidation (1955-1990)

**3. Phase III-** Introduction of Indian Financial & Banking Sector Reforms and Partial Liberalization (1990-2004)

**4. Phase IV-** Period of Increased Liberalisation (2004 onwards)

## Organisational Structure

**1. Reserve Bank of India:**

Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 accordance with the provisions of the Reserve Bank of India Act, 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions.

It has given wide powers to supervise and control the banking structure. It occupies the pivotal position in the monetary and banking structure of the country. In many countries central bank is known by different names.

For example, Federal Reserve Bank of U.S.A, Bank of England in U.K. and Reserve Bank of India in India. Central bank is known as a banker's bank. They have the authority to formulate and implement monetary and credit policies. It is owned by the government of a country and has the monopoly power of issuing notes.

**2. Commercial Banks:**

Commercial bank is an institution that accepts deposit, makes business loans and offer related services to various like accepting deposits and lending loans and advances to general customers and business man.

These institutions run to make profit. They cater to the financial requirements of industries and various sectors like agriculture, rural development, etc. it is a profit making institution owned by government or private of both.

**Commercial bank includes public sector, private sector, foreign banks and regional rural banks:**

**3. Public Sector Banks:**

Currently there are 21 Nationalised banks in India. The public sector accounts for 75 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks.

Now from April 1, 2017 all the 5 associate banks of SBI and Bhartiya Mahila Bank are merged with State Bank of India. After this merger now SBI is counted among the top 50 largest banks of the world.

**Nationalised Banks in India are**

**1.** Allahabad Bank

**2.** Andhra Bank

**3**. Bank of India

**4.** Bank of Baroda

**5.** Bank of Maharashtra

**6.** Canara Bank

**7.** Central Bank of India

**8.** Corporation Bank

**9.** Dena Bank

**10.** Indian Bank

**11.** Indian Overseas Bank

**12**. Oriental Bank of Commerce

**13.** Punjab & Sindh Bank

**14.** Punjab National Bank

**15.** State Bank of India

**16.** Syndicate Bank

**17.** UCO Bank

**18.** Union Bank of India

**19.** United Bank of India

**20.** Vijaya Bank

**4. Private Sector Banks:**

The **private-sector banks in India** represent part of the **Indian banking sector** that is made up of both **private** and public **sector banks**. The "**private-sector banks**" are **banks** where greater parts of stake or equity are held by the **private** shareholders and not by government.

**List of Private Sector Banks is:**

| **Banks** | **Established** |
|---|---|
| **1.** Axis Bank (earlier UTI Bank) | 1993(as UTI Bank) |
| **2.** Bank of Punjab (actually an old generation private bank since it was not founded under post-1993 new bank licensing regime) | |
| **3.** Centurion Bank Ltd. (Merged in Bank of Punjab in late 2005 to become Centurion Bank of Punjab, acquired by HDFC Bank Ltd. in 2008) | 1994 |
| **4.** Development Credit Bank (Converted from Co-operative Bank, now DCB Bank Ltd.) | 1995 |
| **5.** ICICI Bank (previously ICICI and then both merged;total merger SCICI+ICICI+ICICI Bank Ltd) | 1996 |
| **6.** IndusInd Bank | 1994 |
| **7.** Kotak Mahindra Bank | 2003 |
| **8.** Yes Bank | 2005 |
| **9.** Balaji Corporation Bank Limited | 2010 |
| **10.** HDFC bank | 1994 |
| **11.** Bandhan bank | 2015 |
| **12.** IDFC Bank | 2015 |

**5. Foreign Banks:**

A foreign bank with the obligation of following the regulations of both its home and its host countries. Loan limits for these banks are based on the capital of the parent bank, thus allowing foreign banks to provide more loans than other subsidiary banks.

Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India. Currently India has 36 foreign banks.

**6. Regional Rural Bank (RRB):**

The government of India set up Regional Rural Banks (RRBs) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs. There are 82 RRBs in the country. NABARD holds the apex position in the agricultural and rural development. List of some RRBs is given below:

**7. Co-operative Bank:**

Co-operative bank was set up by passing a co-operative act in 1904. They are organised and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.

The cooperative banks in India play an important role even today in rural co-operative financing. The enactment of Co-operative Credit Societies Act, 1904, however, gave the real impetus to the movement. The Cooperative Credit Societies Act, 1904 was amended in 1912, with a view to broad basing it to enable organisation of non-credit societies.

**Name of some co-operative banks India are:**

**1.** Andhra Pradesh State Co-operative Bank Ltd

**2.** The Bihar State Co- operative Bank Ltd.

**3.** Chhatisgarh Rajya Sahakari Bank Maryadit

**4.** The Gujarat State Co-operative Bank Ltd.

**5.** Haryana Rajya Sahakari Bank Ltd.

**Three tier structures exist in the cooperative banking:**

**i.** State cooperative bank at the apex level.

**ii.** Central cooperative banks at the district level.

**iii.** Primary cooperative banks and the base or local level.

**Scheduled and Non-Scheduled Banks:**

The scheduled banks are those which are enshrined in the second schedule of the RBI Act, 1934. These banks have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs, they have to satisfy the RBI that their affairs are carried out in the interest of their depositors.

All commercial banks (Indian and foreign), regional rural banks, and state cooperative banks are scheduled banks. Non- scheduled banks are those which are not included in the second schedule of the RBI Act, 1934. At present these are only three such banks in the country.

## Types of Banks:

**Following are important types of Banks:**

**(i) Commercial Banks**

**(ii) Central Bank:**

Central Banks is the apex institution which supervises and controls the entire banking system. Each country has one central bank. The Reserve Bank of India (RBI) is the central bank of our country.

**Some important functions of the central banks are:**

1. Enjoying exclusive monopoly of issuing currency notes

2. Acting as the Government's bank

3. Acting as controller of credit, in the economy

4. Acting as custodian of the foreign currency reserves of the country, etc.

**(iii) Industrial Banks:**

Industrial banks provide long term and medium term finance to industrial units; for purposes of modernization, expansion etc. These also provide technical and managerial guidance to industrial units.

Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI) etc. are examples of industrial banks.

**(iv) Land Mortgage Banks (or Agricultural Banks):**

These banks provide long-term finance to farmers, against the mortgage of agricultural land etc. for purchasing tractors, installation of modem agricultural facilities, buying cattle, seeds, fertilizers etc.

**(v) Merchant Banks:**

These banks specialize in providing financial services to companies, like issue management, underwriting, consultancy services etc. SBI Capital Market is a leading example of a merchant bank, in India.

**(vi) Exchange Banks:**

These banks provide financing for foreign trade; and deal in foreign exchange.

**(vii) Co-Operative Banks:**

These banks are registered under the Co-operative Societies Act, and function on principles of co-operation. They accept deposits from members and grant loans to them at low rates of interest.

**(viii) Foreign Banks:**

Most of foreign banks in India are subsidiaries of foreign banks. They are owned and managed by foreign promoters. Some foreign banks in India are – Citibank, Bank of America, Standard Chartered Bank, American Express, and Hong-Kong Bank.

**(ix)Savings Banks:**

The main objective of a savings banks is an encourage thrift among people; so that they can save for future. In India, there are hardly any independent savings banks. Mostly these are operated as a part of the post office called Postal Savings banks.

**(x) Indigenous Banks:**

These are money lenders who accept deposits and grant loans. They are popular in villages and small towns. They provide banking facilities to those who cannot approach banks for any reasons whatsoever. Prior to the development of banking system in our country; indigenous bankers played a very important role in the lives of businessmen and common people.

However, they are alleged to be practicing dishonest means in their banking business; and cheating innocent and illiterate people.

## Role and functions of Banks in India

**The major functions of Commercial Banks are as follows:**

**1. Acceptance of Deposits:**

The main function of commercial banks is to accept deposits from the public. Banks maintains demand deposits accounts for their customers and converts deposit money into cash and vice versa, at the direction of the latter. Demand deposits are technically accepted in current accounts, which are with draw able any time by the depositor by means of cheques.

Deposits are made in fixed deposit accounts which are with draw able only after a specific period. Thus, fixed deposits are time liabilities of the banks. Deposits are also received in saving bank accounts subject to certain restrictions on the amount receivable and with draw able. This is how banks pool the scattered savings of the community and serve as the reserves of its savings.

**2. Giving Loans and Advances:**

Another function of commercial banks is to extend loans and advances out of the money which comes to them by way of deposits to businessmen and entrepreneurs against approved securities such as gold or silver bullion, government securities, easily saleable stocks and shares and marketable goods.

**Bank advances to customers may be made in the following ways:**

(i) Overdrafts, (ii) discounting bills, (iii) money-at-call and short notice, (iv) loans and advances (v) various forms of direct loans to traders and producers.

**3. Using Cheque System:**

Banks also render important services by providing an expensive medium of exchange, such as cheques. In modern business transactions, the use of cheques to settle debts is found to be much more convenient than the use of cash. In fact, the cheque is also known as the most developed credit instrument.

**4. Other Functions:**

Commercial banks also perform a multitude of other non-banking functions which may be classified as (a) agency services and (b) general utility services.

**(a) Agency services:**

**The bankers perform certain functions for and on behalf of their customers, such as:**

(i) To act as executor, trustee and attorney for the customer's will.

(ii) To collect or make payments for bills, cheques, promissory notes, interest, dividends, rents, subscriptions, insurance premium, etc. For these services, some charges are usually levied by the banks.

(iii) To remit funds on behalf of the clients by drafts or mail or telegraphic transfers.

(iv) To arrange income-tax experts to prepare income tax returns for their customers, and help them to get refund of income tax in appropriate cases.

(v) To work as correspondents, agents or representatives of their clients.

**(b) General Utility Services:**

**The modem Commercial banks usually perform certain general utility services for society, such as:**

(i) Bank drafts and traveler's cheques are issued in order to provide facilities for transfer of funds from one part of the country to another.

(ii) Letter of credit may be given by the banks to their customers to enable them to go abroad.

(iii) Dealing with foreign exchange or finance foreign trade by accepting or collecting foreign bills of exchange.

(iv) Shares floated by Government, Public bodies and corporations may be underwritten by banks.

(v) Banks arrange the safe deposit vaults, to the customers, for their valuables.

(vi) Banks also compile statistics and business information relating to trade, commerce and industry. Some banks may publish valuable journals or bulletins containing research on financial economic and commercial matters.

## Different Banking Services

In the modern world, banks offer a variety of services to attract customers. However, some basic modern services offered by the banks are discussed below:

- Advancing of Loans.
- Overdraft.
- Discounting of Bills of Exchange.
- Check/Cheque Payment
- Collection and Payment Of Credit Instruments
- Foreign Currency Exchange.
- Consultancy.
- Bank Guarantee.
- Remittance of Funds.
- Credit cards.
- ATMs Services.
- Debit cards.
- Home banking.
- Online banking.
- Mobile Banking.
- Accepting Deposit.
- Priority banking.
- Private banking.

## 1. Advancing of Loans

Banks are profit-oriented business organizations.

So they have to advance a loan to the public and generate interest from them as profit.

After keeping certain cash reserves, banks provide short-term, medium-term and long-term loans to needy borrowers.

## 2. Overdraft

Sometimes, the bank provides overdraft facilities to its customers through which they are allowed to withdraw more than their deposits.

Interest is charged from the customers on the overdrawn amount.

## 3. Discounting of Bills of Exchange

This is another popular type of lending by modern banks.

Through this method, a holder of a bill of exchange can get it discounted by the bank, in a bill of exchange, the debtor accepts the bill drawn upon him by the creditor *(i.e.,* holder of the bill) and agrees to pay the amount mentioned on maturity.

After making some marginal deductions (in the form of commission), the bank pays the value of the bill to the holder.

When the bill of exchange matures, the bank gets its payment from the party, which had accepted the bill.

## 4. Check/Cheque Payment

Banks provide cheque pads to the account holders. Account holders can draw cheque upon the bank to pay money.

Banks pay for cheques of customers after formal verification and official procedures.

## 5. Collection and Payment Of Credit Instruments

In modern business, different types of credit instruments such as the bill of exchange, promissory notes, cheques etc. are used.

Banks deal with such instruments. Modern banks collect and pay different types of credit instruments as the representative of the customers.

## 6. Foreign Currency Exchange

Banks deal with foreign currencies. As the requirement of customers, banks exchange foreign currencies with local currencies, which is essential to settle down the dues in the international trade.

## 7. Consultancy

Modern commercial banks are large organizations.

They can expand their function to a consultancy business. In this function, banks hire financial, legal and market experts who provide advice to customers regarding investment, industry, trade, income, tax etc.

## 8. Bank Guarantee

Customers are provided the facility of bank guarantee by modern commercial banks.

When customers have to deposit certain fund in governmental offices or courts for a specific purpose, a bank can present itself as the guarantee for the customer, instead of depositing fund by customers.

## 9. Remittance of Funds

Banks help their customers in transferring funds from one place to another through cheques, drafts, etc.

## 10. Credit cards

A credit card is cards that allow their holders to make purchases of goods and services in exchange for the credit card's provider immediately paying for the goods or service, and the cardholder promising to pay back the amount of the purchase to the card provider over a period of time, and with interest.

## 11. ATMs Services

ATMs replace human bank tellers in performing giving banking functions such as deposits, withdrawals, account inquiries. Key advantages of ATMs include:

- 24-hour availability
- Elimination of labor cost
- Convenience of location

## 12. Debit cards

Debit cards are used to electronically withdraw funds directly from the cardholders' accounts.

Most debit cards require a Personal Identification Number (PIN) to be used to verify the transaction.

## 13. Home banking

Home banking is the process of completing the financial transaction from one's own home as opposed to utilizing a branch of a bank.

It includes actions such as making account inquiries, transferring money, paying bills, applying for loans, directing deposits.

## 14. Online banking

Online banking is a service offered by banks that allows account holders to access their account data via the internet. Online banking is also known as "Internet banking" or "Web banking."

Online banking through traditional banks enable customers to perform all routine transactions, such as account transfers, balance inquiries, bill payments, and stop-payment requests, and some even offer online loan and credit card applications.

Account information can be accessed anytime, day or night, and can be done from anywhere.

**15. Mobile Banking**

Mobile banking (also known as M-Banking) is a term used for performing balance checks, account transactions, payments, credit applications and other banking transactions through a mobile device such as a mobile phone or Personal Digital Assistant (PDA),

**16. Accepting Deposit**

Accepting deposit from savers or account holders is the primary function of a bank. Banks accept deposit from those who can save money but cannot utilize in profitable sectors.

People prefer to deposit their savings in a bank because by doing so, they earn interest.

**17. Priority banking**

Priority banking can include a number of various services, but some of the popular ones include free checking, online bill pay, financial consultation, and information.

**18. Private banking**

Personalized financial and banking services that are traditionally offered to a bank's digital, high net worth individuals (HNWIs). For wealth management purposes,

HNWIs have accrued far more wealth than the average person, and therefore have the means to access a larger variety of conventional and alternative investments.

Private Banks aim to match such individuals with the most appropriate options.

## Banking Products

## Deposit Products

**The main kinds of deposits are:**

**(i) Current Account Deposits or Demand Deposits:**

**These deposits refer to those deposits which are repayable by the banks on demand:**

1. Such deposits are generally maintained by businessmen with the intention of making transactions with such deposits.

2. They can be drawn upon by a cheque without any restriction.

3. Banks do not pay any interest on these accounts. Rather, banks impose service charges for running these accounts.

**(ii) Fixed Deposits or Time Deposits:**

Fixed deposits refer to those deposits, in which the amount is deposited with the bank for a fixed period of time.

1. Such deposits do not enjoy cheque-able facility.

2. These deposits carry a high rate of interest.

**(iii) Saving Deposits:**

**These deposits combine features of both current account deposits and fixed deposits:**

1. The depositors are given cheque facility to withdraw money from their account. But, some restrictions are imposed on number and amount of withdrawals, in order to discourage frequent use of saving deposits.

2.They carry a rate of interest which is less than interest rate on fixed deposits. It must be noted that Current Account deposits and saving deposits are chequable deposits, whereas, fixed deposit is a non-chequable deposit.

## (iv) Recurring Deposits

In this case, a fixed amount, as decided by the depositor, is deposited at regular intervals till the end of the tenure. The accumulated interest and the principal is given back to the depositor at the end of the tenure. The tenure of a recurring deposit can be anything from six months to 120 months.

**(v) CASA Deposits**

CASA Deposits refers to Current Account Saving Account Deposits. As an aggregate the CASA deposits are low interest deposits for the Banks compared to other types of the deposits. So banks tend to increase the CASA deposits and for this they offer various services such as salary accounts to companies, and encouraging merchants to open current accounts, and use their cash-management facilities. The Bank is High CASA ratio (CASA deposits as % of total deposits) are in a more comfortable position than the Banks with low CASA ratios , which are more dependent on term deposits for their funding, and are vulnerable to interest rate shocks in the economy, plus lower spread they earn.

CASA stands for Current Account and Savings Account which is mostly used in West Asia and South-east Asia. CASA deposit is the amount of money that gets deposited in the current and savings accounts of bank customers. It is the cheapest and major source of funds for banks. The savings accounts portion pays more interest compared to current accounts.

**Description:** Banks offer mainly two types of accounts. These could be term deposits- like fixed or recurring deposits or non-term deposits - like current or savings accounts.

A term deposit is valid for a fixed period of time and in return the bank pays interest at a fixed rate with the condition that you do not touch the money in the interim. For example, you put in Rs 10,000 in a fixed deposit for a period of seven years and the bank pays you an interest at the rate of 12 per cent per annum.

On the other hand, current and savings accounts are used for daily operations and are valid as long as the customer wants them to be. They have lower interest rates than term deposits depending on the bank’s terms and conditions. For example, in an urban area ICICI Bank pays 4.0 per cent interest on a savings account with cheque book on a minimum balance of Rs 10,000.

Since interest rates are lower than term deposits, CASA is a cheaper source of funds for banks. For this reason, financial experts also look at CASA ratio to understand a bank's financial health, as the same reflects the bank's capacity to raise money with lower borrowing costs.

## Loan Products

**Different types of loans and advances made by Commercial banks are:**

**(i) Cash Credit:**

Cash credit refers to a loan given to the borrower against his current assets like shares, stocks, bonds, etc. A credit limit is sanctioned and the amount is credited in his account. The borrower may withdraw any amount within his credit limit and interest is charged on the amount actually withdrawn.

**(ii) Demand Loans**:

Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the account and interest is payable on the entire sum.

**(iii) Short-term Loans:**

They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire sum of loan granted.

## Different types of loans available in the market and their specific characteristics that make these loans useful to the customers.

### Personal Loans:

Most banks offer personal loans to their customers and the money can be used for any expense like paying a bill or purchasing a new television. Generally, these loans are unsecured loans. The lender or the bank needs certain documents like proof of assets, proof on income, etc. before approving the personal loan amount. The borrower must have enough assets or income to repay the loan. In case of personal loans, the application is 1

or 2 pages in length. The borrower gets to know about the denial or approval of the loan within a couple of days.

You must remember that the rate of interest associated with these loans can be on the higher side. The tenure of these loans is not that long. So, if you borrow a big amount, it can be difficult for you to repay without planning your finances properly.

Personal loans can prove to be of great help when you wish to take a small amount loan and repay it as soon as possible.

**Credit Card Loans:**

When you are using a credit card, you must understand that you will have to repay for all the purchases you make at the end of the billing cycle. Credit cards are accepted almost everywhere, even when you are travelling abroad. As it is one of the most convenient ways to pay for the things you buy, it has become a popular loan type.

In order to apply and avail a credit card, all you need to do is fill out a simple application form provided by the card issuer. You can also choose to apply for a credit card online. These plastic cards come with great rewards and benefits. It's the loan where you need to repay on time but you are also handsomely rewarded for using it.

Obviously, there are pitfalls associated with this type of loan. You must understand that there is a high amount of interest on the amounts you borrow on your credit card. If you do not pay your credit card bills on time, the interests will keep piling and might be difficult for you to manage your finances with the rising outstanding balance. But if you use a credit card wisely and clear all your debts on time, it can definitely prove to your best friend in your pocket.

**Home Loans:**

When you wish to purchase a house, applying for a home loan can help you to a great extent. It provides you the financial support and helps you buy the house for yourself and your loved ones. These loan generally come with longer tenures (20 years to 30 years). The rates offered by some of the top banks in India with their home loans start at 8.30%. Your credit score is checked before the loan request is approved by the lender. If you

have a good credit score, there is a fair chance that you will be able to enjoy lower rates of interest with your home loan.

Home loans are primarily taken for buying new homes. However, these loan can also be used for home renovations, home extensions, purchasing land property, under-construction houses, etc.

**Car Loans:**

Buying a car can definitely instil a great sense of joy and happiness in you. A car will remain as your asset and it is going to be one of the biggest investments that you make. A car loan helps you to pave the path between your dream of owning a car and actually buying your car. Since credit reports are crucial for judging your eligibility towards any loan, it is good to have a high credit score when you apply for a car loan. The loan application will get approved easily and you might get a lower rate of interest associated with the loan.

Car loans are secured loans. If you fail to pay your instalments, the lender will take back your car and recover the outstanding debt.

**Two-Wheeler Loans:**

A two-wheeler is pretty essential in today's world. May it be going for a long ride or a busy road in a city – bikes and scooters help you to commute conveniently. A two-wheeler loan is easy to apply for. This amount you borrow under this loan type helps you to purchase a two-wheeler. But if you do not pay the instalments on time and clear your debt, the insurer will take your two-wheeler to recover the loan amount.

**Small Business Loans:**

Small Business Loans are loans that are provided to small scale and medium scale businesses to meet various business requirements. These loans can be used for a variety of purposes that help in growing the business. Some of these could include purchase of equipment, buying inventory, paying the salaries of employees, marketing expenses, paying off business debts, meeting administrative expenses, or even to open a new branch or take up a franchise.

The eligibility criteria for small business loans varies from lender to lender, but the common ones are the age of the business owner, the number of years the business has been operational, income tax returns, and statement of the previous year's turnover that has been audited by a Chartered Accountant (CA).

**Payday Loans:**

Payday loans are also called salary loans. These are unsecured short-term loans that require the customer to be employed with a steady income. They usually have high interest rates. This is based on the applicant's credit profile, age, and income. Documents required would be salary statements and other proof of income.

**Cash Advances:**

These loans are offered by credit card issuers and allow credit card users to withdraw cash from an ATM machine using the credit card. The amount of cash that can be withdrawn from a credit card in this way will depend on the credit limit available. The cash has to be paid back with interest, which is usually calculated from the day the cash has been withdrawn. There are also other fees associated with a cash advance, such as cash advance fees and ATM or bank fees.

**Home Renovation Loan:**

Home innovation loans are offered by most lenders. These can be availed to meet the expenses related to renovation, repairs, or improvement of an existing residential property. Depending on the lender, there is a lot of flexibility with what you can do with a home renovation loan. You can use it to buy products or pay for services. For example, you can use it to pay for the services of a contractor, architect, or interior decorator. You can also use it to buy furniture, furnishings, or household appliances such as a refrigerator, washing machine, air conditioner, etc. It can be used for painting, carpentry, or masonry work as well.

**Agriculture Loan:**

Agriculture loans are loans that are provided to farmers to meet the expenses of their day-to-day or general agricultural requirements. These loans can be short term or long term. They can be used for raising working capital for crop cultivation or to buy agricultural equipment.

## Gold Loan:

A gold loan can be used to raise cash to meet emergency or planned financial requirements, such as business expansion, education, medical emergencies, agricultural expenses, etc. The loan against gold is a secured loan where gold is placed as security or collateral in return for a loan amount that corresponds to the per gram market value of gold on the day that the gold has been pledged. Any other metals, gems, or stones that are in the jewelry will not be calculated when determining the value of the gold loan.

## Loan Against Credit Card:

Loan against credit card is like a personal loan that is taken against your credit card. These are usually pre-approved loans that do not require any additional documentation. Depending on the lender, this can be converted into a personal loan that is interest free within a certain period of time. After that, it will attract a certain percentage of interest. There is a processing fee associated with converting the credit limit that is pre-assigned into a loan.

## Education Loan:

An education loan is availed specifically to finance educational requirements towards school or college. Depending on the lender, it will cover the basic fees of the course, the exam fees, accommodation fees, and other miscellaneous charges. The student is the borrower with any other close relative being the co-applicant, such as a parent, grandparent, spouse, or sibling. It can be availed for courses in India or abroad. It can be taken for a wide variety of recognised courses which are either part time or full time. They cover vocational courses as well as undergraduate and postgraduate courses.

## Consumer Durable Loan:

Consumer durable loans are loans that are availed to finance the purchase of consumer durables such as a electronic gadgets and household appliances. Depending on the lender, they can be used to buy anything from mobile phones to television sets. Loan amounts range from Rs.5,000 to Rs.5 lakh. There is no security deposit required usually. Some lenders offer 0% interest on consumer durable loans with instant approvals and minimal documentation required as well.

# Recent Trends of Banking system in India

**1) Electronic Payment Services – E Cheques**

Now-a-days we are hearing about e-governance, e-mail, e-commerce, e-tail etc. In the same manner, a new technology is being developed in US for introduction of e-cheque, which will eventually replace the conventional paper cheque. India, as harbinger to the introduction of e-cheque, the Negotiable Instruments Act has already been amended to include; Truncated cheque and E-cheque instruments.

**2) Real Time Gross Settlement (RTGS)**

Real Time Gross Settlement system, introduced in India since March 2004, is a system through which electronics instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by the RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial operations. As the name suggests, funds transfer between banks takes place on a 'Real Time' basis. Therefore, money can reach the beneficiary instantaneously and the beneficiary's bank has the responsibility to credit the beneficiary's account within two hours.

**3) Electronic Funds Transfer (EFT)**

Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/company etc. can approach his bank and make cash payment or give instructions/authorization to transfer funds directly from his own account to the bank account of the receiver/beneficiary. Complete details such as the receiver's name, bank account number, account type (savings or current account), bank name, city, branch name etc. should be furnished to the bank at the time of requesting for such transfers so that the amount reaches the beneficiaries' account correctly and faster. RBI is the service provider of EFT.

**4) Electronic Clearing Service (ECS)**

Electronic Clearing Service is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller

amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfers by individuals.

5) **Automatic Teller Machine (ATM)**

Automatic Teller Machine is the most popular devise in India, which enables the customers to withdraw their money 24 hours a day 7 days a week. It is a devise that allows customer who has an ATM card to perform routine banking transactions without interacting with a human teller. In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry etc.

6) **Point of Sale Terminal**

Point of Sale Terminal is a computer terminal that is linked online to the computerized customer information files in a bank and magnetically encoded plastic transaction card that identifies the customer to the computer. During a transaction, the customer's account is debited and the retailer's account is credited by the computer for the amount of purchase.

7) **Tele Banking**

Tele Banking facilitates the customer to do entire non-cash related banking on telephone. Under this devise Automatic Voice Recorder is used for simpler queries and transactions. For complicated queries and transactions, manned phone terminals are used.

8) **Electronic Data Interchange (EDI)**

Electronic Data Interchange is the electronic exchange of business documents like purchase order, invoices, shipping notices, receiving advices etc. in a standard, computer processed, universally accepted format between trading partners. EDI can also be used to transmit financial information and payments in electronic form.

**IMPLICATIONS**

The banks were quickly responded to the changes in the industry; especially the new generation banks. The continuance of the trend has re-defined and re-engineered the banking operations as whole with more customization through leveraging technology. As technology makes banking convenient, customers can access banking services and do banking transactions any time and from any ware. The importance of physical branches is going down.

**CHALLENGES FACED BY BANKS**

The major challenges faced by banks today are as to how to cope with competitive forces and strengthen their balance sheet. Today, banks are groaning with burden of NPA's. It is rightly felt that these contaminated debts, if not recovered, will eat into the very vitals of the banks. Another major anxiety before the banking industry is the high transaction cost of carrying Non Performing Assets in their books. The resolution of the NPA problem requires greater accountability on the part of the corporate, greater disclosure in the case of defaults, an efficient credit information sharing system and an appropriate legal framework pertaining to the banking system so that court procedures can be streamlined and actual recoveries made within an acceptable time frame. The banking industry cannot afford to sustain itself with such high levels of NPA's thus, "lend, but lent for a purpose and with a purpose ought to be the slogan for salvation."

The Indian banks are subject to tremendous pressures to perform as otherwise their very survival would be at stake. Information technology (IT) plays an important role in the banking sector as it would not only ensure smooth passage of interrelated transactions over the electric medium but will also facilitate complex financial product innovation and product development. The application of IT and e-banking is becoming the order of the day with the banking system heading towards virtual banking.

As an extreme case of e-banking World Wide Banking (WWB) on the pattern of World Wide Web (WWW) can be visualized. That means all banks would be interlinked and individual bank identity, as far as the customer is concerned, does not exist. There is no need to have large number of physical bank branches, extension counters. There is no need of person-to-person physical interaction or dealings. Customers would be able to do all their banking operations sitting in their offices or homes and operating through internet. This would be the case of banking reaching the customers.

