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Higher Education for All

FINANCIAL SERVICES AND MARKET

COURSE CODE: SGB24CM504ME

Bachelor of Commerce (Honours)
Major Discipline Specific Elective
Self Learning Material



SREENARAYANAGURU OPEN UNIVERSITY

The State University for Education, Training and Research in Blended Format, Kerala

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To increase access of potential learners of all categories to higher education, research and training, and ensure equity through delivery of high quality processes and outcomes fostering inclusive educational empowerment for social advancement.

Mission

To be benchmarked as a model for conservation and dissemination of knowledge and skill on blended and virtual mode in education, training and research for normal, continuing, and adult learners.

Pathway

Access and Quality define Equity.

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Financial Services and Market

Course Code: SGB24CM504ME

Semester - V

Four Year Undergraduate Programme
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MESSAGE FROM VICE CHANCELLOR

Dear Learner,

It is with great pleasure that I welcome you to the Four Year BCom Programme offered by Sreenarayanaguru Open University.

Established in September 2020, our university aims to provide high-quality higher education through open and distance learning. Our guiding principle, 'access and quality define equity', shapes our approach to education. We are committed to maintaining the highest standards in our academic offerings.

Our university proudly bears the name of Sreenarayanaguru, a prominent Renaissance thinker of modern India. His philosophy of social reform and educational empowerment serves as a constant reminder of our dedication to excellence in all our academic pursuits.

The Four Year BCom Programme covers all relevant areas aligned with modern business practices and economic principles. We have incorporated the latest trends in commercial studies to ensure a comprehensive and up-to-date curriculum. Moreover, the programme encompasses flexible options for learners to choose from a range of Ability Enhancement Courses, Multi-disciplinary Courses, Value Added Courses, and Skill Enhancement Courses, complemented by discipline-oriented Advanced and Additional Advanced Courses.

Our teaching methodology combines three key elements: Self Learning Material, Classroom Counselling, and Virtual modes. This blended approach aims to provide a rich and engaging learning experience, overcoming the limitations often associated with distance education. We are confident that this programme will enhance your understanding of commercial principles and practices, preparing you for various career paths and further academic pursuits.

Our learner support services are always available to address any concerns you may have during your time with us. We encourage you to reach out with any questions or feedback regarding the programme.

We wish you success in your academic journey with Sreenarayanaguru Open University.

Best regards,



Dr. Jagathy Raj V.P.
Vice Chancellor
Sreenarayanaguru Open University

01-09-2026

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BLOCK 1

Indian Financial System

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Unit 1
Introduction to Indian Financial System

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ gain insight into the concept of financial system
- ◊ describe the structure and components of the Indian Financial System
- ◊ familiarise the role and functions of financial institutions, financial markets, financial instruments and financial services
- ◊ classify the different types of financial institutions, financial markets, financial instruments, and financial services based on their characteristics and functions.
- ◊ understand the interactions among the components of the Indian Financial System

Prerequisite

Arun is a software professional who has been setting aside a part of his monthly income as savings. After accumulating a good amount of money, he wants to invest it in a suitable avenue to earn a return. Meena, on the other hand, runs a small handmade jewellery business and wants to expand her business by purchasing new machinery, increasing production, and opening another outlet. However, she does not have sufficient funds to meet her expansion requirements. Here we have two individuals: one with surplus funds and another who needs funds. How can Arun's savings help Meena expand her business? The answer lies in the Indian Financial System.

Arun can deposit his savings in a bank, invest in a mutual fund, or purchase securities through the financial market. Meena can approach a bank or financial institution for funds or

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raise money by issuing financial instruments such as shares, bonds, or debentures. If Arun wants to invest his money for a short period, he may come across the Money Market, where short-term financial instruments are traded. If he wants to invest in shares or other long-term securities, he can participate in the Capital Market, where long-term funds are raised and invested. In this way, the savings of people like Arun can ultimately reach businesses like Meena's.

As Arun explores different investment options, he also comes across various financial services. A stockbroker helps him buy and sell securities, a merchant banker assists companies in raising funds, and a credit-rating agency provides information about the creditworthiness of certain securities. Banks and other financial institutions also play an important role in collecting savings and making funds available to businesses and other users.