Banking landscape is changing very fast. Many new players with different muscle powers will enter the market. The Reserve Bank in its bid to move towards the best international banking practices will further sharpen the prudential norms and strengthen its supervisor mechanism. There will be more transparency and disclosures. In the days to come, banks are expected to play a very useful role in the economic development and the emerging market will provide ample business opportunities to harness. Human Resources Management is assuming to be of greater importance. As banking in India will become more and more knowledge supported, human capital will emerge as the finest assets of the banking system. Ultimately banking is people and not just figures.

India's banking sector has made rapid strides in reforming and aligning itself to the new competitive business environment. Indian banking industry is the midst of an IT revolution. Technological infrastructure has become an indispensable part of the reforms process in the banking system, with the gradual development of sophisticated instruments and innovations in market practices.

## IT IN BANKING

Indian banking industry, today is in the midst of an IT revolution. A combination of regulatory and competitive reasons has led to increasing importance of total banking automation in the Indian Banking Industry. Information Technology has basically been used under two different avenues in Banking. One is Communication and Connectivity and other is Business Process Reengineering. Information technology enables sophisticated product development, better market infrastructure, implementation of reliable techniques for control of risks and helps the financial intermediaries to reach geographically distant and diversified markets.

The bank which used the right technology to supply timely information will see productivity increase and thereby gain a competitive edge. To compete in an economy which is opening up, it is imperative for the Indian Banks to observe the latest technology and modify it to suit their environment. Not only banks need greatly enhanced use of technology to the customer friendly, efficient and competitive existing services and business, they also need technology for providing newer products and newer forms of services in an increasingly dynamic and globalize environment. Information technology offers a chance for banks to build new systems that address a wide range of customer needs including many that may not be imaginable today.

- It is becoming increasingly imperative for banks to assess and ascertain the benefits of technology implementation. The fruits of technology will certainly taste a lot sweeter when the returns can be measured in absolute terms but it needs precautions and the safety nets.
- It has not been a smooth sailing for banks keen to jump onto the IT bandwagon. There have been impediments in the path like the obduracy once shown by trade unions who felt that IT could turn out to be a threat to secure employment. Further, the expansion of banks into remote nooks and corners of the country, where logistics continues to be a handicap, proved to be another stumbling stock. Another challenge the banks have had to face concerns the inability of banks to retain the trained and talented personnel, especially those with a good knowledge of IT.
- The increasing use of technology in banks has also brought up ‘security' concerns. To avoid any pitfalls or mishaps on this account, banks ought to have in place a well-documented security policy including network security and internal security. The passing of the Information Technology Act has come as a boon to the banking sector, and banks should now ensure to abide strictly by its covenants. An effort should also be made to cover e-business in the country's consumer laws.
- Some are investing in it to drive the business growth, while others are having no option but to invest, to stay in business. The choice of right channel, justification of IT investment on ROI, e-governance, customer relationship management, security concerns, technological obsolescence, mergers and acquisitions, penetration of IT in rural areas, and outsourcing of IT operations are the major challenges and issues in the use of IT in banking operations. The main challenge, however, remains to motivate the customers to increasingly make use of IT while transacting with banks. For small banks, heavy investment requirement is the compressing need in addition to their capital requirements. The coming years will see even more investment in banking technology, but reaping ROI will call for more strategic thinking.
- The banks may have to reorient their resources in the form of reorganized branch networks, reduced manpower, dramatic reduction in establishment cost, honing the skills of the staff, and innovative ways of attracting talented managerial pool. The Government of India and the Reserve Bank of India (RBI) on their part would strengthen the existing norms in terms of governing and directing the functioning of these banks. Banks needs to strengthen their audit function. They would be evaluated based on their performance in the market place. It is in this context that we have invited the chief executive officers of Indian banks to respond to the issues mentioned earlier

**FUTURE OUTLOOK**

Everyone today is convinced that the technology is going to hold the key to future of banking. The achievements in the banking today would not have make possible without IT revolution. Therefore, the key point is while changing to the current environment the banks has to understand properly the trigger for change and accordingly find out the suitable departure point for the change.

Although, the adoption of technology in banks continues at a rapid pace, the concentration is perceptibly more in the metros and urban areas. The benefit of Information Technology is yet to percolate sufficiently to the common man living in his rural hamlet. More and more programs and software in regional languages could be introduced to attract more and more people from the rural segments also.

Standards based messaging systems should be increasingly deployed in order to address cross platform transactions. The surplus manpower generated by the use of IT should be used for marketing new schemes and banks should form a ‘brains trust' comprising domain experts and technology specialists.

**CONCLUSION**

Indian banking system will further grow in size and complexity while acting as an important agent of economic growth and intermingling different segments of the financial sector. It automatically follows that the future of Indian banking depends not only in internal dynamics unleashed by ongoing returns but also on global trends in the financial sectors. Indian Banking Industry has shown considerable resilience during the return period. The second generation returns will play a crucial role in further strengthening the system. The banking today is re-defined and re-engineered with the use of Information Technology and it is sure that the future of banking will offer more sophisticated services to the customers with the continuous product and process innovations. Thus, there is a paradigm shift from the seller's market to buyer's market in the industry and finally it affected at the bankers level to change their approach from "conventional banking to convenience banking" and "mass banking to class banking". The shift has also increased the degree of accessibility of a common man to bank for his variety of needs and requirements. Adoption of stringent prudential norms and higher capital standards, better risk management systems, adoption of internationally accepted accounting practices and increased disclosures and transparency will ensure the Indian Banking industry keeps pace with other developed banking systems.

# Indian Insurance System

# Definition of Insurance

Insurance refers to a contractual arrangement in which one party, i.e. insurance company or the insurer, agrees to compensate the loss or damage sustained to another party, i.e. the insured, by paying a definite amount, in exchange for an adequate consideration called as premium.

It is often represented by an insurance policy, wherein the insured gets **financial protection** from the insurer against losses due to the occurrence of **any event which is not under the control of the insured**.

Insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company.

## Principles of Insurance

The seven principles of insurance are :-

1. Principle of Uberrimae fidei (Utmost Good Faith),
2. Principle of Insurable Interest,
3. Principle of Indemnity,
4. Principle of Contribution,
5. Principle of Subrogation,
6. Principle of Loss Minimization, and
7. Principle of Causa Proxima (Nearest Cause).

### 1. Principle of Uberrimae fidei (Utmost Good Faith)

Principle of *Uberrimae fidei* (a Latin phrase), or in simple english words, the Principle of **Utmost Good Faith**, is a very basic and first primary principle of insurance. According to this principle, the insurance contract must be signed by both parties (i.e insurer and insured) in an absolute good faith or belief or trust.

The person getting insured must willingly disclose and surrender to the insurer his complete true information regarding the subject matter of insurance. The insurer's liability gets void (i.e legally revoked or cancelled) if any facts, about the subject matter of insurance are either omitted, hidden, falsified or presented in a wrong manner by the insured.

## 2. Principle of Insurable Interest

The principle of insurable interest states that the person getting insured must have insurable interest in the object of insurance. A person has an insurable interest when the physical existence of the insured object gives him some gain but its non-existence will give him a loss. In simple words, the insured person must suffer some financial loss by the damage of the insured object.

**For example** :- The owner of a taxicab has insurable interest in the taxicab because he is getting income from it. But, if he sells it, he will not have an insurable interest left in that taxicab.

From above example, we can conclude that, ownership plays a very crucial role in evaluating insurable interest. Every person has an insurable interest in his own life. A merchant has insurable interest in his business of trading. Similarly, a creditor has insurable interest in his debtor.

## 3. Principle of Indemnity

Indemnity means security, protection and compensation given against damage, loss or injury.

According to the principle of indemnity, an insurance contract is signed only for getting protection against unpredicted financial losses arising due to future uncertainties. Insurance contract is not made for making profit else its sole purpose is to give compensation in case of any damage or loss.

In an insurance contract, the amount of compensations paid is in proportion to the incurred losses. The amount of compensations is limited to the amount assured or the actual losses, whichever is less. The compensation must not be less or more than the actual damage. Compensation is not paid if the specified loss does not happen due to a particular reason during a specific time period. Thus, insurance is only for giving protection against losses and not for making profit.

However, in case of **life insurance**, the principle of indemnity does not apply because the value of human life cannot be measured in terms of money.

## 4. Principle of Contribution

Principle of Contribution is a corollary of the principle of indemnity. It applies to all contracts of indemnity, if the insured has taken out more than one policy on the same subject matter. According to this principle, the insured can claim the compensation only to the extent of actual loss either from all insurers or from any one insurer. If one insurer pays full compensation then that insurer can claim proportionate claim from the other insurers.

**For example** :- Mr. John insures his property worth $ 100,000 with two insurers "AIG Ltd." for $ 90,000 and "MetLife Ltd." for $ 60,000. John's actual property destroyed is worth $ 60,000, then Mr. John can claim the full loss of $ 60,000 either from AIG Ltd. or MetLife Ltd., or he can claim $ 36,000 from AIG Ltd. and $ 24,000 from Metlife Ltd.

So, if the insured claims full amount of compensation from one insurer then he cannot claim the same compensation from other insurer and make a profit. Secondly, if one insurance company pays the full compensation then it can recover the proportionate contribution from the other insurance company.

## 5. Principle of Subrogation

Subrogation means substituting one creditor for another.

Principle of Subrogation is an extension and another corollary of the principle of indemnity. It also applies to all contracts of indemnity.

According to the principle of subrogation, when the insured is compensated for the losses due to damage to his insured property, then the ownership right of such property shifts to the insurer.

This principle is applicable only when the damaged property has any value after the event causing the damage. The insurer can benefit out of subrogation rights only to the extent of the amount he has paid to the insured as compensation.

**For example** :- Mr. John insures his house for $ 1 million. The house is totally destroyed by the negligence of his neighbour Mr.Tom. The insurance company shall settle the claim of Mr. John for $ 1 million. At the same time, it can file a law suit against Mr.Tom for $ 1.2 million, the market value of the house. If insurance

company wins the case and collects $ 1.2 million from Mr. Tom, then the insurance company will retain $ 1 million (which it has already paid to Mr. John) plus other expenses such as court fees. The balance amount, if any will be given to Mr. John, the insured.

## 6. Principle of Loss Minimization

According to the Principle of Loss Minimization, insured must always try his level best to minimize the loss of his insured property, in case of uncertain events like a fire outbreak or blast, etc. The insured must take all possible measures and necessary steps to control and reduce the losses in such a scenario. The insured must not neglect and behave irresponsibly during such events just because the property is insured. Hence it is a responsibility of the insured to protect his insured property and avoid further losses.

**For example** :- Assume, Mr. John's house is set on fire due to an electric short-circuit. In this tragic scenario, Mr. John must try his level best to stop fire by all possible means, like first calling nearest fire department office, asking neighbours for emergency fire extinguishers, etc. He must not remain inactive and watch his house burning hoping, "Why should I worry? I've insured my house."

## 7. Principle of Causa Proxima (Nearest Cause)

Principle of *Causa Proxima* (a Latin phrase), or in simple english words, the Principle of Proximate (i.e Nearest) Cause, means when a loss is caused by more than one causes, the proximate or the nearest or the closest cause should be taken into consideration to decide the liability of the insurer.

The principle states that to find out whether the insurer is liable for the loss or not, the proximate (closest) and not the remote (farest) must be looked into.

**For example** :- A cargo ship's base was punctured due to rats and so sea water entered and cargo was damaged. Here there are two causes for the damage of the cargo ship - (i) The cargo ship getting punctured beacuse of rats, and (ii) The sea water entering ship through puncture. The risk of sea water is insured but the first cause is not. The nearest cause of damage is sea water which is insured and therefore the insurer must pay the compensation.

However, in case of life insurance, the principle of **Causa Proxima** does not apply. Whatever may be the reason of death (whether a natural death or an unnatural death) the insurer is liable to pay the amount of insurance.

## Types of Insurance

## Life and Nonlife insurance

### Life Insurance

Life Insurance is different from other insurance in the sense that, here, the subject matter of insurance is the life of a human being.

The insurer will pay the fixed amount of insurance at the time of death or at the expiry of a certain period.

At present, life insurance enjoys maximum scope because life is the most important property of an individual.

Each and every person requires insurance.

This insurance provides protection to the family at the premature death or gives an adequate amount at the old age when earning capacities are reduced.

Under personal insurance, a payment is made at the accident.

The insurance is not only a protection but is a sort of investment because a certain sum is returnable to the insured at the death or the expiry of a period.

## Nonlife insurance/General Insurance

General insurance includes Property Insurance, Liability Insurance, and Other Forms of Insurance.

Fire and Marine Insurances are strictly called Property Insurance. Motor, Theft, Fidelity and Machine Insurances include the extent of liability insurance to a certain extent.

The strictest form of liability insurance is fidelity insurance, whereby the insurer compensates the loss to the insured when he is under the liability of payment to the third party.

## Property Insurance

Under the property insurance property of person/persons are insured against a certain specified risk. The risk may be fire or marine perils, theft of property or goods damage to property at the accident.

## Marine Insurance

The marine perils are; collision with a rock or ship, attacks by enemies, fire, and captured by pirates, etc. these perils cause damage, destruction or disappearance of the ship and cargo and non-payment of freight.

So, marine insurance insures ship (Hull), cargo and freight.

Previously only certain nominal risks were insured but now the scope of marine insurance had been divided into two parts; Ocean Marine Insurance and Inland Marine Insurance.

The former insures only the marine perils while the latter covers inland perils which may arise with the delivery of cargo (gods) from the go-down of the insured and may extend up to the receipt of the cargo by the buyer (importer) at his go down.

## Fire Insurance

In the absence of fire insurance, the fire waste will increase not only to the individual but to the society as well.

With the help of fire insurance, the losses arising due to fire are compensated and the society is not losing much.

The individual is preferred from such losses and his property or business or industry will remain approximately in the same position in which it was before the loss.

The fire insurance does not protect only losses but it provides certain consequential losses also war risk, turmoil, riots, etc. can be insured under this insurance, too.

## Liability Insurance

The general Insurance also includes liability insurance whereby the insured is liable to pay the damage of property or to compensate for the loss of persona; injury or death.

This insurance is seen in the form of fidelity insurance, automobile insurance, and machine insurance, etc.

## Social Insurance

The social insurance is to provide protection to the weaker sections of the society who are unable to pay the premium for adequate insurance.

Pension plans, disability benefits, unemployment benefits, sickness insurance, and industrial insurance are the various forms of social insurance.

Insurance can be classified into 4 categories from the risk point of view.

## Personal Insurance

The personal insurance includes insurance of human life which may suffer a loss due to death, accident, and disease

Therefore, personal insurance is further sub-classified into life insurance, personal accident insurance, and health insurance.

## Property Insurance

The property of an individual and of the society is insured against loss of fire and marine perils, the crop is insured against an unexpected decline in deduction, unexpected death of the animals engaged in business, break-down of machines and theft of the property and goods.

## Guarantee Insurance

The guarantee insurance covers the loss arising due to dishonesty, disappearance, and disloyalty of the employees or second party. The party must be a party to the contract.

His failure causes loss to the first party.

For example, in export insurance, the insurer will compensate the loss at the failure of the importers to pay the amount of debt.

**Other Forms of Insurance**

Besides the property and liability insurances, there are other insurances that are included in general insurance.

Examples of such insurances are export-credit insurances, State employees' insurance, etc. whereby the insurer guarantees to pay a certain amount at certain events.

This insurance is extending rapidly these days.

**Miscellaneous Insurance**

The property, goods, machine, Furniture, automobiles, valuable articles, etc. can be insured against the damage or destruction due to accident or disappearance due to theft.

There are different forms of insurances for each type of the said property whereby not only property insurance exists but liability insurance and personal injuries are also the insurer.

## Re-insurance

Reinsurance occurs when multiple insurance companies share risk by purchasing insurance policies from other insurers to limit their own total loss in case of disaster. Described as "insurance for insurance companies" by the Reinsurance Association of America, the idea is that no insurance company has too much exposure to a particularly large event or disaster.

- Reinsurance occurs when multiple insurance companies share risk by purchasing insurance policies from other insurers to limit their own total loss in case of disaster.
- By spreading risk, an insurance company takes on clients whose coverage would be too great of a burden for the single insurance company to handle alone.
- Premiums paid by the insured is typically shared by all of the insurance companies involved.

Insurers purchase reinsurance for four reasons: To limit liability on a specific risk, to stabilize loss experience, to protect themselves and the insured against catastrophes, and to increase their capacity. But reinsurance can help a company by providing the following:

1. Risk Transfer: Companies can share or transfer specific risks with other companies.
2. Arbitrage: Additional profits can be garnered by purchasing insurance elsewhere for less than the premium the company collects from policyholders.
3. Capital Management: Companies can avoid having to absorb large losses by passing risk; this frees up additional capital.
4. Solvency Margins: The purchase of surplus relief insurance allows companies to accept new clients and avoid the need to raise additional capital.
5. Expertise: The expertise of another insurer can help a company obtain a higher rating and premium.

It is a process whereby one entity (the reinsurer) takes on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment. In other words, it is a form of an insurance cover for insurance companies.

***Description:*** Unlike co-insurance where several insurance companies come together to issue one single risk, reinsurers are typically the insurers of the last resort. The insurance business is based on laws of probability which presupposes that only a fraction of the policies issued would result in claims.

As a result, the total sum insured by an insurance company would be several times its net worth. It is based on this same probability of loss that insurance companies fix the insurance premium. The premiums are fixed in such a manner that the total premium collected would be enough to pay for the total claims incurred after providing for expenses.

However, there is a possibility that in a bad year, the total value of claims may be much more than the premium collected. If the losses are of a very large magnitude, there is a chance that the net worth of the company would be wiped out. It is to avoid such risks that insurance companies take out policies. Secondly, insurance companies take the support of reinsurers when they do not have the capacity to provide a cover on their own.

Broadly, reinsurance can be classified under two heads - treaty reinsurance and facultative reinsurance.

There are two basic types of reinsurance arrangements: facultative reinsurance and treaty reinsurance. Facultative reinsurance is designed to cover single risks or defined packages of risks, whereas treaty reinsurance covers a ceding company's entire book of business, for example a primary insurer's homeowners' insurance book.

**Facultative reinsurance**

With facultative reinsurance transactions, the ceding company can offer an individual risk or a defined package of risks to a reinsurer. The reinsurer retains the right to accept or reject the risk, just like the primary insurer has the right to decide whether to insure a policyholder. Under a facultative arrangement, the reinsurer will perform its own underwriting for some or all of the policies to be reinsured, and each policy is considered a single transaction.

Facultative reinsurance is typically used for high-value or hazardous risks because the policies can be tailored to specific circumstances. It can sometimes be less attractive to the ceding company, because the reinsurer may insist the ceding company retains some of the liability on the riskiest policies. In those scenarios, the ceding company may have to approach multiple different reinsurers to transfer any remaining liability.

**Treaty reinsurance**

In treaty reinsurance transactions, the ceding company transfers all risks within a book of business to the reinsurer. For example, a primary insurer might transfer its entire book of commercial auto or all of its homeowners' risk. The two parties will enter into an agreement, known as the treaty, in which the reinsurer is obliged to accept all covered business.

Treaty reinsurance arrangements are typically long-term, and they will accept policies that the ceding company has not yet written, as long as they fit in with the treaty's pre-agreed risk class. The reinsurer typically expects to make a profit, but these expectations are measured and adjusted over time.

In contrast to facultative arrangements, reinsurers do not carry out individual underwriting on the risks assumed via treaty arrangements. That responsibility is left to the ceding company, which is why reinsurers will do lots of due diligence to ensure the ceding company is practicing adequate underwriting processes before entering a treaty.

**'Pro rata' versus 'excess of loss'**

Both facultative and treaty reinsurance arrangements can be written on either a pro rata or an excess of loss basis.

Global reinsurer Munich Re describes 'pro rata' as: "A term describing all forms of quota share and surplus share reinsurance in which the reinsurer shares the same proportion of the premium and losses of the ceding company. Pro rata reinsurance is also known as 'proportional reinsurance'. Along with sharing proportionally in premium and losses, the reinsurer typically pays a ceding commission to the ceding company to reimburse for expenses associated with issuing the underlying policy."

Pro rata reinsurance is typically quite easy to administer, and it offers good protection against frequency and severity.

In an excess of loss agreement, also known as 'non-proportional reinsurance,' the ceding insurer will retain a certain amount of liability for losses. It will pay a fee to the reinsurance company for coverage above that retention, and that coverage is generally subject to a fixed upper limit. Excess of loss arrangements are often more economical in terms of reinsurance premium and cost of administration.

## Micro Insurance

Micro insurance products offer coverage to low-income households or to individuals who have little savings and is tailored specifically for lower valued assets and compensation for illness, injury, or death.

**Breaking Down Micro insurance**

As a division of microfinance, micro insurance looks to aid low-income families by offering insurance plans tailored to their needs. Micro insurance is often found in developing countries, where the current insurance markets are inefficient or non-existent. Because the coverage value is lower than the usual insurance plan, the insured people pay considerably smaller premiums.

Micro insurance, like regular insurance, is available for a wide variety of risks. These include both health risks and property risks. Some of these risks include crop insurance, livestock/cattle insurance, insurance for

theft or fire, health insurance, term life insurance, death insurance, disability insurance and insurance for natural disasters, etc.

Like traditional insurance, micro insurance functions based on the concept of risk pooling, regardless of its small unit size and its activities at the level of single communities. Micro insurance combines multiple small units into larger structures, creating networks of risk pools that enhance both insurance functions and support structures.

## Micro insurance Delivery Methods

Delivery of micro insurance is a challenge. Several methods and models exist, which can differ according to the organization, institution, and provider involved. In general, there are four main methods for delivering micro insurance to a client base: the partner-agent model, the provider-driven model, the full-service model, and the community-based model:

- **Partner-agent model**: This model is based on a partnership between the micro insurance scheme and an agent. In some cases a third-party healthcare provider. The micro insurance scheme is responsible for the delivery and marketing of products to the clients, while the agent retains all responsibility for design and development. In this model, Micro insurance schemes benefit from limited risk but are also limited in their control.
- **Full-service model**: In this model, the Micro insurance scheme is in charge of everything; both the design and delivery of products to the clients, working in conjunction with external healthcare providers. While benefiting from full control, the disadvantage of the full-service model is the higher risks.
- **Provider-driven model**: In this model, the healthcare provider is the Micro insurance scheme, and similar to the full-service model, is responsible for all operations, delivery, design, and service. This disadvantage of this method is the limitations of products and services that can be offered.
- **Community-based/mutual model**: In this method, policyholders or clients are run everything, working with external healthcare providers to offer services. This model is advantageous for its ability to design and market products more easily and effectively, but the small size and scope of operations limits effectiveness.

**Benefits of Micro insurance**

The greatest benefit of Micro insurance is its affordability and also the sense of security it brings to low-income families who were previously unable to afford insurance. Think of the savings individuals can realize by never having to pay in money toward a deductible they will never use. Times are changing and as the millennial generation demands more choices when purchasing insurance, the insurance industry will have to learn how to embrace the change. Other benefits include transparency and the ability to handle claims quickly and accurately.

Research also shows that when farmers and other small entrepreneurs feel they are protected by insurance, they are willing to take more risks and invest more in new business venture. This is good for the economy.

**Potential Setbacks**

As with any new technology, there are going to be some set-backs. What are the potential setbacks for Micro insurance in the United States? To start with, the U.S. insurance industry is very highly regulated. There are legal requirements for insurers including liability and reserves that must be maintained. With Micro insurance, the need for these reserves would be eliminated since Micro insurance is a very “short-term” policy. U.S. insurance regulations will have to catch up as the use of Micro insurance becomes more widely accepted inside the U.S.

**The Future of Micro insurance**

Insurance is not always the fastest industry to embrace change but research has indicated that there may be a place for Micro insurance. Micro insurance is one area where growth in developing countries has outpaced growth in the rest of the industrialized world.

## IRDA: Role, Functions and Powers

IRDA - Insurance Regulatory Development and Authority is the statutory, independent and apex body that governs and supervise the Insurance Industry in India.

- It was constituted by Parliament of India Act called **Insurance Regulatory and Development Authority of India (IRDA of India)** after the formal declaration of Insurance Laws (Amendment) Ordinance 2014, by the President of India Pranab Mukherjee on December 26,2014.

## Establishment:

- IRDA Act was passed upon the recommendations of **Malhotra Committee report** (7 Jan,1994), headed by **Mr R.N. Malhotra (Retired Governor, RBI)**
- Main Recommendations - Entrance of Private Sector Companies and Foreign promoters & An independent regulatory authority for Insurance Sector in India
- In April,2000, it was set up as statutory body, with its headquarters at New Delhi.
- The **headquarters** of the agency were shifted to **Hyderabad, Telangana** in 2001.

## Organisational Setup of IRDA:

IRDA is a **ten member body** consists of :

- One Chairman (For 5 Years & Maximum Age - 60 years )
- Five whole-time Members (For 5 Years and Maximum Age- 62 years)
- Four part-time Members (Not more than 5 years)

The chairman and members of IRDAI are appointed by **Government of India**.

The present Chairman of IRDAI is **Subhash Chandra Khuntia**.

## Objectives of IRDA:

- To promote the interest and rights of policy holders.
- To promote and ensure the growth of Insurance Industry.
- To ensure speedy settlement of genuine claims and to prevent frauds and malpractices
- To bring transparency and orderly conduct of in financial markets dealing with insurance.

## Functions And Duties of IRDA:

**Section 14 of IRDA Act,1999** lays down the duties and functions of IRDA:

- It issues the registration certificates to insurance companies and regulates them.
- It protects the interest of policy holders.

- It provides license to insurance intermediaries such as agents and brokers after specifying the required qualifications and set norms/code of conduct for them.
- It promotes and regulates the professional organisations related with insurance business to promote efficiency in insurance sector.
- It regulates and supervise the premium rates and terms of insurance covers.
- It specifies the conditions and manners, according to which the insurance companies and other intermediaries have to make their financial reports.
- It regulates the investment of policyholder's funds by insurance companies.
- It also ensures the maintenance of solvency margin (company's ability to pay out claims) by insurance companies.

**Section 14 of IRDAI Act, 1999 lays down the powers of IRDAI**

- Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.
- 1. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include, -

- o issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;
- o protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;
- o specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents
- o specifying the code of conduct for surveyors and loss assessors;
- o promoting efficiency in the conduct of insurance business;
- o promoting and regulating professional organisations connected with the insurance and re-insurance business;
- o levying fees and other charges for carrying out the purposes of this Act;

- o calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;
- o control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);
- o specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;
- o regulating investment of funds by insurance companies;
- o regulating maintenance of margin of solvency;
- o adjudication of disputes between insurers and intermediaries or insurance intermediaries;
- o supervising the functioning of the Tariff Advisory Committee;
- o specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);
- o specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and
- o exercising such other powers as may be prescribed

## Different Insurance Product and Their Applicability

## Pension plan

***A pension plan is a type of savings or investment plans which you can avail for yourself so that you can live a standard life after retirement. A pension plan accumulates a part of your savings for over a period of time which you can finally use after you have retired.***

After years and years of hard work, retirement is a phase most of us look forward to in our lives. While retirement is supposed to be the most peaceful phase of our lives, one must also be aware of the fact that one’s regular monthly income comes to a stop during this time. If you have not planned for this during your productive years, you might end up facing various financial difficulties in your life.

This is where an annuity or pension plan comes into play. One of the major benefits of a pension plan is that it provides regular income to the policyholder even after his/her retirement. If you are worried about your monthly expenditure following retirement, you must invest in a pension plan and build a corpus large enough to take care of your requirements.

Pension plans typically come in many forms, and they offer flexible benefits to policyholders depending upon their requirements. Customers can choose between unit-linked retirement plans or endowment plans based on their risk appetite. Most of the insurers in the market have multiple variants of pension plans to reach out to a wide range of customers. Also, customers can choose between single premium pension plans and regular premium pension plans based on their requirements.

By starting the investment early during the productive years of their life, people can build a large corpus with only a small portion of their annual income. Alternatively, they can also pay a lump sum single premium amount and get regular income from the investment. Most pension plans allow customers to choose the age at which the annuity can begin.

We all work hard and save money for one of the key stages of life i.e. 'Retirement'. It is essential to have enough savings post your retirement in order to sustain your lifestyle the way you've always been living. Therefore, "Pension Plan" plays a very important role in your financial planning.

Everyone would like to continue living a lifestyle the way you have been living during your working life, which is why Pension Plans are also known as 'Retirement plans'. A certain amount of your current income is transferred and stored for your future by your employer. This amount is then given to the employee as pension fund on his/her retirement.

**Pension Plans** are known as retirement plans that require you to make contributions into a pool of funds set aside for your benefit in future. This pool of fund is invested on your behalf, and the earnings on the investment generate income on your retirement.

For your retirement plan, there are heaps of pension plans available in the market. These plans are different from each other. Their benefits, features, exclusions etc. are different too. Pension plans are basically an investment or saving tool to provide for your future retirement needs.

All the pension plans are divided into two parts.

The first part is accumulation where you (insured) pays the premium.

The second part is distribution.

Here, you are paid a regular income through an annuity plan after your retirement. Annuity Plan is a type of insurance which starts paying you an income from the start as per the options chosen by you.

The benefit of choosing this investment option i.e. pension plan, is that it provides financial security and stability during one's golden years. Individuals would not have to compromise on their standard of living after retiring from their respective jobs.

To ensure a worry-free, quality retired life, one must ensure to plan for retirement well in advance. Retirement planning deals with identifying income sources, estimating the expenses that are going to arise, executing a savings program and managing risk and assets. It must begin long before the individual retires, and the sooner he or she starts, the better. Financial experts often recommend people to begin retirement planning from the day they start earning. Starting early gives them more time for their wealth to grow. A well-chosen retirement plan can help one rise above inflation. Individuals are advised to make use of a retirement calculator to get an idea about how much they will need to save for the kind of retirement they wish to have.

**Types of Pension Plans in India**

Following are the types of Pension Plans in India.

## Deferred Annuity

This pension scheme allows you to accumulate corpus through regular premiums or through single premium over a policy term. Once the policy term is over, the pension will begin. The benefits of deferred pension plans are massive. It also includes tax benefit that is associated with this pension scheme. There is no tax levied on the money invested in the plan unless he/she withdraws it. This scheme can be purchased by making regular or by one-time payment towards it. Thus, this plan suits all types of investors.

## Immediate Annuity

In this scheme, pension starts immediately. You have to deposit a lump-sum amount and pension will start immediately on basis of the amount invested by the policyholder. You can choose from a range of annuity options available. Also, the premium paid is exempted as per the Income Tax Act, 1961. And, in case of death of the policyholder, the nominee/beneficiary will be entitled to get money as per the option selected.

A few annuity options preferred by many people are:

- **Annuity Certain / Guaranteed Period Annuity**

The annuity is paid to the annuitant for a specific number of years as per this clause. The annuitant has the right to choose the period and in case he/she dies before exhausting all the payments, the annuity will be paid to the beneficiary/ nominee. As per this plan, annuity is given to the life assured for certain periods like 5, 10, 15 or 20 years whether or not he/she survives that duration.

- **Life Annuity**

As per Life Annuity option, the pension amount will be paid to the annuitant until his/her death. However, if you choose the 'with spouse' the amount of pension will be given to the spouse of the policyholder (in case of death).

## With Cover and without cover Pension Plans

The pension plans with cover have a life cover component in the plan and states that a lump sum amount will be paid to the family members on the death of the policyholder. The cover amount here is not high, as a major part of premium is diverted towards growing the corpus than covering the risk of life.

On the other hand, without cover pension plan states that there is no life cover. And, in case of an unfortunate death, the nominee/beneficiary of the policy will get corpus accumulated (premiums paid till the date of the death).

## National Pension scheme (NPS)

The NPS was introduced by the Government for people to build up the pension amount. However, you can put your savings in the new pension scheme where your money will be invested in equity and debt market as per

your preference. Also, you can withdraw 60% of the amount at retirement and rest 40% can be used to purchase the annuity.

**Note**: Maturity amount is not tax-free.

## Pension Funds

Investing in Pension funds is a smart option as these plans remain in force for a long time and also offer better returns at maturity. The Pension Fund Regulatory and Development Authority (PFRDA), established by the government body allows 6 companies as fund managers.

### Features of Pension Plans in India

### Vesting Age

Vesting age refers to the age at which the policyholder of a pension plan starts receiving your monthly pension. In most cases, the minimum vesting age is generally between 40 years and 50 years and is flexible up to the age of 70 years. However, there are a few companies that extend their vesting age till 90 years.

### Payment Period

Do not confuse this with accumulation period. This is the period in which you receive the pension after retiring. For instance, if one receives the pension from the age 60 to age 75, the payment period will be 15 years. Most funds keep this separate from accumulation period, though some funds allow partial/full withdrawals during accumulation periods too.

### Surrender value

Surrendering one's pension plan before maturity is not a smart move even after paying the required minimum premium. This results in the investor losing every benefit of the plan including the assured sum and life insurance cover.

### Accumulation Duration

In this period the investor pays regularly or once in this period. This is the time when your wealth starts accumulating in order to build a huge corpus. For example: In case you start investing at the age of 25 years and continue investing till the age of 60. Here, your accumulation period will be 35 years and your pension for the chosen period comes from this corpus.

**Benefits of Pension Plans in India**

**Liquidity**

A pension plan is essentially a low liquidity product. There are insurance companies that offer pension funds that are designed to enable policyholders to withdraw your pension amount at the time of accumulation stage. This feature ensures that are always prepared for an unforeseen emergency, in case it arises. Most importantly, it prevents you from being dependent on banks for a loan under such situations.

**Guaranteed Pension/Income**

This serves the purpose of a stable and reliable source of income after your retirement or as per your preference. This enables you to plan in advance, so that you are financially independent even after your retirement. It is recommended that you use the retirement calculator to get a rough estimation of the retirement corpus you need to aim for. For instance, if you want to build a corpus of Rs. 5 crores as your retirement plan, you have to pay your premiums accordingly.

**Tax Efficiency**

Policyholders of pension plans can avail tax exemptions under Section 80C of the Income Tax Act, 1961. Besides this, there are other provisions for tax benefits as per Chapter VI-A of Section 80C, Section 80CCC and Section 80CCD of the Income Tax Act, 1961. For example, the NPS (National Pension Scheme) and Atal Pension Yojana (APY) are both subject to tax deductions as per Section 80CCD of the Income Tax Act, 1961.

**Death Benefit**

It carries a guaranteed death benefit. This is the amount that the nominee can avail on the unforeseen death of the policyholder during the tenure of the pension plan, and is generally 105% of the total premium paid till

then. It also includes the benefits of top ups that the policyholder may have selected while purchasing the pension plan. For a plan that has been discontinued, the Death Benefit comprises of the accrued funds against the plan.

In the case of the unforeseen death of the pension plan accountholder, the nominee can opt for any one of these 3 options - withdraw 1/3rd of the maturity amount, utilize the entire benefit amount to buy an annuity plan, or choose a combination of both.

### Choice of investments

Every ULIP pension plan has varied investment objectives and risk appetites. Some prefer investments that generate high returns within a short time by exposing the portfolio to comparatively high market risks. Short term equity investments are suitable for such investors. In contrast, some others have a low or moderate risk appetite and, therefore, prefer investing over a long term. The type of pension plan you will select will determine the returns you can avail.

## Banc-assurance

Bancassurance is a French term referring to the selling of insurance through a bank's established distribution channels. In other words, we can say Bancassurance is the provision of insurance (*assurance*) products by a bank. The usage of the word picked up as banks and insurance companies merged and banks sought to provide insurance, especially in markets that have been liberalised recently. It is a controversial idea, and many feel it gives banks too great a control over the financial industry. In some countries, bancassurance is still largely prohibited, but it was recently legalized in countries like USA when the Glass Steagall Act was repealed after the passage of the Gramm Leach Bililey Act.

Bancassurance is the selling of insurance and banking products through the same channel, most commonly through bank branches. Selling insurance.means distribution of insurance and other financial products through Banks. Bancassurance concept originated in France and soon became a success story even in other countries of Europe. In India a number of insurers have already tied up with banks and some banks have already flagged off bancassurance through select products.

Bancassurance has become significant. Banks are now a major distribution channel for insurers, and insurance sales a significant source of profits for banks. The latter partly being because banks can often sell insurance at better prices (i.e., higher premiums) than many other channels, and they have low costs as they use the infrastructure (branches and systems) that they use for banking.

Bancassurance primarily rests on the relationship the customer has developed over a period of time with the bank. And pushing risk products through banks is a much more cost-effective affair for an insurance company compared to the agent route, while, for banks, considering the falling interest rates, fee based income coming in at a minimum cost is more than welcome.

**Advantages of Bancassurance:**

The following factors have mainly led to success of bancassurance

(i) Pressure on banks' profit margins. Bancassurance offers another area of profitability to banks with little or no capital outlay. A small capital outlay in turn means a high return on equity.

(ii) A desire to provide one-stop customer service. Today, convenience is a major issue in managing a person's day to day activities. A bank, which is able to market insurance products, has a competitive edge over its competitors. It can provide complete financial planning services to its customers under one roof.

(iii) Opportunities for sophisticated product offerings.

(iv) Opportunities for greater customer lifecycle management.

(v) Diversify and grow revenue base from existing relationships.

(vi) Diversify risks by tapping another area of profitability.

(vii) The realisation that insurance is a necessary consumer need. Banks can use their large base of existing customers to sell insurance products.

(viii) Bank aims to increase percentage of non-interest fee income

(ix) Cost effective use of premises

**Various Models for Bancassurance**

Various models are used by banks for bancassurance. ***(a) Strategic Alliance Model :*** Under this Model, there is a tie-up between a bank and an insurance company. The bank only markets the products of the insurance company. Except for marketing the products, no other insurance functions are carried out by the bank. ***(b) Full Integration Model :*** This model entails a full integration of banking and insurance services. The bank sells the insurance products under its brand acting as a provider of financial solutions matching customer needs. Bank controls sales and insurer service levels including approach to claims. Under such an arrangement the Bank has an additional core activity almost similar to that of an insurance company. ***(c) Mixed Models:*** Under this Model, the marketing is done by the insurer's staff and the bank is responsible for generating leads only. In other words, the database of the bank is sold to the insurance company. The approach requires very little technical investment.

**Status of Bancassurance in India**

Reserve Bank of India (RBI) has recognized "bancassurance" wherein banks are allowed to provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to the banks' customers with adequate disclosure and transparency, and in turn earn referral fees on the basis of premia collected. This would utilize the resources in the banking sector in a more profitable manner.

Bancassurance can be important source of revenue. With the increased competition and squeezing of interest rates spreads profit of the are likely to be under pressure. Fee based income can be increased through hawking of risk products like insurance.

There is enormous potential for insurance in India and recent experience has shown massive growth pace. A combination of the socio-economic factors are likely to make the insurance business the biggest and the fastest growing segment of the financial services industry in India.

However, before taking the plunge in to this new field, banks as insurers need to work hard on chalking out strategies to sell risk products especially in an emerging competitive market. However, future is bright for bancassurance. Banks in India have all the right ingredients to make Bancassurance a success story. They have large branch network, huge customer base, enjoy customer confidence and have experience in selling non-

banking products. If properly implemented, India could take leadership position in bancassurance all over the world

Government of India Notification dated August 3, 2000, specified 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949. Then onwards, banks are allowed to enter the insurance business as per the guidelines and after obtaining prior approval of Reserve Bank of India.

## Guidelines for Banks for Entry of banks into Insurance business

1.**Scheduled commercial bank would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation.** The subsidiaries of banks will also be allowed to undertake distribution of insurance product on agency basis.

2**. Banks which satisfy the eligibility criteria given below will be permitted to set up a joint venture company for undertaking insurance business with risk participation,** subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid-up capital of the insurance company. On a selective basis the Reserve Bank of India may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period (see Note 1 below). The eligibility criteria for joint venture participant are as under:-

(a) The net worth of the bank should not be less than Rs.500 crore;

(b) The CRAR of the bank should not be less than 10 per cent;

(c) The level of non-performing assets should be reasonable;

(d) The bank should have net profit for the last three consecutive years;

(e) The track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

3. In cases where a foreign partner contributes 26 per cent of the equity with the approval of Insurance Regulatory and Development Authority/Foreign Investment Promotion Board, **more than one public sector**

**bank or private sector bank may be allowed to participate in the equity of the insurance joint venture.** As such participants will also assume insurance risk, only those banks which satisfy the criteria given in paragraph 2 above, would be eligible.

**4. A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. S**ubsidiaries would include bank subsidiaries undertaking merchant banking, securities, mutual fund, leasing finance, housing finance business, etc.

5. **Banks which are not eligible as joint venture participant as above, can make investments up to 10% of the networth of the bank or Rs.50 crore, whichever is lower,** in the insurance company for providing infrastructure and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank. The eligibility criteria for these banks will be as under:

(i) The CRAR of the bank should not be less than 10%;

(ii)The level of NPAs should be reasonable;

(iii) The bank should have net profit for the last three consecutive years.

6. All banks entering into insurance business will be required to **obtain prior approval of the Reserve Bank.** The Reserve Bank will give permission to banks on case to case basis keeping in view all relevant factors including the position in regard to the level of non-performing assets of the applicant bank so as to ensure that non-performing assets do not pose any future threat to the bank in its present or the proposed line of activity, viz., insurance business. It should be ensured that risks involved in insurance business do not get transferred to the bank and that the banking business does not get contaminated by any risks which may arise from insurance business. There should be ‘arms length’ relationship between the bank and the insurance outfit.

Notes: -

1. Holding of equity by a promoter bank in an insurance company or participation in any form in insurance business will be subject to compliance with any rules and regulations laid down by the IRDA/Central Government. This will include compliance with Section 6AA of the Insurance Act as amended by the IRDA Act, 1999, for divestment of equity in excess of 26 per cent of the paid up capital within a prescribed period of time.

2. Latest audited balance sheet will be considered for reckoning the eligibility criteria.

3. Banks which make investments under paragraph 5 of the above guidelines, and later qualify for risk participation in insurance business (as per paragraph 2 of the guidelines) will be eligible to apply to the Reserve Bank for permission to undertake insurance business on risk participation basis.

## ULIPs

ULIP stands for unit linked insurance plans. ULIP is a combination of insurance and investment. Here policyholder can pay a premium monthly or annually. A small amount of the premium goes to secure life insurance and rest of the money is invested just like a mutual fund does. Policyholder goes on investing through the term of the policy – 5,10 or 15 years and accumulates the units. ULIP offers investors options that invest in equity and debt.

A unit linked insurance plan (ULIP) is a multi-faceted product issued by insurance companies that combine insurance coverage and investment exposure in a single offering. This product requires policyholders to make regular premium payments, part of which are utilized to provide insurance coverage, while the remaining portions are pooled with assets from other policyholders, then invested in equity and debt instruments, much like mutual funds.

A unit linked insurance plan can be utilized for various benefit payouts, including life insurance, retirement income, and education expenses. In most cases, an investor opens a ULIP to offer these types of provisions to his or her beneficiaries. With a life insurance ULIP, the beneficiary would receive payments following the owner’s death.

A unit linked insurance plan’s investment options are structured similar to that of mutual funds, in that they pool investments with those from other investors. As such, a ULIP's assets are managed with an eye towards accomplishing a specified investment objective. Investors can buy shares in a single strategy or diversify their investments across multiple market-linked ULIP funds.

Policyholders must commit an initial lump sum payment when they first buy into a ULIP, followed by annual, semi-annual, or monthly premium payments. Although the premium payment obligations vary from product to product, in all cases, they are proportionally invested towards a designated investment mandate. But ULIPs

are unique in that they offer flexibility to investors, who may adjust their fund preferences throughout the duration of their investment. For example, depending on their investment needs, they can shuttle between stock funds, bond funds, and diversified funds.

**5 Benefits of investing in ULIPs**

- **Freedom to choose your Life Cover:**

In Unit Linked insurance policies, you can choose the amount of Life Cover that you want. In most ULIPs, the minimum Life Cover offered is 10 times your annual premium amount. However, depending on the policy and the insurance company, you can select your Life Cover amount as much as 40 times of your annual premium or even higher.

- **Freedom to choose your investment type:**

There are two basic types of funds – Equity Funds, Debt Funds and a mix of both called the Balanced Funds. Equity funds include investments such as buying in shares of companies. Debt funds invest in debt instruments. Balanced funds are those funds that invest equal proportions of equity and debt funds.
ULIPs allow you to invest in different funds on the basis of your investment goals and risk appetite. For example, if you wish to grow your wealth and don't mind taking risk on your investment, you can invest in equity funds. Similarly if you wish to get steady returns on your investment, you can invest in debt funds.
In addition, you can also move your money between equity and debt funds by using an option called switch. Most insurance policies offer a number of free switches in a year, and for additional switches, a small fee is charged.

- **Liquidity:**

With Unit Linked insurance policies, you also get an option called partial withdrawal+, which allows you to withdraw a part of the money invested in your policy. This option helps you to take care of immediate expenses such as, your child's 10th, 12th or graduation fees, going on a family vacation, in case of emergencies, etc. Partial withdrawals are usually free of cost.

- **Goal based planning:**

ULIPs are structured to help you secure your key goals such as the potential for wealth creation, retirement planning or saving for your child's education. ULIPs also give you the added benefit of knowing that your premium is working towards securing your future goals.

- **Tax benefits:**

Under the Income Tax Act, 1961, you can save tax on your hard earned money by investing in a ULIP. You can get tax advantage at different stages of your life insurance policy.

**Stage 1:** Entry Advantage – You receive tax benefits^ on your premium payments, under the Sections 80C.

**Stage 2:** Exclusive Switching Advantage – You can make completely tax-free^ debt-equity switches

**Stage 3:** Exit Advantage – You also receive a tax free^ Maturity Benefit# subject to conditions of Section 10(10D)

## Endowment Plan

**Endowment plans** are a type of life insurance **policy**, which provides the combined benefit of insurance coverage and savings. **Endowment plan** helps the insured to save regularly over a particular time period in order to avail a lump-sum amount at the maturity of the **policy**.

A traditional insurance plan pays out a lump sum assured in the event of the death of the policyholder. The beneficiaries/dependents/nominees of the life insured receive a benefit (called a death benefit) if the worst should come to pass for the insurance holder. An endowment plan works the same way, but has an additional clause that states that a lump sum payment will be made to the insurance holder if he or she survives till the end of a specified period known as the "maturity period", "endowment policy term" or "survival term". There are variations to the payout clause in endowment policies – some companies have a lump sum payout on the detection of a critical illness, or other life changing events.

### Key Features of Endowment Policies:

- Sum assured in an **endowment policy** is payable either on survival to the term or on death occurring within the term.
- Endowment policies are available as 'With Profit' and 'Without Profit' plans.
- Under Endowment policies, bonus for the full term is payable on the date of maturity or in the event of death, whichever is earlier.
- Premiums for endowment policies can be limited to shorter term or can be paid as single premium.

- Premiums cease on death or on expiry of the term, whichever is earlier.

## Benefits of Endowment Policies:

Endowment policies carry plenty of benefits, a few of which are listed below:

- An endowment policy will provide insurance cover during the policy term.
- An endowment policy will pay out a sizeable lump sum amount at the end of the policy term i.e. once the policy has matured.
- An endowment policy works to serve a dual purpose. Not only does it work as an insurance policy but also serves as a long-term investment offering decent returns.
- Endowment policies come with tax benefits.
- In terms of investing, endowment policies are relatively safer than other types of investments and offer returns which are close to those offered by mutual funds.
- Endowment policies enable long-term savings.
- With an *endowment policy*, you can be assured of receiving a considerable amount upon maturity.
- Most will extend insurance coverage and the promise of benefits even after the maturity date, in some cases up to a time when the life insured attains the age of 100.
- Policy holders have the options of opting for additional riders which provide cover for specific illnesses, critical illnesses, disabilities, etc.

## How Do Endowment Policies Work?

Endowment policies are not very different from regular insurance policies. These policies, like insurance policies, not only provide cover to the life insured, but also help them save regularly over a specific period of time. Once the policy has matured and given that the policy holder has survived the policy term, they will receive a lump sum maturity amount which can be utilized for meeting financial needs like purchasing property, children’s education, organizing a wedding or preparing for one’s retirement.

## Are endowment plans for you?

The decision to take on an endowment plan must be well thought out and its benefits, returns on investment, etc. must be compared against those of similar investments.

If you are a healthy individual in need of life insurance cover and an investment that helps you save on tax in addition to giving you huge returns, you may choose to opt for a combination of financial products, or opt for a single endowment plan which does the same thing.

You may purchase a and invest in a separate mutual fund, etc. and expose yourself to the risks involved in a mutual fund investment. It's quite ideal for those with a high risk appetite. For those who find that their life savings are too valuable to leave to chance, an endowment life insurance policy is ideal.

An endowment policy is far less risky than a mutual fund investment, and also has ULIP options which invest in various equity and debt schemes. In addition to being a tax saving investment with guaranteed returns at the end of the term, it also provides comprehensive life insurance cover – which is a win-win situation for the investor (and his dependents).

There are arguments against endowment plans because the returns on investment are not as high as those offered by mutual fund, equity and debt related investments of similar amounts for similar tenures. Purchasing two separate financial products – one for a life insurance policy and one for a product directed to give you returns on investment will pay off better with a higher percentage of returns. That being said, it must be noted that while there are better options for returns on investments, endowment policies are first and foremost insurance policies. They just have the added benefit of giving you a return on the premium you've invested – on plan maturity.

Consider your risk appetite and requirement for life insurance cover before taking any major financial decision.

## Types of Endowment Policies:

There are 3 types of basic endowment policies which one can choose from.

- **Unit Linked Endowment** - Under Unit Linked policies, the insurance premiums are directed into multiple units held under a specific investment fund which can be chosen by the policyholders.
- **Full Endowment** – Under this policy, the basic amount ensured to be provided will be equal to the death benefit, right from the start of the policy. Depending on the speculated market-based appreciation, the final payout provided is comparatively higher.

- **Low Cost Endowment** – This endowment plan has been introduced with the intention of allowing individuals to accumulate the funds which have to be paid after a specified time period, usually mortgage.

## How to Choose an Endowment Policy?

Just like other insurance plans, the market is now flooded with different types of endowment policies. There are several factors which come into play, when it comes to choosing the right endowment insurance policy. Individual needs, current life stage, income and risk appetite are just a few factors to consider. Given that the premiums of endowment plans are pricier as compared to term plans, cost of premiums is also a deciding factor. After premium costs, another crucial factor to keep in mind is the insurance provider's track record in terms of the bonus payments. Beside these, some other factors to keep in mind would be the customer service provided by the insurer, their claim settlement ratio, financial status of the insurer, etc. when choosing an endowment policy, pick one which is simple and does not come with features and benefits which are difficult to comprehend and the finer details of the policy may get lost in the fine print.

## Documents Required:

In order to apply for an endowment policy, customers will mostly be required to submit basic documentation such as the following:

- Fully filled Application form/Proposal form.
- Photograph.
- Proof of residence / address proof.
- Proof of age.
- Medical reports (only if required).

## Endowment Policy Premium Calculator:

With the Endowment Plan Premium Calculator you can know the details like Premium amount, maturity value, surrender value, loan value and returns of the Policy. Endowment Policy Premium calculators will ask you to input information like your age, policy term and amount of sum assured. Using this information, the calculator will compute the premium which you will be required to pay towards your endowment policy.

**Riders For Endowment Policy:**

Most endowment policies offer add-ons to enhance the protection provided by the policy. Some of the riders commonly available with endowment policies are as follows.

- Critical illness
- Waiver of premium
- Accidental death and dismemberment
- Accelerated sum assured
- Partial and permanent disability
- Hospital cash

## Some Popular Endowment Plans In India:

### Reliance Endowment Plan

- Sum Assured plus vested bonuses on maturity, subject to 100.1% of premiums paid.
- Death benefit of 10 times the annualized premium or base Sum Assured plus vested bonuses. Either that, or 105% of all premiums paid.
- Policy term from 10 – 25 years.
- Loan against policy available

### Kotak Classic Endowment Plan

- A participating endowment plan providing coverage up to 75 years of the life insured.
- Yearly bonuses applicable from the first year.
- Wide range of term options.
- Tax benefits under Section 80C and 10(10D) of the Income Tax Act, 1961.
- Riders available to enhance protection.

### Kotak Premier Endowment Plan

- Receive 5% p.a. (simple) of basic Sum Assured as Guaranteed Additions during the first 5 policy years.

- Bonuses accrue from the 6th policy year onwards.
- Regular or limited premium paying term for 5, 7, 10 or 15 years for different term combinations.
- 7 additional riders available.

### LIC New Endowment Plan

- Minimum sum assured of Rs.1,00,000.
- Death benefit no less than 105% the total premiums paid.
- Death benefit is the higher of basic Sum Assured or 10 times the Annualized premium.
- Accidental death and disability rider available.

### Shriram Life Insurance - New Shri Life

- Life cover plus reversionary bonuses.
- Advance premium payment option with a discount.
- Additional protection available through riders.
- Minimum Sum Assured of Rs.50, 000.
- Monthly, quarterly, half yearly and annual modes of premium payment.

## Money Back Plan

A traditional insurance plan pays out a lump Sum Assured in the event of the death of the life insured. The beneficiaries / dependants / nominees of the life insured receive a benefit (called a death benefit) if the worst should come to pass for the insurance holder.

A **money back insurance plan** pays out the same maturity benefits in the form of several guaranteed “survival benefits" which are staggered evenly throughout the course of the policy. So, a money back insurance policy is an endowment plan with the benefit of regular liquidity.

## Why You Need To Buy a Money back Policy?

A money back policy provides periodic pay-outs, ensuring a steady source of income to help policyholders meet expenses at different stages during the policy duration.

*Money back policies* provide the benefits of an insurance policy as well as an investment, ensuring that the policy earns the policyholder an income instead of just merely providing a lump sum in case of his/her demise.

These plans offer a guaranteed return on investment as well as periodic pay-outs and insurance cover, making it an ideal plan for individuals looking for both protection as well as a source of income.

In addition to the standard life insurance offered by regular policies, a money back policy offers a policyholder a maturity benefit as well as a regular income in the form of 'survival benefits' for the duration of the policy.

A thus provides policyholders with a secure and assured return on investment in addition to providing them with an opportunity to grow their wealth through investment opportunities.

### How Does Money Back Policy Work?

A Money back policy is a type of that offers policyholders Survival Benefits as well as investment opportunities in addition to Maturity Benefits.

An average money back policy with a 20 year tenure would thus pay the policyholder what is known as a 'Survival Benefit' a few years after the start of the policy. Around 20% of the Sum Assured would be paid out periodically, while the balance would be paid out at the time of policy maturity with a bonus, if any.

In the event the insured individual does not survive till the policy maturation, the nominee would receive the Death Benefit (the entire Sum Assured) and the policy would be terminated.

### Features of Money Back Policy:

The money back policy has a number of distinct features that set it apart from other life insurance products, as mentioned below:

- Money back plans provide policyholders with low risk investment options as well as insurance coverage.
- The policies provide a regular source of income in the form of 'Survival Benefits' for the duration of the policy.
- In the event of the policyholder's demise during the policy term, the entire Sum Assured is paid out to the nominee irrespective of the amount already paid through the Survival Benefits.

## Money Back Life Insurance Benefits:

- Provides insurance cover during the policy term.
- Pays out regular benefits throughout the term.
- Works as an insurance policy as well as a long-term investment with good returns.
- Provides tax benefits.
- Less risky than other investments offering similar returns like mutual funds.
- Enables long-term savings and regular income.
- Ensures that amounts are disbursed regularly.
- Some plans extend the insurance coverage guaranteed death benefits even after the maturity date and the last survival period, up to when the life insured attains the age of 100.
- There are optional riders that cover things like specific illnesses, critical illnesses, disabilities, etc.

## How to Choose a Money Back Policy:

Choosing the right money back policy is key to ensuring individuals receive the maximum benefits from a particular policy.

When choosing a money back plan, individuals should look at the policy tenure. The average tenure for a money back policy is around 20 years.

As money back policies pay policyholders a Survival Benefit, prospective policyholders should ascertain the percentage of the Sum Assured that will be paid out in instalments. The amount should be enough to cover any expenses the policyholder might have.

The type of investments available through the investment component of the policy should be looked over. Policyholders should also verify the duration of the pay-outs being made over the course of the policy term as Survival Benefits. Some plans pay policyholders every 5 years, others have a different timeline depending on the policy tenure.

Policyholders should also check to see if the money back policy offers tax benefits. Some plans do not offer a tax benefit if 20% of the Sum Assured is being provided as Survival Benefit.

**Eligibility Criteria for Money Back Policy:**

Prospective policyholders should meet certain criteria to qualify for a money back policy. The eligibility criteria are broadly listed below:

- Policyholder should be above the minimum entry age and below the maximum entry age (varies from policy to policy).
- Policyholder should be able to pay the Sum Assured as per the policy guidelines.

**Documents Required for Money Back Policy:**

The documents required to apply for a money back policy are listed below:

- Proof of age document.
- Proof of address document.
- Application form duly filled in.
- Medical reports (if applicable).

**Money Back Policy Calculator:**

For the purpose of computing the premium amount as well as the benefits that will be accrued, a number of insurance companies provide individuals with policy calculators. These calculators can be used to approximate the returns as well as costs associated with the policy in question. The individual can then choose to apply for the policy after looking over the figures to see if they are in line with his/her requirements.

A money back policy calculator computes the average premium to be paid based on the policy tenure and the Sum Assured. Additional details such as the age of the policyholder are also factors considered for calculation.

On entering the figures, the calculator computes the maturity benefit payable at the time of policy maturity as well as the premium payable.

## Money Back Policy Riders:

Money back policies provide policyholders with the option to add cover that is not included in the original policy document in the form of riders. These riders cover additional possibilities such as accidental death, hospitalization expenses, permanent disability and critical illness to name a few.

The riders provided along with a money back policy differ from insurer to insurer and also depend on other variables such as the policy tenure.