In this situation, Arun represents the saver or investor, while Meena represents the borrower or fund-seeking entrepreneur. Banks, mutual funds, and other financial institutions help mobilise and provide funds; the Money Market and Capital Market provide avenues for short-term and long-term financial transactions; shares, bonds, and debentures serve as financial instruments; and stockbrokers, merchant bankers, credit-rating agencies, and other service providers facilitate financial activities. Together, these components interact with one another to mobilise savings, facilitate investment, provide finance to businesses, and support economic development.

Thus, the experiences of Arun and Meena show how the Indian Financial System connects people with surplus funds to those who need funds and facilitates the efficient flow of financial resources in the economy. This unit discusses the components of the Indian Financial System, the role and functions of each component, the interactions among these components, and recent developments in the Indian Financial System.

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Keywords

Financial System, Financial Institutions, Financial Markets, Financial Instruments, Financial Services

Discussion

1.1.1 Financial System

1.1.1.1 Meaning of Financial System

The economic growth and development of a nation predominantly depend upon the existence of a well-integrated and efficient financial system. So, what exactly is a financial system?

A financial system refers to an integrated network of financial institutions, financial markets, financial instruments, and financial services that work together to facilitate the transfer, allocation, and management of funds efficiently and effectively. These subsystems provide a mechanism for transforming savings into productive investments. The financial system caters to both the short-term and long-term financial requirements of households and the corporate sector. By mobilising savings and directing them towards investment opportunities, the financial system ensures the efficient utilisation of a nation's resources and aids in capital formation.

1.1.1.2 Role/Functions of the Financial System

A financial system plays a crucial role in the economic development of a country by facilitating the flow of funds from savers to investors. It acts as an intermediary between those with surplus funds and those who require funds for productive purposes. The financial system performs the following functions:

i. Link Between Savers and Investors

The financial system helps to mobilise savings from scattered sources and channel them into productive investment. It thus serves as a vital link between those with excess funds (savers) and those who are in need of funds (investors).

ii. Selection and Evaluation of Investment Projects

By evaluating the performance of each project on a periodical basis, the financial system aids in the identification and selection of the most suitable projects for investment.

iii. Provision of Payment Mechanism

The financial system provides an efficient payment mechanism that facilitates the exchange of goods and services within the economy.

iv. Transfer of Resources Across Geographic Boundaries

An efficient financial system facilitates the transfer of financial resources across different geographical regions. Funds collected in one geographical region can be channelled to regions where investment opportunities and financial requirements exist. This promotes balanced economic development by ensuring that capital is allocated efficiently across states, regions, and countries.

v. Management and Control of Risk

The financial system provides mechanisms for managing and controlling the risks associated with mobilising savings and allocating credit.

vi. Promotion of Capital Formation

The financial system promotes capital formation by mobilising surplus funds from individuals and institutions and channelling them toward productive investment activities. This process, in turn, helps to increase the availability of capital for industrial growth, infrastructure development, and economic expansion.

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vii. Reduction in Transaction Costs

An efficient financial system helps to reduce transaction costs. Lower transaction costs, in turn, encourage individuals and businesses to participate more actively in saving and investment activities.

viii. Provision of Information to Market Participants

The financial system provides financial and economic information to various market participants such as individuals, business organisations, investors, and government agencies. The availability of accurate information, in turn, supports informed decision-making and improves transparency in the economy.

1.1.2 Components of Indian Financial System

A financial system mobilises individual savings and channels them into productive investments. It plays a vital role in economic development by promoting capital formation, encouraging savings and investments, providing liquidity, and ensuring the efficient allocation of resources. It also supports trade, industry, and overall financial stability within a country.

The Indian Financial System comprises the following components:

a. Financial Institutions
b. Financial Markets
c. Financial Instruments
d. Financial Services

1.1.2.1 Financial Institutions

Financial institutions are intermediaries that play an important role in ensuring the smooth functioning of the financial system by connecting investors and borrowers. They mobilise savings from savers and channel them into productive activities that generate better returns. These institutions also provide advisory services to individuals, businesses, and governments. Additionally, they assist entities in raising funds from financial markets and other sources.

Role/Functions of Financial Institutions

1. Mobilisation of Savings

Financial institutions encourage individuals and organisations to save by offering safe and attractive investment options. They mobilise these savings and channel them into productive economic activities.

2. Allocation of Financial Resources

Financial institutions transfer funds from surplus units to deficit units and provide various forms of finance, such as loans, venture capital, and seed capital, to support business and industrial growth.