A general list of riders that can be purchased along with a money back policy are given below:

- **Accidental Death Rider:** this rider provides coverage in case the policyholder meets with an accidental death as outlines in the rider guidelines. In such a scenario, the policyholder's beneficiaries/nominees will receive a lump sum as additional benefit.
- **Term Rider:** this rider provides the policyholder with a waiver from paying the premium amount under certain circumstances but still provides coverage to the policyholder.
- **Critical Illness Rider:** this rider provides the policyholder with financial assistance in the event he/she contracts a critical illness as defined by the rider.
- **Hospitalization Rider:** this rider provides the policyholder with assistance in paying hospital bills in the event the policyholder is hospitalized. A daily allowance is issued to the policyholder to cover expenses related to treatment.

## Popular Money Back Plans by Insurers

### 1. LIC Money Back With Profit

**Feature and Benefits:**

- Comprehensive life insurance cover against death.
- The amount payable on death is the Sum Assured plus all bonuses, as a lump sum, irrespective of all survival benefits paid earlier.
- With-profit plan which participates in the profits of LIC's life insurance business.
- Surrender Values are available.

## 2. Popular LIC Money Back Plans

- LIC Money Back Plan 20 Years
- LIC Bima Bachat

## 3. HDFC Life Super Income Plan – Money Back policy

**Feature and Benefits:**

- Limited premium paying terms of 8, 10 or 12 years.
- Guaranteed yearly income, for 8, 10, 12 or 15 years.
- Coverage against death throughout premium paying term and pay out period.
- No need for medical tests on the completion of a short medical questionnaire.
- Regular income at the rate of 8.0% to 12.5% of the Sum Assured on Maturity, payable yearly.

## 4. SBI Life – Smart Money Back Gold

**Feature and Benefits:**

- Survival benefits of 110% of the Sum Assured paid till maturity.
- 4 term options – 12, 15, 20 and 25 years.
- Monthly, quarterly, half yearly and yearly premium paying modes.
- 4 riders available:
  - SBI Life – Accidental Death Benefit Rider.
  - SBI Life – Accidental Total and Permanent Disability Rider.
  - SBI Life – Preferred Term Rider.
  - SBI Life – Criti Care 13 Non-Linked Rider.
  - Tax benefits.

## 5. Birla Sun Life Insurance Bachat Money Back Plan

**Feature and Benefits:**

- Monthly base premium amount can be chosen from these bands:
  - Band 1 – Rs.400 to Rs.599, per month.
  - Band 3 – Rs.600 to Rs.800, per month.
  - Band 4 – Rs.900 and above, per month.
- Annual and semi-annual modes of premium payment entitles you to rebates of 2% and 4% respectively.
- Survival benefit of 20% of the monthly base premium paid out on the 5th, 10th and 15th policy anniversaries.
- Maturity benefit payable after 20 years of the policy term includes
  - All monthly base premiums paid, plus
  - All Bachat addition earned, plus
  - Loyalty additions, minus
  - All Survival Benefits paid.
- Death benefit includes:
  - All monthly base premiums paid (or Sum Assured, whichever is higher), plus
  - All Bachat addition earned, plus
  - Loyalty additions, minus
  - All Survival Benefits paid.

## 6. Reliance Super Money Back Plan

- Money back benefits paid every 5 policy years, until maturity.
- Increasing regular monthly income.
- Loyalty addition payable at the end of the premium paying term.
- Maturity addition payable at the end of the policy term.
- Policy term options of 10, 20, 30, 40 and 50 years.
- Premium paying term only half of the policy term.
- Monthly, quarterly, semi-annual and yearly premium paying modes.

# MODULE- II

# Money Market

**Features of Money Market:**

Money market is a market for short-term funds. We define the short-term as a period of 364 days or less. In other words, the borrowing and repayment take place in 364 days or less. The manufacturers need two types of finance: finance to meet daily expenses like purchase of raw material, payment of wages, excise duty, electricity charges etc., and finance to meet capital expenditure like purchase of machinery, installation of pollution control equipment etc.

The first category of finance is invested in the production process for a short-period of time. The market where such short-time finance is borrowed and lent is called 'money market'. Almost every concern in the financial system, be it a financial institution, business firm, a corporation or a government body, has a recurring problem of liquidity management, mainly because the timing of the expenditures rarely synchronize with that of the receipts.

**Following are the features of money market:**

1. Money market has no geographical constraints as that of a stock exchange. The financial institutions dealing in monetary assets may be spread over a wide geographical area.

2. Even though there are various centers of money market such as Mumbai, Calcutta, Chennai, etc., they are not separate independent markets but are inter-linked and interrelated.

3. It relates to all dealings in money or monetary assets.

4. It is a market purely for short-term funds.

5. It is not a single homogeneous market. There are various sub-markets such as Call money market, Bill market, etc.

6. Money market establishes a link between RBI and banks and provides information of monetary policy and management.

7. Transactions can be conducted without the help of brokers.

8. Variety of instruments are traded in money market.

**Objectives of Money Market:**

**Following are the objectives of money market:**

1. To cater to the requirements of borrowers for short term funds, and provide liquidity to the lenders of these funds.

2. To provide parking place for temporary employment of surplus fund.

3. To provide facility to overcome short term deficits.

4. To enable the central bank to influence and regulate liquidity in the economy.

5. To help the government to implement its monetary policy through open market operation.

## Importance of money market

**Money market provides short-term funds:**

The money market provides short-term funds by which working capital is available to manufacturers and agriculturists. This leads to more production in the country. Without the short-term funds, production will come to a standstill which will affect development in the country.

**Money market provides opportunity for more commercial banks:**

Commercial banks provide the major source of short-term funds. They earn profit due to the difference in interest rate between lending and borrowing. So, it provides opportunity for more commercial banks to operate in the economy.

**Money market helps growth of investments:**

The presence of commercial banks promotes savings in the country and thereby it channelizes the funds for investments. Thus, money market helps growth of investments in the country. Foreign trade, apart from domestic trade is also promoted by money market. The exporter need not wait for the receipt of money for exports as he can discount the bills with the commercial banks.

## Composition of Money Market

There are two sets of people in the money market. One is the **borrower** and other is the **lender**.

**Who are the borrowers in money market?**

Borrowers in money market consists of Government (the biggest borrower), Agriculturists (for meeting cost of cultivation), Traders, Businessmen, Commercial Banks and Non-Banking financial companies (NBFCs)

**Who are the lenders in money market?**

Lenders in money market includes Central Banks, Commercial banks, Co-operative banks, Foreign banks, Commercial house, Non-banking financial companies (Chit companies, Nidhis, Benefit societies, finance companies, factoring companies), Money lenders and indigenous bankers.

Commercial banks and non banking financial companies are found both on the borrowing side as well as on the lending side. The commercial banks borrow from the Central bank and then lend to the businessmen. Non banking financial companies borrow from the public or accept deposits from the public and finance others' activities.

### Structure of Indian Money Market:

(i) Broadly speaking, the money market in India comprises two sectors- (a) Organised sector, and (b) Unorganised sector.

(ii) The organised sector consists of the Reserve Bank of India, the State Bank of India with its seven associates, twenty nationalised commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and Regional Rural Banks. It is called organised because its part is systematically coordinated by the RBI.

(iii) Non-bank financial institutions such as the LIC, the GIC and subsidiaries, the UTI also operate in this market, but only indirectly through banks, and not directly.

(iv) Quasi-government bodies and large companies also make their short-term surplus funds available to the organized market through banks.

(v) Cooperative credit institutions occupy the intermediary position between organised and unorganised parts of the Indian money market. These institutions have a three-tier structure. At the top, there are state cooperative banks. At the local level, there are primary credit societies and urban cooperative banks. Considering the size, methods of operations, and dealings with the RBI and commercial banks, only state and central, cooperative banks should be included in the organised sector. The cooperative societies at the local level are loosely linked with it.

(vi) The unorganised sector consists of indigenous banks and money lenders. It is unorganised because activities of its parts are not systematically coordinated by the RBI.

(vii) The money lenders operate throughout the country, but without any link among themselves.

(viii) Indigenous banks are somewhat better organised because they enjoy rediscount facilities from the commercial banks which, in turn, have link with the RBI. But this type of organisation represents only a loose link with the RBI.

**Constituents of Indian Money Market:**

Money market is a centre where short-term funds are supplied and demanded. Thus, the main constituents of money market are the lenders who supply and the borrowers who demand short-term credit.

**I. Supply of Funds:**

**There are two main sources of supply of short-term funds in the Indian money market:**

(a) Unorganised indigenous sector, and

(b) Organised modern sector.

**(i) Unorganized Sector:**

The unorganised sector comprises numerous indigenous bankers and village money lenders. It is unorganized because its activities are not controlled and coordinated by the Reserve Bank of India.

**(ii) Organized Sector:**

**The organized modern sector of Indian money market comprises:**

(a) The Reserve Bank of India;

(b) The State Bank of India and its associate banks;

(c) The Indian joint stock commercial banks (scheduled and non-scheduled) of which 20 scheduled banks have been nationalised;

(d) The exchange banks which mainly finance Indian foreign trade;

(e) Cooperative banks;

(f) Other special institutions, such as, Industrial Development Bank of India, State Finance Corporations, National Bank for Agriculture and Rural Development, Export-Import Bank, etc., which operate in the money market indirectly through banks; and

(g) Quasi-government bodies and large companies also make their funds available to the money market through banks.

**II. Demand for Funds:**

In the Indian money market, the main borrowers of short-term funds are: (a) Central Government, (b) State Governments, (c) Local bodies, such as, municipalities, village panchayats, etc., (d) traders, industrialists, farmers, exporters and importers, and (e) general public.

**Sub-Markets of Organised Money Market:**

**The organised sector of Indian money market can be further classified into the following sub-markets:**

## A. Call Money Market:

The most important component of organised money market is the call money market. It deals in call loans or call money granted for one day. Since the participants in the call money market are mostly banks, it is also called interbank call money market.

The banks with temporary deficit of funds form the demand side and the banks with temporary excess of funds form the supply side of the call money market.

**The main features of Indian call money market are as follows:**

(i) Call money market provides the institutional arrangement for making the temporary surplus of some banks available to other banks which are temporary in short of funds.

(ii) Mainly the banks participate in the call money market. The State Bank of India is always on the lenders' side of the market.

(iii) The call money market operates through brokers who always keep in touch with banks and establish a link between the borrowing and lending banks.

(iv) The call money market is highly sensitive and competitive market. As such, it acts as the best indicator of the liquidity position of the organised money market.

(v) The rate of interest in the call money market is highly unstable. It quickly rises under the pressures of excess demand for funds and quickly falls under the pressures of excess supply of funds.

(vi) The call money market plays a vital role in removing the day-to-day fluctuations in the reserve position of the individual banks and improving the functioning of the banking system in the country.

## B. Treasury Bill Market:

The treasury bill market deals in treasury bills which are the short-term (i.e., 91, 182 and 364 days) liability of the Government of India. Theoretically these bills are issued to meet the short-term financial requirements of the government.

But, in reality, they have become a permanent source of funds to the government. Every year, a portion of treasury bills are converted into long-term bonds. Treasury bills are of two types: ad hoc and regular.

Ad hoc treasury bills are issued to the state governments, semi- government departments and foreign central banks. They are not sold to the banks and the general public, and are not marketable.

The regular treasury bills are sold to the banks and public and are freely marketable. Both types of ad hoc and regular treasury bills are sold by Reserve Bank of India on behalf of the Central Government.

The treasury bill market in India is underdeveloped as compared to the treasury bill markets in the U.S.A. and the U.K.

**In the U.S.A. and the U.K., the treasury bills are the most important money market instrument:**

(a) Treasury bills provide a risk-free, profitable and highly liquid investment outlet for short-term, surpluses of various financial institutions;

(b) Treasury bills from an important source of raising fund for the government; and

(c) For the central bank the treasury bills are the main instrument of open market operations.

On the contrary, the Indian Treasury bill market has no dealers expect the Reserve Bank of India. Besides the Reserve Bank, some treasury bills are held by commercial banks, state government and semi-government bodies. But, these treasury bills are not popular with the non-bank financial institutions, corporations, and individuals mainly because of absence of a developed treasury bill market.

**C. Commercial Bill Market:**

Commercial bill market deals in commercial bills issued by the firms engaged in business. These bills are generally of three months maturity. A commercial bill is a promise to pay a specified amount in a specified period by the buyer of goods to the seller of the goods. The seller, who has sold his goods on credit draws the bill and sends it to the buyer for acceptance. After the buyer or his bank writes the word ‘accepted’ on the bill, it becomes a marketable instrument and is sent to the seller.

The seller can now sell the bill (i.e., get it discounted) to his bank for cash. In times of financial crisis, the bank can sell the bills to other banks or get them rediscounted from the Reserved Bank. In India, the bill market is undeveloped as compared to the same in advanced countries like the U.K. There is absence of specialised institutions like acceptance houses and discount houses, particularly dealing in acceptance and discounting business.

**D. Collateral Loan Market:**

Collateral loan market deals with collateral loans i.e., loans backed by security. In the Indian collateral loan market, the commercial banks provide short- term loans against government securities, shares and debentures of the government, etc.

**E. Certificate of Deposit and Commercial Paper Markets:**

Certificate of Deposit (CD) and Commercial Paper (CP) markets deal with certificates of deposit and commercial papers. These two instruments (CD and CP) were introduced by Reserve Bank of India in March 1989 in order to widen the range of money market instruments and give investors greater flexibility in the deployment of their short-term surplus funds.

## Instruments of money Market:

The short-term funds are borrowed by manufacturers, industrialists, traders, businessmen and even by government which issue credit instruments. These are cheques, bills, promissory notes, commercial paper, treasury bills and short-dated Government Bonds. These are called near money. Near money is one which has claim over money and is convertible into money.

- **The bills**, consisting of treasury bills are issued by the government.
- **Trade bill**, issued by the traders arising out of trade transactions.
- **Finance bill,** issued by businessmen for raising short-term funds for business transactions.
- **Treasury bills** are issued at discount by the Government when it requires temporary loans after calling for tenders, and usually payable in full after 3 months.
- **Foreign bills** arising out of foreign transactions either in the form of trade or executing any projects in foreign country.

Commercial paper is one which is issued by a leading commercial house and it will enable businessmen to borrow money in the market. These commercial papers carry credit worthiness, due to the commercial house which is issuing the commercial paper. Short dated bonds are issued either by government or by quasi government institutions for the purpose of raising short-term funds.

**Promissory Note:**

A promissory note is one of the earliest type of bills. It is a financial instrument with a written promise by one party, to pay to another party, a definite sum of money by demand or at a specified future date, although it falls in due for payment after 90 days within three days of grace. However, Promissory notes are usually not used in the business, but USA is an exception.

**Bills of exchange or commercial bills**

The bills of exchange can be compared to the promissory note; besides it is drawn by the creditor and is accepted by the bank of the debater. The bill of exchange can be discounted by the creditor with a bank or a broker. Additionally, there is a foreign bill of exchange which becomes due for payment from the date of acceptance. However, the remaining procedure is the same for the internal bills of exchange.

**Treasury Bills (T-Bills)**

- The Treasury bills are issued by the Central Government and known to be one of the safest money market instruments available. Besides, they carry zero risk, so the returns are not attractive. Also, they come with different maturity periods like 1 year, 6 months or 3 months and are also circulated by primary and secondary markets. The central government issues them at a lesser price than their face-value.
- The difference of maturity value of the instrument and the buying price of the bill, which is decided with the help of bidding done via auctions, is basically the interest earned by the buyer.
- There are three types of treasury bills issued by the Government of India currently that is through auctions which are 91-day, 182-day and 364-day treasury bills.

**Call and Notice Money**

Call and Notice Money exist in the market. With respect to Call Money, the funds are borrowed and lent for one day, whereas in the Notice Market, they are borrowed and lent up to 14 days, without any collateral security. The commercial banks and cooperative banks borrow and lend funds in this market. However, the all-India financial institutions and mutual funds only participate as lenders of funds.

**Inter-bank Term Market**

The inter-bank term market is for the cooperative and commercial banks in India who borrow and lend funds for a period of over 14 days and up to 90 days. This is done without any collateral security at the rates determined by markets.

**Commercial Papers (CPs)**

- Commercial papers can be compared to an unsecured short-term promissory note which is issued by top rated companies with a purpose of raising capital to meet requirements directly from the market.
- They usually have a fixed maturity period which can range anywhere from 1 day up to 270 days.
- They offer higher returns as compared to treasury bills. They are automatically not as secure in comparison. Also, Commercial papers are traded actively in secondary market.

**Certificate of Deposits ( CD's )**

- This functions as a deposit receipt for money which is deposited with a financial organization or bank. The Certificate of Deposit is different from a Fixed Deposit receipt in two ways. i. Certificate of deposits are issued only of the sum of money is huge. ii. Certificate of deposit is freely negotiable.
- The RBI first announced in 1989 that the Certificate of Investments have become the most preferred choice of organization in terms of investments as they carry low risk whilst providing high interest rates than the Treasury bills and term deposits.
- CD's are also issued at discounted price like the Treasury bills and they range between a span of 7 days up to 1 year.
- The Certificate of Deposit issued by banks range from 3 months, 6 months and 12 months.
- Note: CD's can be issued to individuals (except minors), companies, corporations, funds, non–resident Indians, etc.

**Banker's Acceptance (BA)**

- A Banker's Acceptance is a document that promises future payment which is guaranteed by a commercial bank. Also, it is used in money market funds and will specify the details of repayment like the date of repayment, amount to be paid, and details of the individual to which the repayment is due.
- BA's features maturity periods that range between 30 days up to 180 days.

**Repurchase Agreements (Repo)**

- Repo's are also known as Reverse Repo or as Repo. They are loans of short duration which are agreed by buyers and sellers for the purpose of selling and repurchasing.
- However, these transactions can be carried out between RBI approved parties.
- Note: Transactions can only be permitted between securities approved by RBI like the central or state government securities, treasury bills, central or state government securities, and PSU bonds.

## Players and Institutions of Money Market

A large number of borrowers and lenders make up the money market.

**Some of the important players are listed below:**

**1. Central Government:**

Central Government is a borrower in the money market through the issue of Treasury Bills (T-Bills). The T-Bills are issued through the RBI. The T-Bills represent zero risk instruments. They are issued with tenure of 91 days (3 months), 182 days (6 months) and 364 days (1 year). Due to its risk free nature, banks, corporates and many such institutions buy the T-Bills and lend to the government as a part of it short- term borrowing programme.

**2. Public Sector Undertakings:**

Many government companies have their shares listed on stock exchanges. As listed companies, they can issue commercial paper in order to obtain its working capital finance. The PSUs are only borrowers in the money market. They seldom lend their surplus due to the bureaucratic mindset. The treasury operations of the PSUs are very inefficient with huge cash surplus remaining idle for a long period of time.

**3. Insurance Companies:**

Both general and life insurance companies are usual lenders in the money market. Being cash surplus entities, they do not borrow in the money market. With the introduction of CBLO (Collateralized Borrowing and Lending Obligations), they have become big investors. In between capital market instruments and money market instruments, insurance companies invest more in capital market instruments. As their lending programmes are for very long periods, their role in the money market is a little less.

**4. Mutual Funds:**

Mutual funds offer varieties of schemes for the different investment objectives of the public. There are many schemes known as Money Market Mutual Fund Schemes or Liquid Schemes. These schemes have the investment objective of investing in money market instruments.

They ensure highest liquidity to the investors by offering withdrawal by way of a day's notice or encashment of units through Bank ATMs. Naturally, mutual funds invest the corpus of such schemes only in money market. They do not borrow, but only lend or invest in the money market.

**5. Banks:**

Scheduled commercial banks are very big borrowers and lenders in the money market. They borrow and lend in call money market, short-notice market, repo and reverse repo market. They borrow in rediscounting market from the RBI and IDBI. They lend in commercial paper market by way of buying the commercial papers issued by corporates and listed public sector units. They also borrow through issue of Certificate of Deposits to the corporates.

**6. Corporates:**

Corporates borrow by issuing commercial papers which are nothing but short-term promissory notes. They are issued by listed companies after obtaining the necessary credit rating for the CP. They also lend in the CBLO market their temporary surplus, when the interest rate rules very high in the market. They are the lender to the banks when they buy the Certificate of Deposit issued by the banks. In addition, they are the lenders through purchase of Treasury bills.

There are many other small players like non-banking finance companies, primary dealers, provident funds and pension funds. They mainly invest and borrow in the CBLO market in a small way.

# Capital Market

## Concept and Meaning of Capital Market

Capital Market is one of the significant aspect of every financial market. Hence it is necessary to study its correct meaning. Broadly speaking the capital market is a market for financial assets which have a long or indefinite maturity. Unlike money market instruments the capital market instruments become mature for the period above one year. It is an institutional arrangement to borrow and lend money for a longer period of time. It consists of financial institutions like IDBI, ICICI, UTI, LIC, etc. These institutions play the role of lenders in the capital market. Business units and corporate are the borrowers in the capital market. Capital market involves various instruments which can be used for financial transactions. Capital market provides long term debt and equity finance for the government and the corporate sector. Capital market can be classified into primary and secondary markets. The primary market is a market for new shares, where as in the secondary market the existing securities are traded. Capital market institutions provide rupee loans, foreign exchange loans, consultancy services and underwriting.

## Significance, Role or Functions of Capital Market

Like the money market capital market is also very important. It plays a significant role in the national economy. A developed, dynamic and vibrant capital market can immensely contribute for speedy economic growth and development.

Let us get acquainted with the important functions and role of the capital market.

1. **Mobilization of Savings** : Capital market is an important source for mobilizing idle savings from the economy. It mobilizes funds from people for further investments in the productive channels of an economy. In that sense it activates the ideal monetary resources and puts them in proper investments.
2. **Capital Formation** : Capital market helps in capital formation. Capital formation is net addition to the existing stock of capital in the economy. Through mobilization of ideal resources it generates savings; the mobilized savings are made available to various segments such as agriculture, industry, etc. This helps in increasing capital formation.
3. **Provision of Investment Avenue** : Capital market raises resources for longer periods of time. Thus it provides an investment avenue for people who wish to invest resources for a long period of time. It provides suitable interest rate returns also to investors. Instruments such as bonds, equities, units of mutual funds, insurance policies, etc. definitely provides diverse investment avenue for the public.
4. **Speed up Economic Growth and Development** : Capital market enhances production and productivity in the national economy. As it makes funds available for long period of time, the financial requirements of business houses are met by the capital market. It helps in research and development. This helps in, increasing production and productivity in economy by generation of employment and development of infrastructure.
5. **Proper Regulation of Funds** : Capital markets not only helps in fund mobilization, but it also helps in proper allocation of these resources. It can have regulation over the resources so that it can direct funds in a qualitative manner.
6. **Service Provision** : As an important financial set up capital market provides various types of services. It includes long term and medium term loans to industry, underwriting services, consultancy services, export finance, etc. These services help the manufacturing sector in a large spectrum.
7. **Continuous Availability of Funds** : Capital market is place where the investment avenue is continuously available for long term investment. This is a liquid market as it makes fund available on continues basis. Both buyers and seller can easily buy and sell securities as they are continuously available. Basically capital market transactions are related to the stock exchanges. Thus marketability in the capital market becomes easy.

These are the important functions of the capital market.

# Primary Market

## Functions of Primary Market

The main function of the New Issue Market is to facilitate the 'transfer of resources' from savers to users. Conceptually, however, the New Issue Market should not be conceived as a platform only for the purpose of raising finance for new capital expenditure.

In fact, the facilities of the market are also utilized for selling existing concerns to the public as going concerns through conversions of existing proprietary enterprises or private companies into public companies.

It, therefore, becomes imperative at this stage to classify new issues. One classification suggested by R.F. Henderson (c.f. The New Issue Market & Finance for Industry, 1951), categorises new issues into those by:

(a) New companies also called 'initial issues' and

(b) Old companies also called 'further issues'.

These bear no relation to the age of the company, but are based on the fact whether the company already has stock exchange listing. This classification is thus concerned only with the flow of 'new money'. Another classification (c.f. Merrett, Howe & New bould "Equity Issues and the London Capital Market" 1967) distinguishes between flow of funds into the market and flow of "new money" hence we have 'new money issues' or issues of capital involving newly created share and 'no new money issues' i.e. sale of securities already in existence and sold by their holders.

This is more an "exclusive" classification in that two types of issues are excluded from the category of new issues.

(a) Bonus/capitalisation issues which represent only book keeping entries.

(b) Exchange issues: by which shares in one company are/exchanged for securities of another.

Now, the main function of the New Issue Market, i.e. channelling of investible funds, can be divided, from the operational stand-point, into a triple-service function:

(a) Origination

(b) Underwriting

(c) Distribution

The institutional setup dealing with these can be said to constitute the New Issue Market organisation. Let us elucidate a little on all of these.

**(a) Origination :**

Origination refers to the work of investigation and analysis and processing of new proposals. This in turn may be:

(i) A preliminary investigation undertaken by the sponsors (specialised agencies) of the issue. This involves a/careful study of the technical, economic, financial and/legal aspects of the issuing companies to ensure that/it warrants the backing of the issue house.

(ii) Services of an advisory nature which go to improve the quality of capital issues. These services include/advice on such aspects of capital issues as: determination of the class of security to be/issued and price of the issue in terms of market conditions; the timing and magnitude of issues; method of flotation; and technique of selling and so on.

The importance of the specialised services provided by the New Issue Market organisation in this respect can hardly be over-emphasized. On the thoroughness of investigation and soundness of judgement of the sponsoring institution depends, to a large extent, the allocative efficiency of the market. The origination, however, thoroughly done, will not by itself guarantee success of an issue. A second specialised service i.e. “Underwriting” is often required.

**(b) Underwriting:**

The idea of underwriting originated on account of uncertainties prevailing in the capital market as a result of which the success of the issue becomes unpredictable. If the issue remains undersubscribed, the directors

cannot proceed to allot the shares, and have to return money to the applicants if the subscription is below a minimum amount fixed under the Companies Act. Consequently, the issue and hence the project will fail.

Underwriting entails an agreement whereby a person/organization agrees to take a specified number of shares or debentures or a specified amount of stock offered to the public in the event of the public not subscribing to it, in consideration of a commission the underwriting commission.

If the issue is fully subscribed by the public, there is no liability attaching to the underwriters; else they have to come forth to meet the shortfall to the extent of the under- subscription. The underwriters in India may broadly be classified into the following two types:

(i) Institutional Underwriters;

(ii) Non-Institutional Underwriting.

Institutional Underwriting in our country has been development oriented. It stands as a major support to those projects which often fail to catch the eye of investing public. These projects rank high from the points of view of national importance e.g. steel, fertilizer, and generally receive higher priority by such underwriters.

Thus institutional underwriting may be broadly recognised, in the context of development credit, as playing a decisive role in directing the economic resources of the country towards desired activities.

This does not mean that they are barred entrance in the issue market from so called glamorous issues to which public can be expected to readily subscribe. They may be underwriting in such cases, but what is expected of them is their support to projects in the priority sector.

One of the principal advantages they offer is that resource-wise they are undoubted. They are in a position to fulfill their underwriting commitments even in the worst foreseeable situations.

The public financial institutions namely IDBI, IFCI, ICICI, LIC and UTI, underwrite a portion of the issued capital. Usually, the underwriting is done in addition to granting term finance by way of loans on debentures. These institutions are usually approached when one or more of the following situations prevail:

(i) The issue is so large that broker-underwriting may not be able to cover the entire issue.

(ii) The gestation period is long enough to act as distinctive

(iii) The project is weak, inasmuch as it is being located in a backward area.

(iv) The project is in the priority sector which may not be able to provide an attractive return on investment.

(v) The project is promoted by technicians.

(vi) The project is new to the market.

The quantum of underwriting assistance varies from institution to institution according to the commitments of each of them for a particular industry.

However, institutional underwriting suffers from the following two drawbacks:

1. The institutional handling involves procedural delays which sometimes dampen the initiative of the corporate managers or promoters.

2. The other disadvantage is that the institutions prefer to wait and watch the results to fulfill their obligations only where they are called upon to meet the deficit caused by under subscription.

**(c) Distribution :**

The sale of securities to the ultimate investors is referred to as distribution; it is another specialised job, which can be performed by brokers and dealers in securities who maintain regular and direct contact with the ultimate investors. The ability of the New Issue Market to cope with the growing requirements of the expanding corporate sector would depend on this triple-service function.

## IPO

**Initial public offering** (**IPO**) or **stock market launch** is a type of public offering in which shares of a company are sold to institutional investors and usually also retail (individual) investors. An IPO is underwritten by one or more investment banks, who also arrange for the shares to be listed on one or more stock exchanges. Through this process, colloquially known as *floating*, or *going public*, a privately held company is transformed into a public company. Initial public offerings can be used to raise new equity capital for companies, to monetize the

investments of private shareholders such as company founders or private equity investors, and to enable easy trading of existing holdings or future capital raising by becoming publicly traded.

After the IPO, shares are traded freely in the open market at what is known as the free float. Stock exchanges stipulate a minimum free float both in absolute terms (the total value as determined by the share price multiplied by the number of shares sold to the public) and as a proportion of the total share capital (i.e., the number of shares sold to the public divided by the total shares outstanding). Although IPO offers many benefits, there are also significant costs involved, chiefly those associated with the process such as banking and legal fees, and the ongoing requirement to disclose important and sometimes sensitive information.

Details of the proposed offering are disclosed to potential purchasers in the form of a lengthy document known as a prospectus. Most companies undertake an IPO with the assistance of an investment banking firm acting in the capacity of an underwriter. Underwriters provide several services, including help with correctly assessing the value of shares (share price) and establishing a public market for shares (initial sale).

## SEBI Guidelines for IPO

11A.1 A company proposing to issue capital to public through the on-line system of the stock exchange for offer of securities shall comply with the requirements as contained in this Chapter in addition to other requirements for public issues as given in these Guidelines, wherever applicable.

11A.2. **Agreement with the Stock exchange.**

11A.2.1 The company shall enter into an agreement with the Stock Exchange(s) which have the requisite system of on-line offer of securities.

Provided that, where the Regional Stock Exchange has the requisite system of on-line offer of securities, the company shall also, enter into an agreement with the Regional Stock Exchange for offering securities to public through on-line system.

11A.2.2 The agreement mentioned in the above clause shall specify inter-alia, the rights, duties, responsibilities and obligations of the company and stock exchange (s) inter se. The agreement may also provide for a dispute resolution mechanism between the company and the stock exchange.

11A.3 **Appointment of Brokers**

11A.3.1 The stock exchange, shall appoint brokers of the exchange, who are registered with SEBI, for the purpose of accepting applications and placing orders with the company.

11A.3.2 For the purposes of this Chapter, the brokers, so appointed accepting applications and application monies, shall be considered as 'collection centres'.

11A.3.3. The broker/s so appointed, shall collect the money from his/their client for every order placed by him/them and in case the client fails to pay for shares allocated as per the Guidelines, the broker shall pay such amount.

11A.3.4 The company/lead manager shall ensure that the brokers having terminals are appointed in compliance with the requirement of mandatory collection centres, as specified in clause 5.9 of Chapter V of the Guidelines.

11A.3.5 The company/lead manager shall ensure that the brokers so appointed are financially capable of honoring their commitments arising out of defaults of their clients, if any.

11A.3.6. The company shall pay to the broker/s a commission/fee for the services rendered by him/them. The exchange shall ensure that the broker does not levy a service fee on his clients in lieu of his services.

**11A.4 Appointment of Registrar to the Issue**

11A.4.1 The Company shall appoint a Registrar to the Issue having electronic connectivity with the Stock Exchange/s through which the securities are offered under the system.

**11A.5 Listing**

11A.5.1 Subject to the requirement of listing on the Regional Stock Exchange, the company may apply for listing of its securities on an exchange other than the exchange through which it offers its securities to public through the on-line system.

11A.6. **Responsibility of the Lead Manager**

11A.6.1 The Lead Manger shall be responsible for co-ordination of all the activities amongst various intermediaries connected in the issue / system.

11A.6.2 The names of brokers appointed for the issue alongwith the names of the other intermediaries namely Lead managers to the issue and Registrars to the Issue shall be disclosed in the prospectus and application form.

11A.7 **Mode of operation**

11A.7.1. The company shall, after filing the offer document with ROC and before opening of the issue, make an issue advertisement in one English and one Hindi daily with nationwide circulation, and one regional daily with wide circulation at the place where the registered office of the issuer company is situated.

11A.7.2 the advertisement shall contain the salient features of the offer document as specified in Form 2A of the Companies (Central Governments) General Rules and Forms, 1956. The advertisement in addition to other required information shall also contain the following:

i.

- i. the date of opening and closing of the issue
- ii. the method and process of application and allotment
- iii. the names, addresses and the telephone numbers of the stock brokers and centres for accepting the applications.

11A.7.3 During the period the issue is open to the public for subscription, the applicants may

a. approach the brokers of the stock exchange/s through which the securities are offered under on-line system, to place an order for subscribing to the securities. Every broker shall accept orders from all clients who place orders through him;
b. directly send the application form alongwith the cheque/Demand Draft for the sum payable towards application money to the Registrar to the Issue or place the order to subscribe through a stock- broker under the on-line system.

11A.7.4 In case of issue of capital of Rs. 10 crores or above the Registrar to the Issue shall open centres for collection of direct applications at the four metropolitan centres situated at Delhi, Chennai, Calcutta and Mumbai.

11A.7.5 The broker shall collect the client registration form duly filled up and signed from the applicants before placing the order in the system as per "Know your client rule" as specified by SEBI and as may be modified from time to time.

11A.7.6 The broker shall, thereafter, enter the buy order in the system, on behalf of the clients and enter details including the name, address, telephone number and category of the applicant, the number of shares applied for, beneficiary ID, DP code etc. and give an order number/order confirmation slip to the applicant.

11A.7.7 The applicant may withdraw applications in terms of the Companies Act, 1956.

11A.7.8 The broker may collect an amount to the extent of 100% of the application money as margin money from the clients before he places an order on their behalf.

11A.7.9 The broker shall open a separate bank account [Escrow Account] with the clearing house bank for primary market issues and the amount collected by the broker from his clients as margin money shall be deposited in this account.

11A.7.10 The broker shall, at the end of each day while the issue is open for subscription, download/forward the order data to the Registrar to the Issue on a daily basis. This data shall consist of only valid orders (excluding those that are cancelled). On the date of closure of the issue, the final status of orders received shall be sent to the Registrar to the issue/company.

11A.7.11 On the closure of the issue, the Regional Stock Exchange, alongwith the Lead merchant banker and Registrars to the Issue shall ensure that the basis of allocation is finalised in fair and proper manner on the lines of the norms with respect to basis of allotment as specified in Chapter VII of the Guidelines, as may be modified from time to time.

11A.7.12 After finalization of basis of allocation, the Registrar to the Issue/company shall send the computer file containing the allocation details i.e. the allocation numbers, allocated quantity etc., of successful applicants to the Exchange. The Exchange shall process and generate the broker-wise funds pay-in obligation and shall send the file containing the allocation details to member brokers.

11A.7.13 On receipt of the basis of allocation data, the brokers shall immediately intimate the fact of allocation to their client /applicant. The broker shall ensure that each successful client/applicant submits the

duly filled-in and signed application form to him along with the amount payable towards the application money. Amount already paid by the applicant as margin money shall be adjusted towards the total allocation money payable. The broker shall, thereafter, hand over the application forms of the successful applicants who have paid the application money, to the exchange, which shall submit the same to the Registrar to Issue/company for their records.

11A.7.14 The broker shall refund the margin money collected earlier, within 3 days of receipt of basis of allocation, to the applicants who did not receive allocation.

11A.7.15 The brokers shall give details of the amount received from each client and the names of clients who have not paid the application money to the exchange. The brokers shall also give soft copy of this data to the exchange.

11A.7.16. On the pay- in day, the broker shall deposit the amount collected from the clients in the separate bank account opened for primary issues with the clearing house/bank. The clearing house shall debit the primary issue account of each broker and credit the amount so collected from each broker to the "Issue Account"

11A.7.17 In the event of the successful applicants failing to pay the application money, the broker through whom such client placed orders, shall bring in the funds to the extent of the client's default. If the broker does not bring in the funds, he shall be declared as a defaulter by the exchange and action as prescribed under the Bye-Laws of the Stock Exchange shall be initiated against him. In such a case, if the minimum subscription as disclosed in the prospectus is not received, the issue proceeds shall be refunded to the applicants.

11A.7.18 The subscriber shall have an option to receive the security certificates or hold the securities in dematerialized form as specified in the Guidelines

11A.7.19 The concerned Exchange shall not use the Settlement/Trade Guarantee Fund of the Exchange for honoring brokers commitments in case of failure of broker to bring in the funds.

11A.7.20 On payment and receipt of the sum payable on application for the amount towards minimum subscription, the company shall allot the shares to the applicants as per these Guidelines. The Registrar to the

issue shall post the share certificates to the investors or, instruct the depository to credit the depository account of each investor, as the case may be.

11A.7.21. Allotment of securities shall be made not later than 15 days from the closure of the issue failing which interest at the rate of 15% shall be paid to the investors.

11A.7.22 In cases of applicants who have applied directly or by post to the Registrar to the issue, and have not received allocation, the Registrar to the issue shall arrange to refund the application monies paid by them within the time prescribed.

11A.7.23 The brokers and other intermediaries engaged in the process of offering shares through the on-line system shall maintain the following records for a period of 5 years :

i.

i. orders received
ii. applications received
iii. details of allocation and allotment
iv. details of margin collected and refunded
v. details of refund of application money

11A.7.24 SEBI shall have the right to carry out an inspection of the records, books and documents relating to the above, of any intermediary connected with this system and every intermediary in the system shall at all times co-operate with the inspection by SEBI. In addition the stock exchange have the right of supervision and inspection of the activities of its member brokers connected with the system.

## Methods of Issuing IPO

Some of the major methods of issuing corporate securities are as follows: 1. Public Issue or Initial Public Offer (IPO) 2. Private Placement 3. Offer for Sale 4. Sale through Intermediaries 5. Sale to Inside Coterie 6. Sale through Managing Brokers 7. Privileged Subscriptions.

**1. Public Issue or Initial Public Offer (IPO):**

Under this method, the company issues a prospectus to the public inviting offers for subscription. The investors who are interested in the securities apply for the securities they are willing to buy. Advertisements are also issued in the leading newspapers. Under the Company Act it is obligatory for a public limited company to issue a prospectus or file a statement in lieu of prospectus with the Registrar of Companies.

Once subscriptions are received, the company makes allotment of securities keeping in view the prescribed requirements. The prospectus must be drafted and issued in accordance with the provisions of the Companies Act and the guidelines of SEBI. Otherwise it may lead to civil and criminal liabilities.

Public issue or direct selling of securities is the most common method of selling new issues of securities. This method enables a company to raise funds from a large number of investors widely scattered throughout the country. This method ensures a wider distribution of securities thereby leading to diffusion of ownership and avoids concentration of economic power in a few hands.

However, this method is quite cumbersome involving a large number of administrative problems. Moreover, this method does not guarantee the raising of adequate funds unless the issue is underwritten. In short, this method is suitable for reputed companies which want to raise large capital and can bear the large costs of a public issue.

**2. Private Placement:**

In this method, the issuing company sells its securities privately to one or more institutional brokers who in turn sell them to their clients and associates. This method is quite convenient and economical. Moreover, the company gets the money quickly and there is no risk of non-receipt of minimum subscription.

Private placement, however suffers from certain drawbacks. The financial institution may insist on a huge discount or other conditions for private purchase of securities. Secondly, it may not sell the securities in the market but keep them with it.

This deprives the public a chance to purchase securities of a flourishing company and there may be concentration of the company's ownership in a few hands. Private placement is very suitable for small issues particularly during depression.

**3. Offer for Sale:**

Under this method, the issuing company allots or agrees to allot the security to an issue house at an agreed price. The issue house or financial institution publishes a document called an 'offer for sale'. It offers to the public shares or debentures for sale at higher price. Application form is attached to the offer document. After receiving applications, the issue house renounces the allotment in favor of the applicants who become direct allottees of the shares or debentures.

This method saves the company from the cost and trouble of selling securities directly to the investing public. It ensures that the whole issue is sold and stamp duty payable on transfer of shares is saved. But the entire premium received is retained by the offerer and not the issuing company.

**4. Sale through Intermediaries:**

In this method, a company appoints intermediaries like stock brokers, commercial banks and financial institutions to assist in finding market for the new securities on a commission basis. The company supplies blank application forms to each intermediary who affixes his seal on them and distributes the among prospective investors. Each intermediary gets commission on the amount of security applications bearing his seal. However, intermediaries do not guarantee the sale of securities.

This method is useful when a company has already offered 49 per cent of issue to the general public which is essential for listing of securities. The pace of sale of securities may be very slow and there is uncertainty about the sale of whole lot of securities offered through intermediaries. But this method saves the administrative problems and expenses involved in direct selling of securities to the public.

**5. Sale to Inside Coterie:**

A company may resort to subscription by promoters and directors. This method helps to save the expenses of public issue. Generally, a percentage of new issue of securities is reserved for subscription by the inside coterie who can in this way share the future prosperity of the company.

**6. Sale through Managing Brokers:**

Sale of securities through managing brokers is becoming popular particularly among new companies. Managing brokers advise companies about the proper timing and terms of the issue of securities. They assist

companies in pre-issue publicity, drafting and issue of prospectus and getting stock exchange listing. They also enlist the support and cooperation of share brokers.

**7. Privileged Subscriptions:**

When an existing company wants to issue further securities, it is required to offer them to existing shareholders on prorate basis. This is known as 'Rights Issue'. Sale of shares by rights issues is simpler and cheaper as compared to sale through prospectus.

But the existing shareholders will subscribe to the new issues only when the past performance and future prospects of the company are good. An existing company may also issue Bonus Shares free of charge to the existing shareholders by capitalising its reserves and surplus.

# Secondary Market

## Functions of Secondary Market

**1. Continuous market for securities**

The Investors are able to invest in good securities and in case of any risk, it enables people to switch over from one security to another. So stock markets provides a ready and continuous opportunities for securities.

**2. Evaluation of securities**

It the stock exchange, the prices of securities clearly indicate the performance of the companies. It integrates the demand and supply of securities in an effective manner. It also clearly indicates the stability of companies. Thus, investors are in a better position to take stock of the position and invest according to their requirements.

**3. Mobilizes savings**

The savings of the public are mobilized through mutual funds, investments trusts and by various other securities. Even those who cannot afford to invest in huge amount of securities are provided opportunities by mutual funds and investment trusts.

**4. Healthy speculation**

The stock exchange encourages healthy speculation and provides opportunities to shrewd businessmen to speculate and reap rich profits from fluctuations in security prices. The price of security is based on supply and demand position. It creates a healthy trend in the market. Any artificial scarcity is prevented due to the rules and regulations of the market.

**5. Mobility of funds**

The stock exchange enables both the investors and the companies to sell or buy securities and thereby enable the availability of funds. By this, the money market also is strengthened as even short-term funds are available. The banks also provide funds for dealing in the stock exchanges.

**6. Stock exchange Protect investors**

As only genuine companies are listed and the activities of the stock exchange are controlled, the funds of the investors are very much protected.

**7. Stock exchange helps Capital formation**

Stock exchange plays an active role in the capital formation in the country. Companies are able to raise funds either by issuing more shares through rights shares or bonus shares. But when a company wants to go in for diversification, they can issue the shares and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.

Stock exchanges also creates the habit of saving, investing and risk bearing amongst the investing public.

**8. Liquidity in Stock Exchange**

Institutions like banks can invest their idle funds in the stock exchange and earn profit even within a short period. When necessity arises , these securities can be immediately sold for raising funds. Thus, it is the stock exchange which provides opportunities for converting securities into cash within a short notice.

**9. Economic barometer**

The most important function of a stock exchange is that it acts as an economic indicator of conditions prevailing in the country. A politically and economically strong government will have an upward trend in the stock market.

Whereas an unstable government with heavy borrowings from other countries will have a downward trend in the stock market. So, every government will adopt policies in such a manner that the stock exchange remains dynamic.

**10. Control on companies**

One of the major function of stock exchange is that it has control on companies. The companies listing their securities in the stock exchange has to submit their annual report and audited balance sheet to the stock exchange. Thus, only genuine companies can function and have the shares transacted. If not, such companies will be black listed and they will find it difficult to raise their capital.

**11. Attracts foreign capital**

Due to its dynamism and higher return on capital, the stock exchange is capable of attracting more foreign funds. Due to this, the exchange rate of the currency will improve when there is more trade undertaken by the government.

**12. Monetary and fiscal policies**

The monetary policy and the fiscal policy of the government have to be favorable to businessmen and producers. If they are not so, then through the stock exchange the government may indicate and accordingly suitable steps can be taken.

**13. Safety of Capital and Fair Dealing**

The stock exchange transactions are made publicly under well defined rules and regulations and bye-laws. This factor ensures a great measure of safety and fair dealings to the average investors.

**14. Proper Canalization of Capital**

Stock exchange directs the flow of savings into the most productive and profitable channels.

**15. Regulation of Company management**

The companies, which want to get their securities listed in the stock exchange, should have to follow certain rules and fulfill certain conditions. Thus stock exchanges safeguards the interest of the investing public and also regulates company management.

**16. Barometer of Business Progress**

Stock exchanges function as a barometer of the business conditions in the country. Booms and depressions are reflected by the index of prices of various securities maintained by the stock exchange. By analyzing the ups and downs of the market quotations, the causes for the changes in the business climate can be ascertained.

## Instruments Traded in Secondary Market:

The principal ***secondary market instruments*** used for long term funds are:
(i) Mortgages.
(ii) Corporation bonds.
(iii) State and local government bonds.
(iv) Federally sponsored credit agency securities.
(v) Finance company bonds.
(vi) Commercial banks bonds and commercial paper.
(viii) Corporate stock.

a) Equity Shares and its Features.

b) Preference Shares

c) Fully Convertible Cumulative Preference Shares

d) Debentures

e) Non Convertible Debentures

f) Bonds

g) Sweat Equity Shares

h) Warrants

i) Secured Premium Notes

j) Foreign Currency Convertible Bonds

k) Derivatives

l) Futures

m) Options

n) Index Futures and Options

o) Currency Futures

p) Interest Rate Futures

q) Exchange Traded Funds.

## Money Market and Capital Market : A comparison

| Point of Distinction | Money Market | Capital Market |
|---|---|---|
| 1. Time period / Term | Deals in short-term funds. | Long term funds. |
| 2. Instrument Dealt In | Deals in securities like treasury bills, commercial paper, bills of exchange, certificate of deposits etc. | Deals in securities like shares, debentures, bonds and government securities. |
| 3. Participants | Commercial banks, NBFS, chit funds etc. | Stock brokers, under writers, mutual funds, |

| | | |
|---|---|---|
| | | individual investors, financial institutions |
| 4. Regulatory body | RBI | SEBI |

## **Primary Market vs Secondary Market –** Differences

| **Basis of Comparison** | **Primary Market** | **Secondary Market** |
|---|---|---|
| **Meaning** | A platform that offers security for the first time is the primary market. | The market where investor's trade already issued securities is known as the secondary market. |
| **Another name** | New issue market (NIM). | Aftermarket or share market. |
| **Type of product** | Products are limited, and mainly include IPO and FPO (Follow-on Public Offer). | Many products are available such as shares, warrants, derivatives and more. |
| **Purchase type** | All the purchases in this market happen directly. | The issuer (company raising capital) is not involved in the trading. |
| **Frequency of selling** | Security can be sold to the investors just once in this market. | Here the traders can buy and sell the shares as many times they want. |
| **Parties involved** | Company and the investors are involved in buying and selling the security. | Here investors buy and sell the securities among themselves. |
| **Beneficiary** | Company | Investor |
| **How to identify investment?** | Investors primarily rely on prospectus and word-of-mouth publicity to pick an investment in the primary market. | Several tools are available to the investors to help them pick good investments, such as price to |

| | | |
|---|---|---|
| | | earnings (P/E), price to book (P/B), price to sales (P/S) and more. |
| **Intermediary** | Underwriters are the intermediaries in the primary market. | Here the intermediaries are the brokers. |
| **Purpose** | Help new and existing companies to raise capital for expansion and diversification. | Does not provide funding to companies; rather help investors to make money. |
| **Price** | The company sells the shares to the investors at a fixed price. | Both buy and sell-side investors work towards finding the best price for the trade. |
| **Presence** | There is no organization set up for the primary market | There is a geographical setup and organizational presence for the secondary market. |
| **Rules and Regulations** | The company issuing securities goes through a lot of regulation and due diligence. | Here investors and brokers need to follow the rules set by the exchange and the governing agency. |

## Trading Mechanism of Secondary Market

**The Trading procedure involves the following steps:**

**1. Selection of a broker:**

The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to select a broker who will buy/sell securities on behalf of the investor or speculator.

**2. Opening DematAccount with Depository:**

Demat(Dematerialized) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form. Second step in trading procedure is to open a Demataccount.

The securities are held in the electronic form by a depository. Depository is an institution or an organization which holds securities (e.g. Shares, Debentures, Bonds, Mutual (Funds, etc.) At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.) There is no direct contact between depository and investor. Depository interacts with investors through depository participants only.

Depository participant will maintain securities account balances of investor and intimate investor about the status of their holdings from time to time.

**3. Placing the Order:**

After opening the DematAccount, the investor can place the order. The order can be placed to the broker either (DP) personally or through phone, email, etc.

Investor must place the order very clearly specifying the range of price at which securities can be bought or sold. e.g. "Buy 100 equity shares of Reliance for not more than Rs 500 per share."

**4. Executing the Order:**

As per the Instructions of the investor, the broker executes the order i.e. he buys or sells the securities. Broker prepares a contract note for the order executed. The contract note contains the name and the price of securities, name of parties and brokerage (commission) charged by him. Contract note is signed by the broker.

**5. Settlement:**

This means actual transfer of securities. This is the last stage in the trading of securities done by the broker on behalf of their clients. There can be two types of settlement.

**(a) On the spot settlement:**

It means settlement is done immediately and on spot settlement follows. T + 2 rolling settlement. This means any trade taking place on Monday gets settled by Wednesday.

**(b) Forward settlement:**

It means settlement will take place on some future date. It can be T + 5 or T + 7, etc. All trading in stock exchanges takes place between 9.55 am and 3.30 pm. Monday to Friday.

## Online Trading

Online trading involves the trading of securities through an online platform. Online trading portals facilitate the trading of various financial instruments such as equities, mutual funds, and commodities.

**How to Trade Online**

- **Open Dematand Trading Account:**

  To begin trading online you need to open an online trading account with an online broking firm. Broking house offers reliable Dematand trading accounts services with low maintenance cost and affordable brokerage. It is essential to choose a broker who is a registered member of all the stock exchanges and is certified by the SEBI.

**BSE-BOLT SYSTEM:** The BOLT system (Bombay On-line Trading) has been introduced in the Bombay stock exchange. Now all scrips on BSE are being traded through BOLT. The brokers and their agents conduct trading under the BOLT system from their Trading Work Stations (TWS). At every TWS, the BOLT system displays „touchline‟ which will share the best bid and offer prices presently available in the market. The BOLT system also displays at every TWS „market view‟ which will provide detailed market information on each listed stock.

**(NSE-NEAT SYSTEM) NEAT**- National Exchange for Automated Trading The NEAT system permits the trading members, i.e., the brokers to entertain orders with various conditions attached to them as per the requirements of investors. These conditions may be broadly classified into the following categories:
•Time conditions
•Quantity conditions
•Price conditions and
•Quantity freezes Time conditions
•Day order A day order is an order which is valid for the day on which it is entered. If the order is not executed during the day, the system automatically cancels the order at the end of the day.
•GTC (A Good Till Cancelled) It is an order which remains in the system until it is cancelled by the user.

## Dematerialization Account

Dematerialization is the process of converting physical shares into electronic format. An investor who wants to dematerialise his shares needs to open a demat account with Depository Participant. Investor surrenders his physical shares and in turn gets electronic shares in his demat account.

**Storage of Dematerialised Shares - Depository**

Depository is the body which is responsible for storing and maintaining investor's securities in demator electronic format. In India there are two depositories i.e. NSDL and CDSL.

**Who is a** Depository Participant?

Depository Participant (DP) is the market intermediary through which investors can avail the depository services. Depository Participant provides financial services and includes organizations like banks, brokers, custodians and financial institutions.

**Advantages of Demat**

Dealing in demat format is beneficial for investors, brokers and companies alike. It reduces the risk of holding shares in physical format from investor’s perspective. It’s beneficial for brokers as it reduces the risk of delayed settlement and enhances profit because of increased participation. From share issuing company’s perspective, issuance in demat format reduces the cost of new issue as papers are not involved.

Efficiency and timeliness of the issue is also maintained while companies deal in demat format. There are a lot of other benefits, but let’s focus on benefits with respect to common investor and the same are listed below.

• Demat format reduces the risk of bad deliveries

• Time and money is saved as you are not dealing in paper now. You need not go to the notary, broker for taking delivery or submitting the share certificate

• Liquidity is very high in case of demat format as whole process in automated.

• All the benefits of corporate action like bonus, stock split, rights etc are managed through the depository leading to elimination of transit losses

• Interest on loan against demat shares are less as compared to physical shares

• Investors save stamp duty while transferring shares in demat format.

• One needs to pay less brokerage in case of demat shares

**Process of *dematerialization***

- The client (registered owner) will submit a request to the DP in the Dematerialization Request Form for dematerialization, along with the certificates of securities to be dematerialized. Before submission, the client has to deface the certificates by writing "SURRENDERED FOR DEMATERIALIZATION".
- The DP will verify that the form is duly filled in and the number of certificates, number of securities and the security type (equity, debenture etc.) are as given in the DRF. If the form and security count is in order, the DP will issue an acknowledgement slip duly signed and stamped, to the client.
- The DP will scrutinize the form and the certificates. This scrutiny involves the following
    - Verification of Client's signature on the dematerialization request with the specimen signature (the signature on the account opening form). If the signature differs, the DP should ensure the identity of the client.
    - Compare the names on DRF and certificates with the client account.
    - Paid up status
    - ISIN (International Securities Identification Number)
    - Lock - in status
    - Distinctive numbers
- In case the securities are not in order they are returned to the client and acknowledgment is obtained. The DP will reject the request and return the DRF and certificates in case:
    - A single DRF is used to dematerialise securities of more than one company.

  - The certificates are mutilated, or they are defaced in such a way that the material information is not readable. It may advise the client to send the certificates to the Issuer/ R&T agent and get new securities issued in lieu thereof.
  - Part of the certificates pertaining to a single DRF is partly paid-up; the DP will reject the request and return the DRF along with the certificates. The DP may advise the client to send separate requests for the fully paid-up and partly paid-up securities.
  - Part of the certificates pertaining to a single DRF is locked-in, the DP will reject the request and return the DRF along with the certificates to the client. The DP may advise the client to send a separate request for the locked-in certificates. Also, certificates locked-in for different reasons should not be submitted together with a single DRF
- In case the securities are in order, the details of the request as mentioned in the form are entered in the DPM (software provided by NSDL to the DP) and a Dematerialization Request Number (DRN) will be generated by the system.
- The DRN so generated is entered in the space provided for the purpose in the dematerialization request form.
- A person other than the person who entered the data is expected to verify details recorded for the DRN. The request is then released by the DP which is forwarded electronically to DM (DM - Depository Module, NSDL's software system) by DPM.
- The DM forwards the request to the Issuer/ R&T agent electronically.
- The DP will fill the relevant portion viz., the authorization portion of the dematrequest form.
- The DP will punch the certificates on the company name so that it does not destroy any material information on the certificate.
- The DP will then despatch the certificates along with the request form and a covering letter to the Issuer/ R&T agent.
- The Issuer/ R&T agent confirms acceptance of the request for dematerialization in his system DPM (SHR) and the same will be forwarded to the DM, if the request is found in order.
- The DM will electronically authorise the creation of appropriate credit balances in the client's account.
- The DPM will credit the client's account automatically.
- The DP must inform the client of the changes in the client's account following the confirmation of the request.

- The issuer/ R&T may reject dematerialization request in some cases. The issuer or its R&T Agent will send an objection memo to the DP, with or without DRF and security certificates depending upon the reason for rejection. The DP/Investor has to remove reasons for objection within 15 days of receiving the objection memo. If the DP fails to remove the objections within 15 days, the issuer or its R&T Agent may reject the request and return DRF and accompanying certificates to the DP. The DP, if the client so requires, may generate a new dematerialization request and send the securities again to the issuer or its R&T Agent. No fresh request can be generated for the same securities until the issuer or its R&T Agent has rejected the earlier request and informed NSDL and the DP about it.

## Brokers

A stockbroker is licensed and regulated financial firm that facilitates buying and selling transactions in various financial instruments- stocks, derivatives, bonds, and IPOs for both retail and institutional investors. Basically, All financial market transactions have to be executed through a broker and they charge commission or brokerage charge for their services.

## Kinds of Brokers

**There are essentially two types of stock brokers:**

- **Full-Service Broker** : A full-service broker, like the name suggests, offers a wide variety of stock and share trading services to the clients including researching on different stocks and shares and offering advice on potential profit making stocks. Their roles include researching the stock market in which the client wants to invest in, study the trend and analyse the different patterns and offer recommendations on which stock the client can invest it and therefore make a profit out of it. Apart from offering advice, they also use their expertise in buying and selling different stocks and shares and stay up to date on the developments taking place in the stock market. Since full-service brokers end up doing much of the work for their clients, their brokerage fee or commission is very high
- **Discount Broker** : As opposed to the full-service broker, a discount broker specializes only in executing buying and selling orders for their clients. They carry out the trade by charging a brokerage fee much less than what is paid for their full-service counterparts. Such discount brokers do not provide any advice on the investment nor do they offer any recommendations to their clients.