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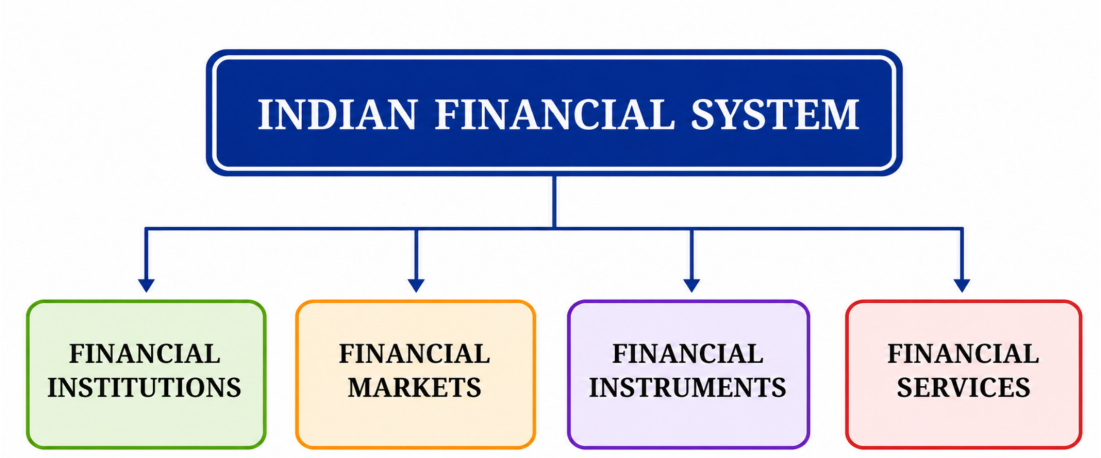


Fig 1.1.1 Structure of the Indian Financial System

3. Risk Management and Financial Stability

Financial institutions help reduce financial risks through diversification, insurance, and other risk-management mechanisms. They also contribute to the stability and smooth functioning of the financial system.

4. Information Processing and Investment Support

Financial institutions collect and analyse information about borrowers and investment opportunities, monitor funded projects, and facilitate informed investment decisions.

5. Promotion of Economic Development and Market Efficiency

Financial institutions improve the allocation of resources, reduce transaction costs, support business activities, and contribute to economic growth and the efficient functioning of financial markets.

Types of Financial Institutions

Financial institutions can be broadly categorised into two types:

a. Banking Institutions

b. Non-Banking Financial Institutions

A. Banking Institutions

The banking sector in India operates under the control and regulation of the Reserve Bank of India (RBI), which serves as the country's central bank. As the apex banking institution, the RBI is responsible for managing, supervising, regulating, and promoting the development of the country's monetary and financial system. Commercial banks in India primarily function within the legal framework established by the Banking Regulation Act, 1949, which sets out the rules and regulations governing their operations.

Banking institutions can be categorised into the Organised Sector and the Unorganised Sector.

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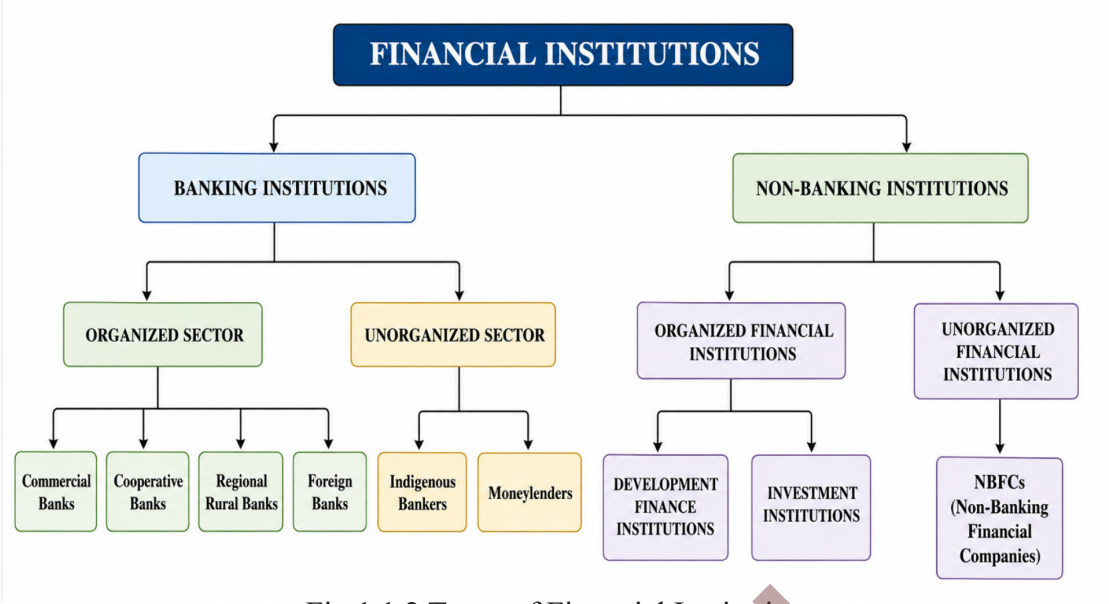