## Registration of Brokers

**Eligibility requirements to become a stock exchange broker**

1. Persons desiring to become brokers should clear the written test and interview conducted by stock exchanges.

2. They should possess the required financial strength to fulfill capital adequacy norms.

3. They should have the required infrastructure (buildings, computer systems, connectivity)

4. They should have the required manpower to service investors.

5. They should adhere to the code of conduct and various regulations prescribed while conducting trade.

6. They should provide regular updates to the stock exchanges regarding their net worth, information relating to directors, partners etc.

**REGISTRATION OF STOCK BROKERS:------**

1. Application for registration of stock broker.

2. Furnishing information, clarification, etc.

3. Consideration of application.

   3A. Criteria for fit and proper person

4. Procedure for registration.

   4A. Conditions of registration.

5. Stock Brokers to abide by Code of Conduct.

6. Procedure where registration is not granted.

7. Effect of refusal of certificate of registration.

8. Payment of fees and the consequences of failure to pay fees.

**SCHEDULE I: FORMS**

**FORM A:** Application Form For Registration As Stock Brokers With Securities And Exchange Board Of India.

**FORM AA:** Application Form For Registration As A Trading And /Or A Clearing Member [And /Or A Self – Clearing Member] With The Securities And Exchange Board Ofindia.

**FORM AB:** Application Form For Registration As A Trading And/Or A Clearing Member Of Currency Derivatives Segment Of A Stock Exchange With The Securities And Exchange Board Of India.

**FORM B:** Application Form For Registration As A Sub Broker With Securities And Exchange Board Of India.

**FORM C:** Recommendation Letter To Be Given By The Member With Whom The Sub Broker Is Affiliated.

**FORM CA:** Recognition Letter To Be Issued By Stock Exchange.

**FORM D:** Certificate Of Registration.

# MODULE- III

# MUTUAL FUNDS

**INTRODUCTION**

Mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is “mutual” as all of its returns, minus its expenses, are shared by the fund’s investors. The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a ‘a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments’. According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be setup in the form of a Trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

•Portfolio management services

•Management of offshore funds

•Providing advice to offshore funds

•Management of pension or provident funds

•Management of venture capital funds

•Management of money market funds

•Management of real estate funds

A mutual fund serves as a link between the investor and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled

under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders. Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilizing the savings of small investors and channelizing the same for productive ventures in the Indian economy.

**History of Mutual Funds**

The history of mutual funds, dates back to 19th century Europe, in particular, Great Britain. Robert Fleming set up in1868 the first investment trust called Foreign and Colonial Investment Trust which promised to manage the finances of the moneyed classes of Scotland by spreading the investment over a number of different stocks. This investment trust and other investment trusts which were subsequently set up in Britain and the US, resembled today's close-ended mutual funds. The first mutual fund in the US, Massachusetts Investors' Trust, was setup in March 1924. This was the first open-ended mutual fund. The stock market crash in 1929, the Great Depression, and the outbreak of the Second World War slackened the pace of growth of the mutual fund industry. Innovations in products and services increased the popularity of mutual funds in the1950s and 1960s. The first international stock mutual fund was introduced in the US in 1940. In 1976, the first tax-exempt municipal bond funds emerged and in 1979, the first money market mutual funds were created. The latest additions are the international bond fund in 1986 and arm funds in 1990. This industry witnessed substantial growth in the eighties and nineties when there was a significant increase in the number of mutual funds, schemes, assets, and shareholders. In the US, the mutual fund industry registered a ten fold growth in the eighties (1980-89) only, with 25% of the household sector's investment in financial assets made through them. Fund assets increased from less than $150 billion in 1980 to over $4 trillion by the end of 1997. Since 1996, mutual fund assets have exceeded bank deposits. The mutual fund industry and the banking industry virtually rival each other in size.

**Growth of Mutual Funds in India**

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: Phase I (1964-87), Phase II (1987-92), Phase III (1992-97), and Phase IV (beyond 1997).

**Phase I:** The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a special act of the Parliament. It became operational in 1964 with a major objective of mobilizing savings through the sale of units and investing them in

corporate securities for maximizing yield and capital appreciation. This phase commenced with the launch of Unit Scheme 1964 (US-64) the first open-ended and the most popular scheme. UTI's investible funds, at market value (and including the book value of fixed assets) grew from Rs 49 crore in1965 to Rs 219 crore in 1970-71 to Rs 1,126 crore in 1980-81 and further to Rs 5,068 crore by June 1987. Its investor base had also grown to about 2 million investors. It launched innovative schemes during this phase. Its fund family included five income-oriented, open-ended schemes, which were sold largely through its agent network built up over the years. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched India Fund in 1986-the first Indian offshore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987.

**Phase II:** The second phase witnessed the entry of mutual fund companies sponsored by nationalized banks and insurance companies. In 1987, SBI Mutual Fund and Canbank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In1988, UTI floated another offshore fund, namely, The India Growth Fund which was listed on the New York Stock Exchange (NYSB). By 1990, the two nationalized insurance giants, LIC and GIC, and nationalized banks, namely, Indian Bank, Bank of India, and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase were perceived to be another banking product offered by the arms of sponsor banks. In October 1989, the first regulatory guidelines were issued by the Reserve Bank of India, but they were applicable only to the mutual funds sponsored by FIIs. Subsequently, the Government of India issued comprehensive guidelines in June 1990 covering all' mutual funds. These guidelines emphasised compulsory registration with SEBI and an arms length relationship be maintained between the sponsor and asset management company (AMC). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry with investible funds, at market value, increasing to Rs53,462 crore and the number of investors increasing to over 23million. The buoyant equity markets in 1991-92 and tax benefits under equity-linked savings schemes enhanced the attractiveness of equity funds.

**Phase III:** The year 1993 marked a turning point in the history of mutual funds in India. Tile Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. SEBI notified regulations bringing all mutual funds except UTI under a common regulatory framework. Private domestic and foreign players were allowed entry in the mutual fund industry. Kothari group of companies, in joint venture with Pioneer, a US fund company, set up the first private mutual fund the Kothari Pioneer Mutual Fund, in 1993.

Kothari Pioneer introduced the first open-ended fund Prima in1993. Several other private sector mutual funds were set up during this phase. UTI launched a new scheme, Master-gain, in May 1992, which was a phenomenal success with a subscription of Rs 4,700 crore from 631akh applicants. The industry's investible funds at market value increased to Rs 78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unit holders saw an erosion in the value of their investments due to a decline in the NA V s of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts, and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure of foreign funds like Morgan Stanley eroded the confidence of investors in fund managers. Investors perception about mutual funds, gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about Rs 13,000. crore in 1991-94 to about Rs 9,000 crore in 1995 and 1996.

**Phase IV:** During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of investor service. Investible funds, at market value, of the industry rose by June 2000 to over Rs 1,10,000 crore with UTI having 68% of the market share. During 1999-2000 sales mobilisation reached a record level of Rs 73,000 crore as against Rs 31,420 crore in the preceding year. This trend was, however, sharply reversed in 2000-01. The UTI dropped a bombshell on the investing public by disclosing the NAV of US-64-itsflagship scheme as on December 28,2000, just at Rs 5.81 as against the face value of Rs 10 and the last sale price of Rs14.50. The disclosure of NAV of the country's largest mutual fund scheme was the biggest shock of the year to investors. Crumbling global equity markets, a sluggish economy coupled with bad investment decisions made life tough for big funds across the world in 2001-02. The effect of these problems was felt strongly in India also. Pioneer m, JP Morgan and Newton Investment Management pulled out from the Indian market. Bank of India MF liquidated all its schemes in 2002.The Indian mutual fund industry has stagnated at around Rs1,00,000 crore assets since 2000-01. This stagnation is partly a result of stagnated equity markets and the indifferent performance by players. As against this, the aggregate deposits of Scheduled Commercial Banks (SCBs) as on May 3, 2002, stood at Rs 11,86,468 crore. Mutual funds assets under management (AUM) form just around 10% of deposits of SCBs. The Unit Trust of India is losing out to other private sector players. While there has been an increase in AUM by around11% during the year 2002, UTI on the contrary has lost more than 11%

in AUM. The private sector mutual funds have benefited the most from the debacle ofUS-64 of UTI. The AUM of this sector grew by around- 60% for the year ending March 2002.

**Benefits of Mutual Funds**

An investor can invest directly in individual securities or indirectly through a financial intermediary. Globally, mutual funds have established themselves as the means of investment for the retail investor.

1. **Professional management:** An average investor lacks the knowledge of capital market operations and does not have large resources to reap the benefits of investment. Hence, he requires the help of an expert. It, is not only expensive to‘ hire the services’ of an expert but it is more difficult to identify a real expert. Mutual funds are managed by professional managers who have the requisite skills and experience to analyze the performance and prospects of companies. They make possible an organized investment strategy, which is hardly possible for an individual investor.
2. **Portfolio diversification:** An investor undertakes risk if he invests all his funds in a single scrip. Mutual funds invest in a number of companies across various industries and sectors. This diversification reduces the riskiness of the investments.
3. **Reduction in transaction costs:** Compared to direct investing in the capital market, investing through the funds is relatively less expensive as the benefit of economies of scale is passed on to the investors.
4. **Liquidity:** Often, investors cannot sell the securities held easily, while in case of mutual funds, they can easily en cash their investment by selling their units to the fund if it is an open-ended scheme or selling them on a stock exchange if it is a close-ended scheme.
5. **Convenience**: Investing in mutual fund reduces paperwork, saves time and makes investment easy.
6. **Flexibility**: Mutual funds offer a family of schemes, and investors have the option of transferring their holdings from one scheme to the other.
7. **Tax benefits**: Mutual fund investors now enjoy income-tax benefits. Dividends received from mutual funds’ debt schemes are tax exempt to the overall limit of Rs 9,000allowed under section 80L of the Income Tax Act.
8. **Transparency:** Mutual funds transparently declare their portfolio every month. Thus an investor knows where his/her money is being deployed and in case they are not happy with the portfolio they can withdraw at a short notice.

9. **Stability to the stock market:** Mutual funds have a large amount of funds which provide them economies of scale by which they can absorb any losses in the stock market and continue investing in the stock market. In addition, mutual funds increase liquidity in the money and capital market.
10. **Equity research**: Mutual funds can afford information and data required for investments as they have large amount of funds and equity research teams available with them.

**CLASSIFICATION OF FUNDS**

The objectives of mutual funds are to provide continuous liquidity and higher yields with high degree of safety to investors. Based on these objectives, different types of mutual fund schemes have evolved.

**Types of Mutual Fund Schemes**

| Functional | Portfolio | Geographical | Other |
|---|---|---|---|
| Open-Ended Event | Income Funds | Domestic | Sectoral Specific |
| Close-Ended Scheme | Growth Funds | Off-shore | Tax savings |
| Interval Scheme | Balanced Funds | | ELSS |
| | Money Market Mutual Funds | | Special |
| | | | Gilt Funds |
| | | | Load Funds |
| | | | Index Funds |
| | | | ETFs |
| | | | PIE Ratio Fund |

**Functional Classification of Mutual Funds:**

1. **Open-ended schemes:** In case of open-ended schemes, the mutual fund continuously offers to sell and repurchase its units at net asset value (NAV) or NAV-related prices. Unlike close-ended schemes, open-ended ones do not have to be listed on the stock exchange and can also offer repurchase soon after allotment. Investors can enter and exit the scheme any time during the life of the fund. Open-ended schemes do not have a fixed corpus. The corpus of fund increases or decreases, depending on the purchase or redemption of units by investors. There is no fixed redemption period in open-ended schemes, which can be terminated whenever the need arises. The fund offers a redemption price at which the holder can sell units to the fund and exit. Besides, an investor can enter the fund again by buying units from the fund at its offer price. Such funds announce sale and repurchase prices from time-to-time. UTI's US-64 scheme is an example of such a fund. The key feature of open-ended funds is liquidity. They increase liquidity of the investors as the units can be continuously bought and sold. The investors can develop their income or saving plan due to free entry and exit frame of funds. Open-ended schemes usually come as a family of schemes which enable the investors to switch over from one scheme to another of same family.
2. **Close-ended schemes:** Close-ended schemes have a fixed corpus and a stipulated maturity period ranging between 2to 5 years. Investors can invest in the scheme when it is launched. The scheme remains open for a period not exceeding 45 days. Investors in close-ended schemes can buy units only from the market, once initial subscriptions are over and thereafter the units are listed on the stock exchanges where they dm be bought and sold. The fund has no interaction with investors till redemption except for paying dividend/bonus. In order to provide an alternate exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. If an investor sells units directly to the fund, he cannot enter the fund again, as units bought back by the fund cannot be reissued. The close-ended scheme can be converted into an open-ended one. The units can be rolled over by the passing of a resolution by a majority of the unit--holders.
3. **Interval scheme:** Interval scheme combines the features of open-ended and close-ended schemes. They are open for sale or redemption during predetermined intervals at NAV-related prices.

**Portfolio Classification**

Here, classification is on the basis of nature and types of securities and objective of investment.

1. **Income funds:** The aim of income funds is to provide safety of investments and regular income to investors. Such schemes invest predominantly in income-bearing instruments like bonds, debentures, government securities, and commercial paper. The return as well as the risk are lower in income funds as compared to growth funds.
2. **Growth funds:** The main objective of growth funds is capital appreciation over the medium-to-long-term. They invest most of the corpus in equity shares with significant growth potential and they offer higher return to investors in the long-term. They assume the risks associated with equity investments. There is no guarantee or assurance of returns. These schemes are usually close-ended and listed on stock exchanges
3. **Balanced funds:** The aim of balanced scheme is to provide both capital appreciation and regular income. They divide their investment between equity shares and fixed nice-bearing instruments in such a proportion that, the portfolios balanced. The portfolio of such funds usually comprises of companies with good profit and dividend track records. Their exposure to risk is moderate and they offer a reasonable rate of return.
4. **Money market mutual funds:** They specialise in investing in short-term money market instruments like treasury bills, and certificate of deposits. The objective of such funds is high liquidity with low rate of return.

**Geographical Classification**

1. **Domestic funds:** Funds which mobilize resources from a particular geographical locality like a country or region are domestic funds. The market is limited and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.
2. **Offshore funds:** Offshore funds attract foreign capital for investment in 'the country of the issuing company. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. Such mutual funds can invest in securities of foreign companies. They open domestic capital market to international investors. Many mutual funds in India have launched a number of offshore funds, either independently or jointly with foreign investment management companies. The first offshore fund, the India Fund, was launched by Unit Trust of India in July 1986 in collaboration with the US fund manager, Merril Lynch.

## Others

1. **Sectoral**: These funds invest in specific core sectors like energy, telecommunications, IT, construction, transportation, and financial services. Some of these newly opened-up sectors offer good investment potential.
2. **Tax saving schemes:** Tax-saving schemes are designed on the basis of tax policy with special tax incentives to investors. Mutual funds have introduced a number of tax-saving schemes. These are close--ended schemes and investments are made for ten years, although investors can avail of encashment facilities after 3 years. These schemes contain various options like income, growth or capital application. The latest scheme offered is the Systematic Withdrawal Plan (SWP) which enables investors to reduce their tax incidence on dividends from as high as 30% to a slow as 3 to 4%.
3. **Equity-linked savings scheme (ELSS):** In order to encourage investors to invest in equity market, the government has given tax-concessions through special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but these schemes carry a lock-in period before the end of which funds cannot be withdrawn.
4. **Special schemes:** Mutual funds have launched special schemes to cater to the special needs of investors. UTI has launched special schemes such as Children's Gift Growth Fund, 1986, Housing Unit Scheme, 1992, and Venture Capital Funds.
5. **Gilt funds:** Mutual funds which deal exclusively in gilts are called gilt funds. With a view to creating a wider investor base for government securities, the Reserve Bank of India encouraged setting up of gilt funds. These funds are provided liquidity support by the Reserve Bank.
6. **Load funds:** Mutual funds incur certain expenses such as brokerage, marketing expenses, and communication expenses. These expenses are known as 'load' and are recovered by the fund when it sells the units to investors or repurchases the units from withholders. In other words, load is a sales charge, or commission, assessed by certain mutual funds to cover their selling costs. Loads can be of two types-Front-end-load and back-end-load. Front-end-load, or sale load, is a charge collected at the time when an investor enters into the scheme. Back-end, or

repurchase, load is a charge collected when the investor gets out of the scheme. Schemes that do not charge a load are called 'No load' schemes. In other words, if the asset management company (AMC) bears the load during the initial launch of the scheme, then these schemes are known as no-load schemes. However, these no-load schemes can have an exit load when the unit holder gets out of the scheme before a stipulated period mentioned in the initial offer. This is done to prevent short-term investments and redemptions. Some funds may also charge different amount of loads to investors depending upon the time period the investor has stayed with the funds. The longer the investor stays with the fund, less is the amount of exit load charged. This is known as contingent deferred sales' charge (CDSL).It is a back-end (exit load) fee imposed by certain funds on shares redeemed with a specific period following their purchase and is usually assessed on a sliding scale.

7. **Index funds:** An index fund is a mutual fund which invests in securities in the index on which it is based BSE Sensex orS&P CNX Nifty. It invests only in those shares which comprise the market index and in exactly the same proportion as the companies/weightage in the index so that the value of such index funds varies with the market index. An index fund follows a passive investment strategy as no effort is made by the fund manager to identify stocks for investment/dis-investment. The fund manager has to merely track the index on which it is based. His portfolio will need an adjustment in case there is a revision in the underlying index. In other words, the fund manager has to buy stocks which are added to the index and sell stocks which are deleted from the index. Internationally, index funds are very popular. Around one-third of professionally run portfolios in the US are index funds. Empirical evidence points out that active fund managers have not been able to perform well. Only 20-25%of actively managed equity mutual funds out-perform benchmark indices in the long-term. These active fund managers park 80% of their money in an index and do active management on the remaining 20%. Moreover, risk a verse investors like provident funds and pension funds prefer investment in passively managed funds like indexfunds.
8. **PIE ratio fund:** PIE ratio fund is another mutual fund variant that is offered by Pioneer IT! Mutual Fund. The PIE(Price-Earnings) ratio is the ratio of the price of the stock of a company to its earnings per share (EPS). The PIE ratio of the index is the weighted average price-earnings ratio of all its constituent stocks. The PIE ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the

market. Broadly, around 90% of the investible funds will be invested inequity if the Nifty Index PIE ratio is 12 or below. If this ratio exceeds 28, the investment will be in debt/money markets. Between the two ends of 12 and 28 PIE ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

9. **Exchange traded funds:** Exchange Traded Funds (ETFs) are a hybrid of open-ended mutual funds and listed individual stocks. They are listed on stock exchanges and trade like individual stocks on the stock exchange. However, trading at the stock exchanges does not affect their portfolio. ETFs do not sell their shares directly to investors for cash. The shares are offered to investors over the stock exchange. ETFs are basically passively managed funds that track a particular index such as S&P CNX Nifty. Since they are listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by the demand-supply forces in the market. In practice, they trade in a small range around the value of the assets (NAV) held by them. ETFs offer several distinct advantages.

- ETFs bring the trading and real time pricing advantages of individual stocks to mutual funds. The ability to trade intra-day at prices that are usually close to the actual intra-day NAV of the scheme makes it almost real-time trading.
- ETFs are simpler to understand and hence they can attract small investors who are deterred to trade in index futures due to requirement of minimum contract size. Small investors can buy minimum one unit of ETF, can place limit orders and trade intra-day. This, in turn, would increase liquidity of the cash market.
- ETFs can be used to arbitrate effectively between index futures and spot index.
- ETFs provide the benefits of diversified index funds. The investor can benefit from the flexibility of stocks as well as the diversification.
- ETFs being passively managed, have somewhat higher NAV against an index fund of the same portfolio. The operating expenses of ETFs are lower than even those of similar index funds as they do not have to service investors who deal in shares through stock exchanges. ETFs can be beneficial for financial institutions also. Financial institutions can use ETFs for utilizing idle cash, managing redemptions, modifying sector allocations, and hedging market exposure. The first exchange traded fund-Standard and Poor's Depository Receipt (SPDR-also called Spider)-was launched in the US in1993. ETFs have grown rapidly with around US$100 billion in assets as on

December 2001. Today, about 60% of trading value on the American Stock Exchange (AMEX) is from ETFs. ETFs were launched in Europe and Asia in 2001. Currently, more than 120 ETFs are available in US, Europe, Singapore, Hongkong, Japan, and other countries. Among the popular ones are SPDRs (Spiders) based on the S&P 500 Index, QQQs(cubes) based on the Nasdaq-100 Index, i SHARES based onMSCI Indices and TRAHK (Tracks) based on the Hang SengIndex. The ETF structure has seen over $120 bn pouring into it in more than 220 funds. It has become the fastest growing fund structure. In year 2001 alone, the number of funds doubled from 100 to 200.The first ETF to be introduced in India is Nifty Bench mark Exchange-Traded Scheme (Nifty BeES). It is an open-ended ETF, launched towards the end of 2001 by Benchmark Mutual Funds. The fund is listed in the capital market segment of the NSE and trades the S&P CNX Nifty Index. The Benchmark Asset Management Company has become the first company in Asia (excluding Japan) to introduce ETF.

**Net Asset Value**

The net asset value of a fund is the market value of the assets minus the liabilities on the day of valuation. In other words, it is the amount which the shareholders will collectively get if the fund is dissolved or liquidated. The net asset value of a unit is the net asset value of fund divided by the number of outstanding units.

Thus NAV = Market Price of Securities + Other Assets – Total Liabilities + Units Outstanding as at the NAV date.

NAV = Net Assets of the Scheme + Number of units outstanding, that is, Market value of investments + Receivables+ Other Accrued Income + Other Assets - Accrued Expenses -Other Payables - Other Liabilities + No. of units outstanding as at the NAV date.

A fund's NAV is affected by four sets of factors: purchase and sale of investment securities, valuation of all investment securities held, other assets and liabilities, and units sold or redeemed. SEBI has issued guidelines on valuation of traded securities, thinly traded securities and non-traded securities. These guidelines were issued to streamline the procedure of calculation of NAV of the schemes of mutual funds. The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15% of the total assets of the scheme and any illiquid securities held above 15% of the total assets shall be valued in the manner as specified in the guidelines issued by the SEBI. Where income receivables on investments has accrued but has not been received for the period specified in the guidelines issued by SEBI, provision shall be made

by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by SEBI.

Mutual funds are required to declare their NAV s and sale-repurchase prices of all schemes updated daily on regular basis on the AMFI website by 8.00 p.m. and declare NAVs of their close-ended schemes on every Wednesday. According to SEBI (Mutual Funds) (Second Amendment)Regulations, 2000, a mutual fund can now invest up to 5% of its NAV in the unlisted equity shares or equity related instruments in case of open-ended schemes; while in case of close-ended schemes, the mutual fund can now invest up to10% of its NAY.

**Mutual Fund Investors**

Mutual funds in India are open to investment by

a. **Residents including**

•Resident Indian Individuals, including high net worth individuals and the retail or small investors.

Indian Companies

•Indian Trusts/Charitable Institutions

•Banks

•Non-Banking Finance Companies

•Insurance Companies

•Provident Funds

b. **Non-Residents, including**

•Non-Resident Indians

•Other Corporate Bodies (OCBs)

c. **Foreign entities,** namely, Foreign Institutional Investors(FIIs) registered with SEBI. Foreign citizens/ entities arehowever not allowed to invest in mutual funds in India.

**ORGANIZATION STRUCTURE OF MUTUAL FUND COMPANY (POWER AND FUNCTIONS)**

What we often phrase as “**Mutual Fund**” is actually a *type of business*. Within this line of business, there are approximately 35-40 nos **fund houses**.

These fund house are actually the companies, whom SEBI has allowed to operate mutual fund schemes. It is these **schemes** which we common people buy and sell as *investment products*.

I am sure you already know this, but allow me to present this information in a more graphical form for clearer understanding.

India's Top 5 Fund Houses in term of the size of the Asset Under Management (AUM) – *as on Dec'18*, are listed below:

| SL | Mutual Fund Houses | AUM (Rs.Crore) |
|---|---|---|
| 1 | HDFC Mutual Fund | 3,34,964 |
| 2 | ICICI Prudential Mutual Fund | 3,07,735 |
| 3 | SBI Mutual Fund | 2,64,353 |
| 4 | Aditya Birla Sun Life Mutual Fund | 2,42,344 |
| 5 | Reliance Mutual Fund | 2,36,256 |

The most visible person of a mutual fund is the "Fund Manager". But do you know, there is a Chairman, CEO, CFO of a fund house?

Example: Aditya Birla Sun Life Mutual Fund.

- Chairman: Kumar Mangalam Birla.
- CEO: A. Balasubramanian.

To have more clarity about how a mutual fund operates, we will have to know the organisation structure of a typical mutual fund house in India.

**Three Tier Structure of Fund House**

The three tier structure of a mutual fund house consists of the following heads:

1. Sponsor.
2. Trustee.
3. AMC.

It is **SEBI** who has prepared the framework of the above 3-tier structure of mutual funds. All mutual funds operates in India under SEBI guidelines.

It is the **SPONSORS** (also called promoters) who first conceptualise the idea of starting a mutual fund business. Before they can act further, they must approach SEBI for *registration* of the business.

If the sponsors has the necessary credentials, SEBI will issue the "Certificate of Registration" to the sponsors. Which are the credentials required?

- The sponsor must have experience of 5 years in financial services.
- They must be a profit making company (3 out of 5 years).
- Last 5 years net worth of the company must be positive.

Once the certification is received, further steps can be taken to start a mutual fund activity. Which are the next steps?

1. Formation of Trust.
2. Appointment of AMC.
3. Appointment of Depository (Custodian), Registrar, Transfer Agent, and Auditor.

**1. Trustee – Father Figure**

The sponsors of mutual fund form a Trust. This Trust must have a "Board of Trustees" (like board of directors).

Who shall be in the Board of Trustee (BOT)? There is a stipulation of SEBI which must be followed in the BOT.

The minimum strength of the board must be four (4) members.

Out of the whole board members, two-third members must be "Independent Directors". Who are independent directors? Those people who have no relation with the sponsors in any way.

The idea of the formation of a Trust is to have a management in place. The priority of this management will be like this:

"Protect the interest of the unit-holders and their invested money"

It is also the responsibility of the Trustee to ensure that, mutual fund operates as per the regulations of SEBI.

As per SEBI guidelines, at all times, out of the total net worth of the AMC, a minimum amount must be contributed by the sponsors.

There is another reason why SEBI has stipulated such strict norms related to the Board of Trustees. What is the reason? Generally corporate houses are the sponsors of mutual fund schemes. Example: Tata Group, ICICI bank, Mahindra and Mahindra Group, HDFC bank etc.

SEBI has stipulated such rules to ensure that the investors pooled money is not used by the sponsors in their group companies.

BOLT members may not engaged in the day to day operations of the mutual fund.

Daily operations of the mutual fund is managed by the appointed “Managers (AMC)” and other team members.

**2. AMC – Manager of Mutual Fund**

After Trustees, the most important entity in the mutual fund is its AMC (The Asset Management Company).

AMC of a mutual fund is formed as per the “Companies Act 1956”. The AMC must also be registered with the Government of India accordingly.

After an AMC is registered, it will start functioning as a full fledged company. This is one reason why we see the following three types of AMC’s in India:

1. Private Limited Company.
2. Wholly Owned Subsidiary of an already Public Limited Co.
3. Joint Venture (Indian or Overseas Companies).

When the trustees are forming the AMC, it is also their job to appoint the following managers who will in turn run the AMC:

- CEO
    - Chief Investment Officer.
        - Fund Manager

Chief Marketing Officer (CMO)Chief Operations Officer (COO)Compliance Officer.Etc.

- Chief Marketing Officer (CMO)Chief Operations Officer (COO)Compliance Officer.Etc.

**Example of Three Tier Structure:**

**3. What is the role of the Custodian (Depository)?**

A mutual fund scheme purchases various types of financial assets. Some of these assets can be like this:

1. Stocks of companies.
2. Government bonds.
3. Company deposits.
4. Cash etc.

It is the responsibility of the depository (custodian) to hold all financial assets safely in its custody.

A good analogy of a 'depository' is our bank's locker. In the locker we can keep important documents, jewellery etc.

**Example**: HDFC Bank provides custodian service to ICICI Pru Mutual Fund.

**4. What a Transfer Agent does?**

AMC appoints a transfer agent. The transfer agent handles the following:

- Communication with investors.
- Maintains investors data.
- Process all transactions of units (purchased or redeemed).

**Example**: For ICICI Pru Mutual Fund, the transfer agent is ICICI Infotech along with CAMS Ltd. For Tata AMC, the transfer agent if CAMS.

**5. What is the role of a Registrar?**

Again, it is the AMC who appoints the Registrar for its mutual funds.

*These days generally the role of Transfer Agent and Registrar is performed by the same company.*

In India the most common registrar utilised by mutual fund companies are CAMS and Karvy.

The main functions of Registrar are the following:

- Data Entry.
- Send Account Statements to Investors.
- Etc.

**6. Role of an Auditor…**

As per companies act, all companies must get their book of accounts audited by an external financial auditor. These auditors are basically certified chartered accountants.

All financial transactions done by a mutual fund company must be presented to the auditors for scrutiny. At the end of the financial year, the auditors also checks and certifies the financial reports prepared by the mutual fund companies.

Once the mutual fund house has organised its 3 tier structure as per SEBI's guidelines, the AMC is ready to launch their new schemes.

This is the stage where the mutual fund house is ready to appoint a competent fund manager.

In todays practice, a single fund manager can handle two or more mutual fund schemes at a time.

**Three Tier structure of few Indian mutual funds**:

| SL | Name of Fund House | Canara Robeco Mutual Fund | ABSL Mutual Fund | Axis Mutual Fund | HDFC Mutual Fund | ICICI Pru Mutual Fund | Kotak Mahindra Mutual Fund |
|---|---|---|---|---|---|---|---|
| 1 | Sponsor | Canara Bank, Robeco Groep | Aditya Birla Nuvo, Sun Life (India) | Axis Bank Limited | HDFC Ltd. / Standard Life Invest. | Prudential Plc and ICICI Bank Ltd. | Kotak Mahindra Bank Limited |

| 2 | Trustee | – | Birla Sun Life Trustee Company Pvt Ltd. | Axis Mutual Fund Trustee Ltd. | HDFC Trustee Company Limited | ICICI Prudential Trust Ltd. | Kotak Mahindra Trustee Co. Ltd. |
|---|---|---|---|---|---|---|---|
| 3 | AMC | Canara Robeco AMC Ltd. | ABSL AMC Ltd. | Axis Mutual Fund AMC | HDFC AMC Ltd | ICICI Pru Mutual Fund | Kotak Asset Management |
| 3A | Custodian / Depository | Hongkong and Shanghai Banking Corp & HDFC Bank | Citibank NA | Deutsche Bank | HDFC Bank, Citibank & Deutsche Bank | HDFC Bank | Deutsche Bank AG, Standard Chartered Bank |
| 3B | Transfer Agent | Karvy Fintech Pvt. Ltd | CAMS Ltd. | Karvy Fintech Pvt Ltd. | CAMS Ltd. | CAMS Ltd. | CAMS Ltd. |
| 3C | Registrar | Karvy Fintech Pvt. Ltd | CAMS Ltd. | Karvy Fintech Pvt Ltd. | CAMS Ltd. | CAMS Ltd. | CAMS Ltd. |
| 3D | Auditor | M/s. S. R. Batliboi | M/s. Haribhakti & Co | M/s S R Batliboi & Co. and and M/s Haribhakti & Co. | BSR & Co. LLP & S.R. Batliboi & Co. LLP | M/s S. R. Batliboi & Co. LLP | Price Waterhouse & S R Batliboi & Co LLP |

**MUTUAL FUND INVESTMENT Vs STOCK MARKET INVESTMENT**

**1. Understanding Stocks and Mutual Funds**

When compared on the risk factor, stocks happen to be far riskier than mutual funds. The risk in mutual funds is spread across and hence, reduced with the pooling of diverse stocks. With stocks, you have to do extensive research before investing, especially if you are a novice investor. Visit ClearTax for more details on the various areas of investments. In the case of mutual funds, the research is done by experts, and a professional fund manager manages the pool of investment. This service is not free and comes with an annual management fee that is charged by the fund house.

## 2. When investing as a novice

If you are a new investor with little or no experience in the financial markets, it is advisable to start your equity investments with mutual funds as not only the risk is comparatively lesser but also because an expert makes the decisions. These professionals have the insight to analyse and interpret financial data to gauge the outlook of a prospective investment.

## 3. Tracking your investment

With an investment in mutual funds, you have the benefit of a fund manager who has extensive expertise and experience in the field. Whether it is picking the stocks or monitoring them and making allocations, you do not have to worry about it. This service is not available in the case of stock investments. You are responsible for picking and tracking your investment.

## 4. Risk and Return

It is already established that mutual funds have the advantage of reducing the risk by diversifying a portfolio. On the other hand, stocks are vulnerable to the fluctuations in the market, and the performance of one stock can’t compensate for another.

## 5. Tax Gains

Note that you are levied with short-term capital gains tax at the rate of 15% if you sell your stock holdings within one year from the date of purchase. On the other hand, there is no tax on capital gains on the stocks that are sold by the fund. This is a substantial benefit for you. The tax saved is also available for you to invest in further, thus making way for further income generation through investment.

## 6. The cost of Investing

Though you have to pay a fee to mutual fund managers, unlike in the case of stocks that you buy individually, the economies of scale also come into play. Active management of funds is indeed an affair that does not come free of cost. But the truth is that due to their large size, mutual funds pay only a small fraction of the brokerage charges that an individual shareholder pays. Individual investors also have to pay the fees for Demat, which can be avoided with mutual funds.

## 7. Diversification

A well-diversified portfolio should include at least 25 to 30 stocks, but that would be a difficult task for a small investor. With mutual funds, investors with low funds can also get a diversified portfolio. Buying units of a fund allows you to invest in multiple stocks without having to invest a considerable corpus.

## 8. Control on your investment

In the case of mutual funds, the fund manager decides the stocks to be included in the portfolio. You do not have control over which stock is to be picked and for what duration. As an investor, if you invest in mutual funds, you do not have the option to exit from some stocks that are in your portfolio. The decisions of the fate of the stocks rest in the hands of the fund manager. This way, an individual investing in stocks has more control over their investment than an investor who invests in mutual funds.

## 9. Time

When you invest directly, you will need to have a lot of time and research into your stock while in the case of mutual funds, you can be passive. The fund manager is the one who invests his time to manage your portfolio.

## 10. Investment Horizon

When investing in mutual funds, remember that you will have to give the funds at least 5-7 years to generate good returns as these have a long-term growth trajectory. In the case of stocks, you can get quick and good returns if you choose the right stocks and sell them at the right time.

Still unsure about which investment option to choose? Visit ClearTax to explore your options for investment from a diverse offering of investment schemes.

**Why Choose Mutual Funds Over Stock?**

Here we list 5 most important reasons why an investor should choose Mutual Funds over Stocks:

**1. Professional Management of Money:**

Leveraging the knowledge and expertise of a professional fund manager to earn good returns is one of the primary reasons for investing in mutual funds.

Investment in stocks without prior experience or knowledge of the working of financial markets can be disastrous and easily drain away your savings. Therefore, it is advisable to invest in mutual funds if you don't have thorough knowledge of financial markets and want to keep your money in safe hands.

**2. Diversification:**

Instead of investing in individual stocks, mutual funds invest in a variety of asset classes to hedge the investment portfolio during turbulent market conditions. Even equity oriented mutual funds invest some portion of their total assets in fixed income or low-risk securities for market risk mitigation.

**3. Convenience:**

Buying and selling stocks require a lot of time and formalities which are not present in mutual funds. In case of mutual funds, all these formalities are done by the Asset Management Companies which manage the fund, for which they charge a nominal fee.

Moreover, the investor doesn't need to time the financial market regularly. S/he can just keep the money invested in the scheme for a long term and earn good returns.

**4. Tax-Saving Benefits:**

Income generated from equity investment is taxable. However, there are certain mutual fund schemes where you can avail tax-saving benefits. Equity Linked Savings Schemes (ELSS) are equity mutual funds where investment upto ₹1.5 lakh is eligible for tax deduction under Section 80(C) of the IT Act.

**5. Overseen by market regulator:**

Unlike stocks, mutual fund houses are subjected to certain restrictions by the national market regulator-Securities and Exchange Board of India (SEBI).

# VENTURE CAPITAL

## MEANING AND TYPES OF VENTURE CAPITAL

Venture capital is a form of private equity and a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off investors, investment banks and any other financial institutions. However, it does not always take a monetary form; it can also be provided in the form of technical or managerial expertise. Venture capital is typically allocated to small companies with exceptional growth potential, or to companies that have grown quickly and appear poised to continue to expand.

Though it can be risky for investors who put up funds, the potential for above-average returns is an attractive payoff. For new companies or ventures that have a limited operating history (under two years), venture capital funding is increasingly becoming a popular – even essential – source for raising capital, especially if they lack access to capital markets, bank loans or other debt instruments. The main downside is that the investors usually get equity in the company, and, thus, a say in company decisions.

In a venture capital deal, large ownership chunks of a company are created and sold to a few investors through independent limited partnerships that are established by venture capital firms. Sometimes these partnerships consist of a pool of several similar enterprises. One important difference between venture capital and other private equity deals, however, is that venture capital tends to focus on emerging companies seeking substantial funds for the first time, while private equity tends to fund larger, more established companies that are seeking an equity infusion or a chance for company founders to transfer some of their ownership stakes.

**Key Takeaways**

- Venture capital financing is funding provided to companies and entrepreneurs. It can be provided at different stages of their evolution.
- It has evolved from a niche activity at the end of the Second World War into a sophisticated industry with multiple players that play an important role in spurring innovation.

**What is Venture Capital?**

It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives. ***Software and other intellectual property*** are generally the most common cases whose value is unproven. That is why; Venture capital funding is most widespread in the fast-growing technology and biotechnology fields.

**Features of Venture Capital investments**

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects

- Suppliers of venture capital participate in the management of the company

**Methods of Venture capital financing**

- Equity
- participating debentures
- conditional loan

**THE FUNDING PROCESS:** ***Approaching a Venture Capital for funding as a Company***

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

**Step 1: Idea generation and submission of the Business Plan**

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

**Step 2: Introductory Meeting**

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

**Step 3: Due Diligence**

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

**Step 4: Term Sheets and Funding**

**If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.**

**Types of Venture Capital funding**

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- *Seed money: Low level financing for proving and fructifying a new idea*
- *Start-up: New firms needing funds for expenses related with marketingand product development*
- *First-Round: Manufacturing and early sales funding*
- *Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit*
- *Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company*

- *Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process*

**A) Early Stage Financing:**

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

**B) Expansion Financing:**

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

**C) Acquisition or Buyout Financing:**

Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

**Advantages of Venture Capital**

- They bring wealth and expertise to the company

- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

**Disadvantages of Venture Capital**

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

**Exit route**

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

**Examples of venture capital funding**

- Kohlberg Kravis & Roberts (KKR), one of the top-tier alternative investment asset managers in the world, has entered into a definitive agreement to invest USD150 million (Rs 962crore) in Mumbai-based listed polyester maker JBF Industries Ltd. The firm will acquire 20% stake in JBF Industries and will also invest in zero-coupon compulsorily convertible preference shares with 14.5% voting rights in its Singapore-based wholly owned subsidiary JBF Global Pte Ltd. The fundingprovided by KKR will help JBF complete the ongoing projects.

- Pepperfry.com, India's largest furniture e-marketplace, has raised USD100 million in a fresh round of funding led by Goldman Sachs and Zodius Technology Fund. Pepperfry will use the fundsto expand its footprint in Tier III and Tier IV cities by adding to its growing fleet of delivery vehicles. It will also open

new distribution centres and expand its carpenter and assembly service network. This is the largest quantum of investment raised by a sector focused e-commerce player in India.

**Types of Venture Capital Funding**

The first professional investor to a deal at the start-up stage is referred to as the Series A investor. This investment is followed by middle and later stage funding – the Series B, C, and D rounds. The final rounds include mezzanine, late stage and pre-IPO funding. A VC may specialize in provide just one of these series of funding, or may offer funding for all stages of the business life cycle. It's important to know the preferences of the VC you're approaching, and to clearly articulate what type of funding you're seeking:

**Seed Capital**: If you're just starting out and have no product or organized company yet, you would be seeking seed capital. Few VCs fund at this stage and the amount invested would probably be small. Investment capital may be used to create a sample product, fund market research, or cover administrative set-up costs.

**Startup Capital:** At this stage, your company would have a sample product available with at least one principal working full-time. Funding at this stage is also rare. It tends to cover recruitment of other key management, additional market research, and finalizing of the product or service for introduction to the marketplace.

**Early Stage Capital**: Two to three years into your venture, you've gotten your company off the ground, a management team is in place, and sales are increasing. At this stage, VC funding could help you increase sales to the break-even point, improve your productivity, or increase your company's efficiency.

**Expansion Capital**: Your company is well established, and now you are looking to a VC to help take your business to the next level of growth. Funding at this stage may help you enter new markets or increase your marketing efforts. You should seek out VCs that specialize in later stage investing.

**Late Stage Capital**: At this stage, your company has achieved impressive sales and revenue and you have a second level of management in place. You may be looking for funds to increase capacity, ramp up marketing, or increase working capital.

**Bridge Financing**: You may also be looking for a partner to help you find a merger or acquisition opportunity, or attract public financing through a stock offering. There are VCs that focus on this end of the business

spectrum, specializing in initial public offerings (IPOs), buyouts, or recapitalizations. If you are planning an IPO, a VC may also assist with mezzanine or bridge financing – short-term financing that allows you to pay for the costs associated with going public.

A key factor for the VC will be risk versus return. The earlier a VC invests, the greater are the inherent risks and the longer is the time period until the VC's exit. It follows that the VC will expect a higher return for investing at this early stage, typically a 10 times multiple return in four to seven years. A later stage VC may be seeking a two to four times multiple return within two years.

## STAGES OF VENTURE CAPITAL FINANCING

Venture capital is a term that's frequently thrown around when the discussion turns to getting startups off the ground. While most know that it's a source of funding, fewer people are familiar with exactly how venture capital financing works.

Venture capital is a form of funding that pools together cash from investors and lends it to emerging companies and startups that the funds believe have the potential for long-term growth. Venture capital investments typically involve high risk in exchange for potentially high reward.

Because every company is different, the various stages can vary somewhat from financing to financing. Generally speaking, though, there are five typical stages of any venture capital financing.

### The Seed Stage

Venture capital financing starts with the seed-stage when the company is often little more than an idea for a product or service that has the potential to develop into a successful business down the road. Entrepreneurs spend most of this stage convincing investors that their ideas represent a viable investment opportunity. Funding amounts in the seed stage are generally small, and are largely used for things like marketing research, product development, and business expansion, with the goal of creating a prototype to attract additional investors in later funding rounds.

**The Startup Stage**

In the startup stage, companies have typically completed research and development and devised a business plan, and are now ready to begin advertising and marketing their product or service to potential customers. Typically, the company has a prototype to show investors, but has not yet sold any products. At this stage, businesses need a larger infusion of cash to fine tune their products and services, expand their personnel, and conducting any remaining research necessary to support an official business launch.

**The First Stage**

Sometimes also called the "emerging stage," first stage financing typically coincides with the company's market launch, when the company is finally about to start seeing a profit. Funds from this phase of a venture capital financing typically go to actual product manufacturing and sales, as well as increased marketing. To achieve an official launch, businesses usually need a much bigger capital investment, so the funding amounts in this stage tend to be much higher than in previous stages.

**The Expansion Stage**

Also commonly referred to as the second or third stages, the expansion stage is when the company is seeing exponential growth and needs additional funding to keep up with the demands. Because the business likely already has a commercially viable product and is starting to see some profitability, venture capital funding in the emerging stage is largely used to grow the business even further through market expansion and product diversification.

**The Bridge Stage**

The final stage of venture capital financing, the bridge stage is when companies have reached maturity. Funding obtained here is typically used to support activities like mergers, acquisitions, or IPOs. The bridge state is essentially a transition to the company being a full-fledged, viable business. At this time, many investors choose to sell their shares and end their relationship with the company, often receiving a significant return on their investments.

An experienced business attorney can guide you through the different stages of venture capital financing and advise you on the best ways to secure funding for your company in its current stage.

**EXIT ROUTES**

An important aspect of venture capital investing is the exit strategies. Venture capital funds primarily invest with an exit in mind after a few years. After successfully funding at seed, pre-production, production and expansion stages, a venture capitalist will start assessing exit strategies. The exit in the form of disinvestment or liquidation is the last and final stage of the venture capital funding. The key types of liquidation/disinvestment are trade sales, sale of quoted equity post initial public offering (IPO), and write-offs. Let's look at each of these in detail:

**Trade Sales**: In this type of strategy the private company is sold or merged with an acquirer for stocks, cash, or a combination of both.

**IPO**: If the company has done well, the venture capital investors will take the IPO route, by issuing shares registered for public offering. An example is the upcoming Facebook IPO, which is expecting to raise about $15 billion through IPO and is valued at approx. 100 billion. The venture capital investors and other private investors will get their portion of shares who can put them in the open marketplace for trading after an initial lock-in period.

**Write-offs**: These are voluntary liquidations that may or may not result in any proceeds.

Apart from the above three types of disinvestment, there are a few other options:

**Bankruptcy:** The company may just go bankrupt.

**Buy-back:** In this method the entrepreneur buys-back the investment share from the venture capitalists and takes it back to being a privately held company.

Investors who invest in a venture capital fund get distributions of public stock or cash from realized venture capital investments. Sometimes the fund may require further investments from limited partners. At other times, they may make cash or share distributions at random times during the lifetime of the fund. Investors can sell their interests to another buyer if they find one.

In a bad case scenario, some funds find themselves with highly illiquid, barely there companies. In a good scenario, they have good investments, which they disinvest from at a stage and find new investments to fund.

# LEASING

## CONCEPT AND CLASSIFICATION

A “lease” is defined as a contract between a lessor and a lessee for the hire of a specific asset for a specific period on payment of specified rentals.

The maximum period of lease according to law is for 99 years. Previously land or real resate, mines and quarries were taken on lease. But now a day’s plant and equipment, modem civil aircraft and ships are taken.

**Definition:**

**(i) Lessor:**

The party who is the owner of the equipment permitting the use of the same by the other party on payment of a periodical amount.

**(ii) Lessee:**

The party who acquires the right to use equipment for which he pays periodically.

**Lease Rentals:**

**This refers to the consideration received by the lessor in respect of a transaction and includes:**

(i) Interest on the lessor’s investment;

(ii) Charges borne by the lessor. Such as repairs, maintenance, insurance, etc;

(iii) Depreciation;

(iv) Servicing charges.

At present there are many leasing companies such as 1st Leasing Company, 20th Century Leasing Company which are doing quite a lot of business through leasing, It has become an important financial service and a lucrative avenue of making sizable profits by leasing companies.

## Types of Leases:

**The different types of leases are discussed below:**

### 1. Financial Lease:

This type of lease which is for a long period provides for the use of asset during the primary lease period which devotes almost the entire life of the asset. The lessor assumes the role of a financier and hence services of repairs, maintenance etc., are not provided by him. The legal title is retained by the lessor who has no option to terminate the lease agreement.

The principal and interest of the lessor is recouped by him during the desired playback period in the form of lease rentals. The finance lease is also called capital lease is a loan in disguise. The lessor thus is typically a financial institution and does not render specialized service in connection with the asset.

### 2. Operating Lease:

It is where the asset is not wholly amortized during the non-cancellable period, if any, of the lease and where the lessor does not rely for is profit on the rentals in the non- cancellable period. In this type of lease, the lessor who bears the cost of insurance, machinery, maintenance, repair costs, etc. is unable to realize the full cost of equipment and other incidental charges during the initial period of lease.

The lessee uses the asset for a specified time. The lessor bears the risk of obsolescence and incidental risks. Either party to the lease may termite the lease after giving due notice of the same since the asset may be leased out to other willing leases.

### 3. Sale and Lease Back Leasing:

To raise funds a company may-sell an asset which belongs to the lessor with whom the ownership vests from there on. Subsequently, the lessor leases the same asset to the company (the lessee) who uses it. The asset thus remains with the lessee with the change in title to the lessor thus enabling the company to procure the much needed finance.

### 4. Sales Aid Lease:

Under this arrangement the lessor agrees with the manufacturer to market his product through his leasing operations, in return for which the manufacturer agrees to pay him a commission.

**5. Specialized Service Lease:**

In this type of agreement, the lessor provides specialized personal services in addition to providing its use.

**6. Small Ticket and Big Ticket Leases:**

The lease of assets in smaller value is generally called as small ticket leases and larger value assets are called big ticket leases.

**7. Cross Border Lease:**

Lease across the national frontiers is called cross broker leasing. The recent development in economic liberalization, the cross border leasing is gaining greater importance in areas like aviation, shipping and other costly assets which base likely to become absolute due to technological changes.

**Merits of Leasing:**

(i) The most important merit of leasing is flexibility. The leasing company modifies the arrangements to suit the leases requirements.

(ii) In the leasing deal less documentation is involved, when compared to term loans from financial institutions.

(iii) It is an alternative source to obtain loan and other facilities from financial institutions. That is the reason why banking companies and financial institutions are now entering into leasing business as this method of finance is more acceptable to manufacturing units.

(iv) The full amount (100%) financing for the cost of equipment may be made available by a leasing company, Whereas banks and other financial institutions may not provide for the same.

(v) The 'Sale and Lease Bank' arrangement enables the lessees to borrow in case of any financial crisis.

(vi) The lessee can avail tax benefits depending upon his tax status.

**Demerits of Leasing:**

(i) In leasing the cost of interest is very high.

(ii) The asset reverts back to the owner on the termination of the lease period and the lesser loses his claim on the residual value.

(iii) Leasing is not useful in setting up new projects as the rentals become payable soon after the acquisition of assets.

(iv) The lessor generally leases out assets which are purchased by him with the help of bank credit. In the event of a default made by the lessor in making the payment to the bank, the asset would be seized by the bank much to the disadvantage of the lessee.

**FINANCIAL EVALUATION OF LEASING**

**There are two ways for financial evaluation of leasing. The ways are: 1. Lessee's Point of View 2. Lessor's Point of View.**

**Financial Evaluation of Leasing: Way # 1. Lessee's Point of View:**

**(Lease or Buy/Lease or Borrow Decisions):**

Once a firm has evaluated the economic viability of an asset as an investment and accepted/selected the proposal, it has to consider alternate methods of financing the investment. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset.

Thus, the firm may consider leasing of the asset rather than buying it. In comparing leasing with buying, the cost of leasing the asset should be compared with the cost of financing the asset through normal sources of financing, i.e., debt and equity.

Since, payment of lease rentals is similar to payment of interest on borrowings and lease financing is equivalent to debt financing, financial analysts argue that the only appropriate comparison is to compare the cost of leasing with that of cost of borrowing. Hence, lease financing decisions relating to leasing or buying options primarily involve comparison between the cost of debt-financing and lease financing.

**The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:**

(i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

(b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.

**The following steps are involved in such an analysis:**

(i) Determine the present value of after-tax cash outflows under the leasing option.

(ii) Determine the present value of after-tax cash outflows under the buying or borrowing option.

(iii) Compare the present value of cash outflows from leasing option with that of buying/borrowing option.

(iv) Select the option with lower presented value of after-tax cash outflows.

We have illustrated the above analysis in the following illustrations.

**Illustration 1:**

**A limited company is interested in acquiring the use of an asset costing Rs. 5,00,000. It has two options:**

(i) To borrow the amount at 18% p.a. repayable in 5 equal installments or

(ii) To take on lease the asset for a period of 5 years at the year end rentals of Rs. 1,20,000.

The corporate tax is 50% and the depreciation is allowed on w.d.v. at 20%. The asset will have a salvage of Rs. 1,80,000 at the end of the 5th year.

You are required to advise the company about lease or buy decision. Will decision change if the firm is allowed to claim investment allowance at 25%?

**Note:**

(1) The present value of Re. 1 at 18% discount factor is:

1st year – .847

2nd year – .718

3rd year – .609

4th year – .516

5th year – .437

(2) The present value of an annuity of Re. 1 at 18% p.a. is Rs. 3.127.

**Solution:**

**(i) Calculation of loan instalment**

$$\text{Loan Instalment} = \frac{\text{Amount of Loan}}{\text{P.V. Factor of Annuity}} = \frac{5{,}00{,}000}{3.127} = ₹\ 1{,}59{,}898 \text{ appx.}$$

**(ii) Schedule of Loan Payment**

| Year | Loan Balance at beginning of the year | Loan Instalment | Interest Payment | Principal Payment | Loan Balance at the end of the year |
|---|---|---|---|---|---|
| | (₹) | (₹) | (₹) | (₹) | (₹) |
| 1. | 5,00,000 | 1,59,898 | 90,000 | 69,898 | 4,30,102 |
| 2. | 4,30,102 | 1,59, 898 | 77,418 | 82,480 | 3,47,622 |
| 3. | 3,47,622 | 1,59,898 | 62,572 | 97,326 | 2,50,296 |
| 4. | 2,50,296 | 1,59,898 | 45,053 | 1,14, 845 | 1,35,451 |
| 5. | 1,35,451 | 1,59,832* | 24,381 | 1,35,451 | Nil |

* The amount of loan instalment in the last year is different from the equal payments because of compensation for rounding error.

**(iii) Calculation of Present Value of After-Tax Cash Outflows under Borrowing/Buying Option**

| Year end | Loan Instalment (₹) | Tax Saving on Interest (₹) | Tax Saving on Dep. (after-tax) (₹) | Tax Saving on Total (₹) | Net cash Outflow (₹) | P.V. factor at 18% | P.V. of after tax Net cash Outflow (₹) |
|---|---|---|---|---|---|---|---|
| Col. 1 | 2 | | | 3 | 4 = 2–3 | 5 | 6 |
| 1. | 1,59,898 | 45,000 | 50,000 | 95,000 | 64,898 | .847 | 54,969 |
| 2. | 1,59,898 | 38,709 | 40,000 | 78,709 | 81,189 | .718 | 58,294 |
| 3. | 1,59,898 | 31,286 | 32,000 | 63,286 | 96,612 | .609 | 58,837 |
| 4. | 1,59,898 | 22,527 | 25,600 | 48,127 | 1,11,771 | .516 | 57,674 |
| 5. | 1,59,832 | 12,190 | 20,480 | 32,670 | 1,27,162 | .437 | 55,570 |
| | | | | | | | Total : 2,85,344 |
| | | | *Less* : P.V. of salvage at the end of 5th year (1,80,000 × .437) | | | | 78,660 |
| | | | | | | | 2,06,684 |

**(iv) Calculation of Present Value of After-Tax Cash Outflows under Lease Option**

| Year end | Lease Rental | Tax Savings on Lease Rent | After-Tax Cash Outflow | P.V. Annuity Factor at 18% | Total P.V. of Cash Outflows |
|---|---|---|---|---|---|
| | (₹) | (₹) | (₹) | (₹) | (₹) |
| 1–5 | 1,20,000 | 60,000 | 60,000 | 3.127 | 1,87,620 |

**(v) Evaluation:**

As the present value of after-tax cash outflows under the leasing option is lesser than the present value of after-tax cash outflows of the buying option, it is advisable to take the asset on lease.

**(vi) Decision if Investment Allowance is allowed:**

In case Investment Allowance is allowed on purchase of asset the total of present value of net cash outflows will decrease by the present value of tax savings on investment allowance as below:

| | ₹ |
|---|---|
| Investment Allowance : | |
| (allowed at the end of 1st year) $5,00,000 \times \frac{25}{100}$ | 1,25,000 |
| Tax Savings (50%) | 62,500 |
| P.V. Factor at the end of year 1 | .847 |
| P.V. of Tax Savings on Investment Allowance | 52,938 |
| Hence, P.V. of Cash Outflows in Buying Option shall be = ₹ 2,06,684-52,938 | 1,53,746 |

In that case, the P.V. of cash outflows under buying option shall be lesser than the P.V. of cash outflows under leasing option and the company should buy the asset.

**Financial Evaluation of Leasing: Way # 2.**

**Lessor's Point of View:**

The financial viability of leasing out an asset from the point of view of lessor can be evaluated with the help of the two time adjusted methods of capital budgeting:

(a) Present Value Method

(b) Internal Rate of Return Method.

**(a) Present Value Method:**

**This method involves the following steps:**

(i) Determine cash outflows by deducing tax advantage of owning an asset, such as investment allowance, if any.

(ii) Determine cash inflows after-tax as below:

| | ₹ |
|---|---|
| Lease Rental (say) | 1,00,000 |
| *Less :* Depreciation (say) | 20,000 |
| Earnings Before Tax (EBT) | 80,000 |
| *Less :* Tax (say 50%) | 40,000 |
| Earnings After Tax (EAT) | 40,000 |
| *Add :* Depreciation | 20,000 |
| Cash Inflows After Tax (CFAT) | 60,000 |

(ii) Determine the present value of cash outflows and after tax cash inflows by discounting at weighted average cost of capital of the lessor.

(iv) Decide in favour of leasing out an asset if P.V. of cash inflows exceeds the P.V. of cash outflows, i.e., if the NPV is +ve; otherwise in case N.P.V. is -ve, the lessor would lose on leasing out the asset.

The above technique has been explained with the help of the following example.