Fig 1.1.2 Types of Financial Institutions

I. Organised Sector

a. Commercial Banks

They form the largest segment of India's organised banking sector. Commercial banks can be categorised as either scheduled or non-scheduled banks. Scheduled Commercial Banks are those included in the Second Schedule of the Reserve Bank of India Act, 1934. Non-Scheduled Commercial Banks, conversely, are not listed in this schedule. As they do not fulfil the conditions required for inclusion, they operate under a different regulatory status and have more limited access to certain facilities available to scheduled banks. Currently, there are 124 Scheduled Commercial Banks and 4 Non-Scheduled Commercial Banks.

Prior to 1969, all major banks, with the exception of the State Bank of India, were in the private sector. A significant transformation in Indian banking occurred in July 1969, when the Government of India nationalised 14 large private banks. This was followed by the nationalisation of 6 more banks in 1980. The primary objective behind the nationalisation of banks was to make the banking system more mass-oriented, leading to significant branch expansion and wider access to banking services across the country. Since the economic reforms of the 1990s, the banking sector has undergone substantial changes, including the entry of new private banks, technological advancements, and banking sector consolidation.

Commercial banks may also be classified as public sector banks or private sector banks. Public Sector Banks are owned and controlled by the Government of India, with the government holding a majority stake (i.e., more than 50%). Examples include the State Bank of India and Punjab National Bank. Private Sector Banks are primarily owned by private shareholders and institutions. Contrary to public sector banks, the majority stake in these banks is held by private owners. Examples include HDFC Bank and ICICI Bank.

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Traditionally, the main functions of commercial banks were accepting deposits and providing short- and medium-term loans to businesses. However, after the economic reforms of the 1990s, their functions expanded to include the provision of funding for long-term projects, especially in infrastructure and other capital-intensive sectors. The liberalisation of the Indian economy led to the establishment of new private sector banks, which increased competition in the banking industry, ultimately leading to greater efficiency, innovation, and improved customer service. Over time, commercial banks also began providing merchant banking services.

Functions of Commercial Banks

The functions of commercial banks can be broadly classified into primary and secondary functions.

i. **Primary Functions:** These include accepting various types of deposits such as savings, current, fixed, and recurring deposits, and granting loans and advances to individuals, businesses, and other sectors of the economy.

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ii. **Secondary Functions:** This includes agency and utility services. Agency services encompass the collection and payment of cheques, bills, dividends, and interest; the transfer of funds; the purchase and sale of securities; and acting as trustees or executors on behalf of customers. Utility services, on the other hand, include providing safe deposit lockers, issuing demand drafts, travellers' cheques, credit and debit cards, internet and mobile banking facilities, foreign exchange services, and electronic payment systems.

b. Co-operative Banks

Co-operative Banks form an important component of the organised banking sector in India. They consist of groups of societies registered under the various State Co-operative Societies Acts. Co-operative banks primarily mobilise savings from their members and provide affordable credit to farmers, small businesses, artisans, self-employed persons, and other economically weaker sections of society, thereby promoting financial inclusion and rural development.

Co-operative credit institutions operating in India can be broadly segregated into two types of credit societies: rural credit societies and urban credit societies. While rural credit societies cater to the financing requirements of agricultural activities, urban credit societies cater to the financial requirements of non-agricultural activities.

There are different kinds of credit societies operating to provide agricultural credit. Short- and medium-term agricultural credit is provided through a three-tier federal structure. At the top, there is an apex body, i.e., State Co-operative Banks, followed by District or Central Co-operative Banks at the middle level, and Primary Agricultural Credit Societies at the village or grass-roots level.

In addition, there are specialised financial institutions called Land Development Banks, which are created to provide medium- and long-term agricultural financing.