**Illustration 2:**

From the information given below, you are required to advise about leasing out of the asset:

| | | |
|---|---|---|
| Cost of Equipment | ₹ 4,00,000 | |
| Average Cost of Capital to the lessor | 12% | |
| Depreciation (Allowable) | 20% | on original cost |
| Expected Life of Asset | 5 | years |
| Salvage Value | Nil | |
| Lease Rent payable at the end of each of 5 years | ₹ 1,50,000 | |
| Corporate Tax (applicable to lessor) | 50% | |
| P.V. of an annuity of Re. 1 for 5 years at 12% is ₹ 3.605 | | |

**Solution:**

| | | (₹) |
|---|---|---|
| (i) | **Calculation of Cash Outflow** | (₹) |
| | Cost of Equipment | 4,00,000 |
| | *Less :* Tax Advantage, if any | Nil |
| | Cash Outflow | 4,00,000 |
| (ii) | **Calculation of After-Tax Cash Inflows** | (₹) |
| | Lease Rental | 1,50,000 |
| | *Less :* Depreciation | 80,000 |
| | Earnings Before Tax (EBT) | 70,000 |
| | *Less :* Tax at 50% | 35,000 |
| | Earnings After Tax (EAT) | 35,000 |
| | *Add :* Depreciation | 80,000 |
| | Cash Inflows After Tax (CFAT) | 1,15,000 |

**(iii) Calculation of Present Value (P.V.) of Cash Outflows**

| *Year* (₹) | *Cash Outflow* (₹) | *P.V. Discount Factor at 12%* | *P.V. of Cash Outflow* (₹) |
|---|---|---|---|
| 0 | 4,00,000 | 1.00 | 4,00,000 |

**(iv) Calculation of P.V. of Cash Inflows**

| *Year* | *Cashflow After Tax (CFAT)* ₹ | *P.V. Annuity Discount Factor at 12%* | *P.V. of Cash Inflows* ₹ |
|---|---|---|---|
| 1-5 | 1,15,000 | 3.605 | 4,14,575 |

| | | ₹ |
|---|---|---|
| (iv) | **Calculation of Net Present Value** | ₹ |
| | Present value of Cash Inflows | 4,14,575 |
| | *Less :* P.V. of Cash Outflows | 4,00,000 |
| | Net Present value of Cash flows | 14,575 |

Since the present value of cash inflows is more than the present value of cash outflows or says N.P.V. is positive, it is desirable to lease out the asset.

**(b) Internal Rate of Return Method:**

The internal rate of return can be defined as that rate of discount at which the present value of cash- inflows is equal to the present value of cash outflows.

**It can be determined with the help of the following mathematical formula:**

$C = A_1/(1+r) + A_2/(1+r)^2 + A_3/(1+r)^3 + \dots \dots \dots \dots + A_n/(1+r)^n$

where, C = Initial Outlay at time Zero.

$A_1, A_2, \dots \dots \dots A_n$ = Future net cash flows at different periods.

2,3 …….. , = Numbers of years

r = Rate of discount of internal rate of return.

The Internal rate of return can also be determined with the help of present value tables.

**The following steps are required to practice the internal rate of return method:**

(1) Determine the future net cash flows for the period of the lease. The net cash inflows are estimated future net cash flows for the period of the lease. The net cash inflows are estimated future earnings, from leasing out the asset, before depreciation but after taxes.

(2) Determine the rate of discount at which the present value of cash inflows is equal to the present value of cash outflows. This may be determined as follows:

(a) When the annual net cash flows are equal over the life of the asset:

Firstly, find out Present Value Factor by dividing initial outlay (cost of the investment) by annual cash flow, i.e., Present Value Factor = Initial Outlay/Annual Cash Flow. Then, consult present value annuity tables with the number of year equal to the life of the asset and find out the rate at which the calculated present value factor is equal to the present value given in the table.

**Illustration 3:**

| | |
|---|---|
| Initial Outlay | ₹ 50,000 |
| Life of the Asset | 5 years |
| Estimated Annual Cash-flow | ₹ 12,500 |
| Calculate the Internal Rate of Return. | |

**Solution:**

$$\text{Present Value Factor} = \frac{\text{Initial Outlay}}{\text{Annual Cash Flow}}$$

$$= \frac{50{,}000}{12{,}500} = 4.$$

Consulting Present Value Annuity Tables for 5 years periods at Present Value Factor of 4. (For Present Value Tables see Appendix A and B given at the end of the book)

Internal Rate of Return =8% approx.

(as seen from the table that at 8% for 5 year period, the present value is 3.9927 which is nearly equal to 4.)

**(b) When the annual cash flows are unequal over the life of the asset:**

In case annual cash flows are unequal over the life of the asset, the internal rate of return cannot be determined according to the technique suggested above. In such cases, the internal rate of return is calculated by hit and trial and that is why this method is also known as hit and trial yield method.

We may start with any assumed discount rate and find out the total present value of all the cash flows by consulting present value tables.

The so calculated total present value of cash inflows as compared with the present value of cash outflows which is equal to the cost of the initial investment where total investment is to be made in the beginning. The rate, at which the total present value of all cash inflows equals the initial outlay, is the internal rate of return. Several discount rates may have to be tried until the appropriate rate is found. The calculation process may be summed up as follows.

(i) Prepare the cash flow table using an arbitrary assumed discount rate to discount the net cash flow to the present value.

(ii) Find out the Net Present Value by deducting from the present value of total cash flows calculated in (i) above the initial cost of the investment.

(iii) If the Net Present Value (NPV) is positive, apply higher rate of discount.

(iv) If the higher discount rate still gives a positive net present value, increase the discount rate further until the NPV becomes negative.

(v) If the NPV is negative at this higher rate, the internal rate of return must be between these two rates:

(3) Accept the proposal if the internal rate of return is higher than or equal to the minimum required rate of return, i.e. the cost of capital or cut off rate.

(4) In case of alternative proposals select the proposal with the highest rate of return as long as the rates are higher than the cost of capital or cut-off rate.

**Illustration 4:**

Initial Investment – Rs. 60,000

Life of the Asset – 4 years

**Estimated Net Annual Cash Flows:**

| | ₹ |
|---|---|
| 1st Year | 15,000 |
| 2nd Year | 20,000 |
| 3rd Year | 30,000 |
| 4th Year | 20,000 |

Compute the internal rate of return and also advise the lessor about the leasing out decision if his expected minimum rate of return is 15%.

**Note:**

Present Value Factor at various rates of discount.

**P.V. Cash Flows Table at Various Assumed Discount Rates of 10%, 12%, 14% & 15%**

| Year | Annual Cash Flow ₹ | Discount rate 10% | | 12% | | 14% | | 15% | |
|---|---|---|---|---|---|---|---|---|---|
| | | P.V.F. | P.V. ₹ | P.V.F. | P.V. ₹ | P.V.F. | P.V. ₹ | P.V.F. | P.V. ₹ |
| 1 | 15,000 | .909 | 13,635 | .892 | 13,380 | .877 | 13,155 | .869 | 13,035 |
| 2 | 20,000 | .826 | 16,520 | .797 | 15,940 | .769 | 15,380 | .756 | 15,120 |
| 3 | 30,000 | .751 | 22,530 | .711 | 21,330 | .674 | 20,220 | .657 | 19,710 |
| 4 | 20,000 | .683 | 13,660 | .635 | 12,700 | .592 | 11,840 | .571 | 11,420 |
| | | | 66,345 | | 63,350 | | 60,595 | | 59,285 |

(1) The present value of cash flows at 14% rate of discount is Rs. 60,595 and at 15% rate of discount it is t 59,285. So the initial cost of investment which is Rs. 60,000 falls in between these two discount rates. At 14% the NPV is+ 595 but at 15% the NPV is – 715, we may say that IRR = 14.5% (approx).

(2) As the IRR is less than the minimum required rate of return, the lessor should not lease out the asset.

**Evaluation of Lease Decision:**

The methods used in evaluation of lease decision are as follows:- 1. Present Value Method 2. Cost of Capital Method 3. Bower-Herringer-Williamson Method.

**1. Present Value Method:**

Under this method the present value of lease rentals are compared with the present value of the cost of an asset acquired on outright purchase by availing a loan. In leasing, the tax advantage in payment of lease rentals will reduce the cash outflow.

In case an asset is purchased by borrowing a loan, the repayment of principal and interest charges on loan is considered as cash outflow and it is reduced by tax advantage of depreciation claim and interest charge. The present value of the net cash outflows over the period of lease is considered to ascertain the present value over the lease/loan period. The alternative with low total present value of cash outflow will be selected.

**2. Cost of Capital Method:**

Under this method, the rate of cost of capital is calculated for the payments of installments and then it is compared with the cost of capital of the other available sources of finance such as fresh issue of equity capital, retained earnings, debentures, term loans etc. The lease option is chosen if the rate is lower than the cost of equity capital etc. This method does not require the prior selection of any discounting rate.

**3. Bower-Herringer-Williamson Method:**

Under this method, the financial and tax aspects of lease financing are considered separately.

**The following steps are involved in evaluation of lease decision:**

**Step 1:**

Make a comparison of the present value of cost of debt with the discounted value of gross amount of lease rentals. The rate of discount applicable is being the gross cost of debt capital. Then, obtain the total present value of a financial advantage/disadvantage of leasing.

**Step 2:**

Again compute the comparative tax benefit during the lease period and discount it at an appropriate cost of capital. The total present value is the operating advantage/ disadvantage of leasing. Step 3 – When the present value of operating advantage of lease is more than its financial disadvantage, then select the leasing. When the present value of financial advantage is more than operating disadvantages, then select the leasing.

**Illustration:**

Vindhya Papers Ltd. planning to install a captive generator set at its plant. Its Finance Manager is asked to evaluate the alternatives either to purchase or acquire generator on lease basis.

$$\frac{Buying}{Leasing\ for\ 5\ years} \quad \frac{Initial\ cost\ Rs.5{,}00{,}000}{Annual\ lease\ rental\ Rs.1{,}50{,}000\ to\ lessee\ in\ 5\ years\ time} \quad \frac{Residual\ Value\ Rs.1{,}60{,}000}{Residual\ value\ Rs.90{,}000\ returned}$$

Depreciation @ 20% p.a. on written down value. Corporate tax rate 40%. After tax cost of debt is 14%.

The time gap between the claiming of the tax allowance and receiving the benefit is one year.

Evaluate the lease or buy decision based on the above information.

**Solution:**

Alternative (1) : Buying

| Year | Cost or W.D.V. | Depreciation @ 20% | Corporate tax @40% |
|---|---|---|---|
| 1 | 5,00,000 | 1,00,000 | 40,000 |
| 2 | 4,00,000 | 80,000 | 32,000 |
| 3 | 3,20,000 | 64,000 | 25,600 |
| 4 | 2,56,000 | 51,200 | 20,480 |
| 5 | 2,04,800 | - | - |
| Less: Residual value | 1,60,000 | - | - |
| | 44,800 | 44,800 | 17,920 |

Calculation of Net Present Value

| Year | Cost (Rs.) | Tax relief (Rs.) | Net cashflow (Rs.) | P.V. factor @ 14% | P.V. (Rs.) |
|---|---|---|---|---|---|
| 0 | (5,00,000) | - | (5,00,000) | - | (5,00,000) |
| 1 | - | - | - | 0.8772 | - |
| 2 | - | 40,000 | 40,000 | 0.7695 | 30,780 |
| 3 | - | 32,000 | 32,000 | 0.6750 | 21,600 |
| 4 | - | 25,600 | 25,600 | 0.5921 | 15,158 |
| 5 | 1,60,000 | 20,480 | 1,80,480 | 0.5194 | 93,741 |
| 6 | - | 17,920 | 17,920 | 0.4556 | 8,164 |
| | | | | N P V = | (3,30,557) |

Alternative (2) : Leasing

| Year | Lease rentals (Rs.) | Tax relief (Rs.) | Net cashflow (Rs.) | P.V. @ 14% | P.V. (Rs.) |
|---|---|---|---|---|---|
| 0 | (1,50,000) | - | (1,50,000) | - | (1,50,000) |
| 1 | (1,50,000) | - | (1,50,000) | 0.8772 | (1,31,580) |
| 2 | (1,50,000) | 60,000 | (90,000) | 0.7695 | (69,255) |
| 3 | (1,50,000) | 60,000 | (90,000) | 0.6750 | (60,750) |
| 4 | (1,50,000) | 60,000 | (90,000) | 0.5921 | (53,289) |
| 5 | 90,000 | 60,000 | 1,50,000 | 0.5194 | 77,910 |
| 6 | (Share residual value) | 60,000 | 24,000 | 0.4556 | 10,934 |
| Tax on residual value | | (36,000) | | | |
| | | | | NPV = | (3,76,030) |

**Analysis:**

From the above analysis, by applying the discounted cashflow technique, we can observe that the net present value of cash outflow is higher in case of leasing decision i.e., Rs. 3,76,030 as compared to buying decision it is only Rs. 3,30,557. The company may go for purchase of the generator instead of acquiring on lease basis.

# HIRE PURCHASE

## CONCEPTUAL FRAMEWORK

Hire-purchase is a mode of financing the price of goods to be sold on a future date.

It is an agreement relating to a transaction in which goods are let on hire, the purchase price is to be paid in installments and the hirer is allowed the option to purchase the goods paying all the installments.

Though the option to purchase the goods/assets is allowed in the very beginning, it can be exercised only at the end of the agreement.
The essence of the agreement is that the property in the goods does not pass at the time of the agreement but remains in the intending seller (hire-vendor) and only passes when the option is exercised by the hirer (intending hire-purchaser).

In contrast, in installment sale the ownership in the goods passes on to the purchaser simultaneously with the payment of the initial/first installment.

**Meaning of Hire Purchase:**

**Hire purchase means a transaction where goods are purchased and sold on the terms that:**

(i) Payment will be made in installments

(ii) The possession of the goods is given to the buyer immediately,

(iii) The property (ownership) in the goods remains with the vendor till the last installment is paid,

(iv) The seller can repossess the goods in case of default in payment of any installment, and

(v) Each installment is treated as hire charges till the last installment is paid.

**Features of Hire Purchase:**

**The main features of a hire purchase agreement are as below:**

1. The payment is to be made by the hirer (buyer) to the hiree, usually the vendor, in installments over a specified period of time.

2. The possession of the goods is transferred to the buyer immediately.

3. The property in the goods remains with the vendor (hiree) till the last installment is paid. The ownership passes to the buyer (hirer) when he pays all installments.

4. The Hiree or the vendor can repossess the goods in case of default and treat the amount received by way of installments as hire charged for that period.

5. The installments in hire purchase include interest as well as repayments of principal.

6. Usually, the hiree charges interest on flat rate.

**Legal Position of Hire Purchase:**

**The Hire Purchase Act, 1972 defines a hire purchase agreement as an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:**

(i) Possession of goods is delivered by the owner there off to a person on a condition that such person pays the agreed amount in periodic payments, and

(ii) The property in the goods is to pass to such person on the payment of the last of such installments, and

(iii) Such person has a right to terminate the agreement at any time before the property so passes." Section 3 of the Act provides that every hire purchase agreement must be in writing and signed by all parties thereto.

**Rights of Hirer:**

**In addition to the usual right of terminating the agreement at any time before the property passes to him and returning the goods to the hiree, the Hire Purchase Act, 1972 has provided the following rights to the hirer:**

(i) The hiree (vendor) cannot terminate the hire purchase agreement for default in payment of hire or due to an un-authorised act or breach of expressed conditions unless a notice in writing in this regard is given to the hirer. The period of notice will be one week where the hire is payable weekly or less than that interval and two weeks in other cases.

(ii) The right to repossess the goods will not exist unless sanctioned by the Court in the following cases:

(a) Where the hire purchases price is less than Rs. 15,000, one half of the hire purchase price has been paid

(b) Where the hire purchase is not less than Rs. 15,000, three fourth of hire-purchase price has been paid.

**However this proportion in case of motor vehicles is as under:**

(a) One half, where the hire purchase price is less than Rs. 5,000.

(b) Three fourths, where the hire purchase price is not less than Rs. 5,000 but less than Rs. 15,000.

(c) Three fourths or such higher proportion not exceeding nine-tenth where the hire purchase price is not less than Rs. 15,000.

(iii) The hirer has a right of receiving a statement from the owner against a payment of rupee one showing the amount paid by or on behalf of the hirer, the amount which has become due under the agreement but remains unpaid and the date upon which each unpaid installment became due, and the amount of each such installment and the amount which is to become payable under the agreement and the date or the mode of determining the date upon which each future installment is to become payable, and the amount of each such installment.

(iv) If the amount paid by the hirer till the date of repossession of the goods or the value of the goods on the date of repossession of goods exceeds the total hire purchase price the excess payment made by the hirer will be returned to the hirer by the owner of the goods.

The owner or vendor, for the purpose of calculating the value of the goods, has the right to deduct the reasonable expenses for repossessing the goods, for storing the goods, or repairing them, for selling them and for payment of arrears of taxes.

**Method of Computing Installment under Hire Purchase:**

Under Hire Purchase, interest is usually charged on a flat rate for the period of hire. We can calculate the amount of installment by adding the amount of principal (cost of the asset) and the total interest for the period, and further by dividing the total amount of payment to be made by the number of installments.

Say, an equipment costing Rs. 1,00,000 is sold on hire purchase on the terms that interest will be charged at 15% p.a. on flat rate basis and the payment is to be made in 5 equal year-end installments.

In the above example, the total Interest burden shall be Rs. 75,000 i.e. 1,00,000 × 15/100 × 5 and the yearly installment shall be 1,00,000 + 75,000/5 = Rs. 35,000

**Method of Splitting H.P. Installment into Interest and Principal Repayments:**

(a) First of all interest included in each installment is calculated on the basis that interest in each installment shall be in ratio of amounts outstanding. In case the installments are of equal amounts, we can apply the sum of digit method.

(b) We can determine the amount of principal repayment in the installment by deducting from it the amount of interest calculated in (a) above.

**The following illustration explains the method of split of hire purchase installment into interest and principal repayments:**

**Illustration 1:**

A company purchased an equipment costing Rs. 5,00,000 on hire purchase basis payable in 4 equal year end installments of Rs. 2,05,000 each. Split of the Installments into interest and principal repayments.

**Solution:**

In the above Illustration, the total amount payable is Rs. 8,20,000-5,00,000.

**The interest can be allocated as below:**

| | | |
|---|---|---|
| Instalment 1 | $3,20,000 \times 4/_{10}$ | ₹ 1,28,000 |
| Instalment 2 | $3,20,000 \times 3/_{10}$ | ₹ 96,000 |
| Instalment 3 | $3,20,000 \times 2/_{10}$ | ₹ 64,000 |
| Instalment 4 | $3,20,000 \times 1/_{10}$ | ₹ 32,000 |

Split of H.P. Instalment can be computed as below :

| *Year* | *H.P. Instalment (₹)* | *Interest (₹)* | *Repayment (₹)* |
|---|---|---|---|
| 1 | 2,05,000 | 1,28,000 | 77,000 |
| 2 | 2,05,000 | 96,000 | 1,09,000 |
| 3 | 2,05,000 | 64,000 | 1,41,000 |
| 4 | 2,05,000 | 32,000 | 1,73,000 |

**Leasing Versus Hire Purchase:**

Both Leasing and hire purchase provide a source of financing fixed assets. However the two are not similar on many accounts.

**The following points of distinction are worth consideration from points of view of the lessee and the hirer:**

| Point of Difference | Leasing | Hire Purchase |
|---|---|---|
| 1. Ownership | Ownership is not transferred to the lessee. | Ownership is transferred to the hirer on payment of last instalment. |
| 2. Tax Deductibility | Entire lease rentals are tax-deductible expenses. | Only the interest component and not the entire instalment is deductible. |
| 3. Depreciation and Other Allowances | Cannot be claimed by the lessee | Can be claimed by the hirer. |
| 4. Salvage Value | Lessee cannot realise salvage value of the asset on the expiry of the lease of life of the asset. | Hirer can realise the salvage value of the asset after payment of last instalment and expiry of the life of the asset. |

**Selecting between Leasing and Hire Purchase:**

If a firm has the choice of selecting between leasing and hire purchase, it should evaluate the financial viability of both the proposals by adopting the normal methods of capital budgeting. We would prefer the technique of comparison of the present values of net outflows after-tax from the two options. The option with lower present value of cash outflows implies lesser cost and hence should be selected.

**FEATURES AND CHARACTERISTICS OF HIRE PURCHASE**

Hire purchase is a typical transaction in which the assets are allowed to be hired and the hirer is provided an option to later purchase the same assets.

Following are the features of a regular hire purchase transaction:

- Rental payments are paid in installments over the period of the agreement.
- Each rental payment is considered as a charge for hiring the asset. This means that, if the hirer defaults on any payment, the seller has all the rights to take back the assets.
- All the required terms and conditions between both the parties involved are documented in a contract called Hire-Purchase agreement.
- The frequency of the installments may be annual, half-yearly, quarterly, monthly, etc. according to the terms of the agreement.
- Assets are instantly delivered to the hirer as soon as the agreement is signed.
- If the hirer uses the option to purchase, the assets are passed to him after the last installment is paid.
- If the hirer does not want to own the asset, he can return the assets any time and is not required to pay any installment that falls due after the return.
- However, once the hirer returns the assets, he cannot claim back any payments already paid as they are the charges towards the hire and use of the assets.
- The hirer cannot pledge, sell or mortgage the assets as he is not the owner of the assets till the last payment is made.
- The hirer, usually, pays a certain amount as an initial deposit / down payment while signing the agreement.
- Generally, the hirer can terminate the hire purchase agreement any time before the ownership rights pass to him.

**HOW THE TRANSACTION / PROCESS OF HIRE PURCHASE TAKES PLACE STEP BY STEP?**

The following info graphics will explain how the transaction takes place.

**ADVANTAGES OF HIRE PURCHASE**

Hire Purchase has the following advantages:

- Immediate use of assets without paying the entire amount.
- Expensive assets can be utilized as the payment is spread over a period of time.
- Fixed rental payments make budgeting easier as all the expenditures are known in advance.
- Easy accessibility as it is a secured financing.

- No need to worry about the asset depreciating quickly in value as there is no obligation to buy the asset.

**DISADVANTAGES OF HIRE PURCHASE**

Hire Purchase suffers from the following disadvantages:

- Total amount paid towards the asset could be much higher than the cost of the asset due to substantially high-interest rates.
- The long duration of the rental payments.
- Ownership only at the end of the agreement. The hirer cannot modify the asset till then.
- The addition of any covenants increases the cost.
- If the hired asset is no longer needed because of any change in the business strategy, there may be a resulting penalty.

**HIRE PURCHASE IS BEST SUITABLE FOR**

Small scale companies and entrepreneurs can benefit from Hire Purchase. Expensive and important assets can be hired and later owned. This ensures that they can start using the asset from very first day and use the money earned to later buy the same assets.

Conclusion

Hire Purchase is an important source of financing in recent times. It provides a convenient way to afford and acquire assets that otherwise be financially unattainable. Thus, hire purchase also helps a nation's economy to grow further. However, before entering an agreement, one should clearly understand the costs involved and the disclosures provided. There are various other like term loan and installment purchase which looks similar but there is the difference between hire purchase and term loan and also there is the difference between hire purchase and installment purchase.

**FINANCIAL EVALUATION OF HIRE PURCHASE**

Now let us discuss the framework of financial evaluation of a hire purchase deal vis-à-vis a finance lease from both the hirer's as well as the finance company's view point.

**From the Point of View of the Hirer (Purchaser):**

The tax treatment given to hire purchase is exactly the opposite of that given to lease financing. It may be recalled that in lease financing, the lessor is entitled to claim depreciation and other deductions associated with the ownership of the equipment including interest on the amount borrowed to purchase the asset, while the lessee enjoys full deduction of lease rentals. In sharp contrast, in a hire purchase deal, the hirer is entitled to claim depreciation and the deduction for the finance charge (interest) component of the hire installment. Thus, hire purchase and lease financing represent alternative modes of acquisition of assets. The evaluation of hire purchase transaction from the hirer's angle, therefore, has to be done in relation to leasing alternative. Decision criterion: The decision criterion from the point of view of hirer is the cost of hire purchase vis a vis the cost of leasing. If the cost of hire purchase is less than the cost of leasing, the hirer should prefer the hire purchase alternative and vice-versa.

**Cost of hire purchase:**

The cost of hire purchase to the hirer consists of the following:

1. Down payment

2. + Service Charges

3. + Present value of hire purchase payments discounted by the cost of debt.

4. – Present value of depreciation tax shield discounted by cost of capital.

5. – Present value of net salvage value discounted by cost of capital.

**Cost of leasing:**

The cost of leasing consists of the followingelements:

1.Lease management fee

2.+ PV of lease payments discounted by cost of debt.

3.– PV of tax shield on lease payments and lease management fee discounted by cost of capital.

4.+ PV of interest tax shield on hire purchase by cost of capital.

**From the View Point of Vendor / Financer**

Hire purchase and leasing represent two alternative investment decisions of a finance company / financial intermediary / hire-vendor. The decision criterion therefore is based on a comparison of the net present values of the two alternatives, namely, hire purchase and lease financing. The alternative with a higher NPV would be selected and the alternative having a lower NPV would be rejected.

**NPV of Hire purchase Plan:**

The NPV of HPP consist of

1. PV of hire purchase installments

2. + Documentation and service fee.

3. + PV of tax shield on initial direct cost

4. – Loan amount

5. – Initial cost.

6. – PV of interest tax on finance income (interest)

7. – PV of income tax on finance income meted for interest tax

8. – PV of income tax on documentation and service fee.

**NPV of Leas Plan:**

The NPV of LP consists of the followingelements:

1. PV of lease rentals.

2. + Leas management fee

3. + PV of tax shield on initial direct costs and depreciation.

4. + PV of Net salvage value.

5. – Initial investment

6. – Initial direct costs.

7. – PV of tax liability on lease rentals and lease management fee.

**Hire Purchase FAQ's**

1. **What is Hire Purchase?**

   It is a transaction by which a person buys a movable asset and pays the sale consideration to the financier in installments. It is an agreement of hire with an option to the hirer to purchase the asset. He is allowed to use the asset immediately, but becomes its owner only after he exercises the option after paying the entire installments. So in effect, he takes a loan from the owner or financier. During there payment period the ownership remains with the financier.

2. **What is 'option to purchase'?**

   In a hire purchase agreement, at the end of the hire period when all hire charges have been paid, the hirer has the option to purchase the asset at a value fixed by the financier. This is known as the option to purchase.
3. **What are the kinds of assets purchased under a hire purchase agreement?**

   Movable assets like cars, machinery, fixtures and furniture, computers and electronic items, that can be delivered physically, can be purchased. Immovable property cannot be purchased under a hire purchase agreement. The transaction with reference to immovable property is normally referred to as sale and lease agreement.
4. **Is a guarantor required in a Hire purchase agreement and if so who can be a guarantor?**

   A guarantor is not essential for a hire purchase transaction, unless the financier insists on it. Most financiers however insist on a guarantor. The guarantor acts as an additional security against default in payment by the hirer. Any creditworthy person can be a guarantor, if the financier is satisfied that he can repay the money in case of default by the hirer.
5. **What is the financier's security in a Hire purchase agreement, without a guarantor?**

   The financier may ask the hirer for an immovable property as security. However the primary security for the financier is the product purchased under the agreement.6.What precautions should a hirer take before he enters into a hire purchase agreement? Before entering into a hire-purchase agreement, a person should

1.Sign on a hire purchase agreement form containing the terms of hire purchase.

2. Insist for a copy of the agreement for his record.

3. Keep a record of all payments made to the financier till the payment of the last installment.

4. Get a 'no dues' receipt from the financier after full payment of the hire purchase charges.

**7. Can I pre-pay all my installments under hire purchase agreement?**

Normally a financier does not allow any pre-payment of installments unless he is compensated for the loss of interest.

**8. Will default or delay in the payment of installments attract penalty?**

Yes. Usually, the hirer has to pay a penalty or fine to the financier for default or delay in the payment of the dues under the agreement.

**9. What are the income tax implications in the case of a hire purchase?**

In the hire purchase the hirer carrying business or profession gets benefit of depreciation. He can also claim deduction on the interest paid on hire charges, in his income tax assessment.

**LEASING Vs HIRE PURCHASE**

**Ownership of the Asset**

In a lease, ownership lies with the lessor. The lessee has the right to use the equipment and does not have the option to purchase. Whereas in hire purchase, the hirer has the option to purchase. The hirer becomes the owner of the asset/equipment immediately after the last installment is paid.

**Depreciation**

In lease financing, the depreciation is claimed as an expense in the books of the lessor. On the other hand, the depreciation claim is allowed to the hirer in the case of hire purchase transaction.

**Rental Payments**

The lease rentals cover the cost of using an asset. Normally, it is derived with the cost of an asset over the asset life. In the case of hire purchase, installment is inclusive of the principal amount and the interest for the time period the asset is utilized.

**Duration**

Generally, lease agreements are done for longer duration and for bigger assets like land, property etc. Hire Purchase agreements are done mostly for shorter duration and cheaper assets like hiring a car, machinery etc.

**Tax Impact**

In the lease agreement, the total lease rentals are shown as expenditure by the lessee. In hire purchase, the hirer claims the depreciation of asset as an expense.

**Repairs and Maintenance**

Repairs and maintenance of the asset in the financial lease are the responsibility of the lessee but in operating lease, it is the responsibility of the lessor. In hire purchase, the responsibility lies with the hirer.

**The extent of Finance**

Lease financing can be called the complete financing option in which no down payments are required but in the case of hire purchase, the normally an amount of margin money is required to be paid upfront by the hirer. Therefore, we call it a partial finance like loans etc.

Businessmen can opt option of lease finance or the hire purchase but they should be analyzed properly as to how much the options suits to the business requirement and situations.

**---------------------------------------------------------------------END-----------------------------------------------------------------**