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These banks operate through a two-tier structure. There are State or Central Land Development Banks at the state level, and branches of these banks and primary land development banks at the local level.

c.Regional Rural Banks (RRBs)

These banks were set up in 1975 with the objective of developing the rural economy. They provide banking services and credit facilities to small and marginal farmers and entrepreneurs in rural areas. They form an important part of the rural financial architecture in India.

The main functions of RRBs include the provision of agricultural credit for farming and allied activities. They also provide loans to rural artisans and small entrepreneurs, accept deposits from the public, support government-sponsored rural development programmes, and encourage savings among rural populations. Through these functions, RRBs play a significant role in rural economic development and financial inclusion.

d. Foreign Banks

These banks are incorporated and headquartered outside India but operate within the country through branches or wholly owned subsidiaries under the regulation of the Reserve Bank of India (RBI). Foreign banks facilitate international trade, foreign investment, remittances, trade finance, and wealth management services. HSBC and Standard Chartered Bank are some examples of foreign banks.

II. Unorganised Sector

The unorganised banking sector consists of indigenous bankers and money lenders who provide financial services outside the formal banking system.

a. Indigenous bankers

These are individuals or partnership firms who act as financial intermediaries and perform basic banking functions such as accepting deposits and lending money. Indigenous bankers have a long history in India and are known by different names in various regions. For example, they are called Chettiars in South India, Gujarati Shroffs or Marwaris in West India, and Sahukars in North India. Unlike commercial banks, indigenous bankers often use both their own funds and deposits collected from the public. Their main functions include accepting deposits from the public and providing loans and advances to traders and agriculturists. They also finance trade and commerce through instruments such as hundies, promissory notes, and mortgages.

b. Money Lenders

Money lenders include traders, merchants, large farmers, goldsmiths, village shopkeepers, and commission agents. They operate in both rural and urban areas. Their main function is to provide quick and easily accessible credit to farmers, labourers, small traders, artisans, and households, particularly in areas where formal banking services are inadequate. They often meet short-term and emergency financial needs and serve borrowers who may find it difficult to obtain loans from banks. However, they

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charge high rates of interest. Unlike indigenous bankers, money lenders generally do not accept deposits from the public or perform other banking functions.

B. Non-Banking Financial Institutions

Non-banking institutions may be classified into Organised Financial Institutions and Unorganised Financial Institutions.

I. Organised Financial Institutions

a. Development Financial Institutions (DFIs)

These are specialised financial institutions which provide medium- and long-term finance, especially for industrial, agricultural, and infrastructural development. Historically, there were many All-India level development financial institutions such as the Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India (IFCI), Industrial Investment Bank of India (IIBI), and Industrial Reconstruction and Development Corporation (IRDC). However, financial sector reforms brought significant changes to the development finance landscape. As a result, IDBI and ICICI were transformed into commercial banks, while IIBI and IRDC ceased operations. At present, important development finance institutions in India include the Industrial Finance Corporation of India (IFCI), the National Bank for Agriculture and Rural Development (NABARD), State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), and the National Bank for Financing Infrastructure and Development (NaBFID). These institutions continue to support economic development by providing long-term finance and promoting investment in priority sectors.

◊ **Industrial Finance Corporation of India (IFCI)**

It was established in 1948 and was the first development financial institution in India. It provides medium- and long-term financial assistance to industrial enterprises through loans and guarantees. It also provides underwriting and advisory services. IFCI further supports infrastructure projects, small and medium enterprises, and entrepreneurship development.

◊ **National Bank for Agriculture and Rural Development (NABARD)**

NABARD is the apex institution for agricultural and rural financing in India, established in 1982. It provides refinance facilities to banks and cooperative institutions, supports agricultural and allied activities, promotes rural industries and self-employment programmes, and finances infrastructure projects in rural areas. NABARD plays a vital role in strengthening rural credit systems and enhancing agricultural productivity.

◊ **National Bank for Financing Infrastructure and Development (NaBFID)**

Established in 2021, NaBFID is India's principal development finance institution, set up to fund long-term infrastructure projects. It provides long-term funding for infrastructure projects in various sectors such as transport, energy, digital infrastructure, and urban development.

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◊ **State Financial Corporations (SFCs)**

These are state-level development financial institutions established under the State Financial Corporations Act, 1951. SFCs primarily aim to provide medium- and long-term financial assistance to small and medium enterprises (SMEs) within their respective states. They offer financial support by granting loans and advances, providing underwriting services, and guaranteeing loans and deferred payments.

◊ **State Industrial Development Corporations (SIDCs)**

These institutions are established by state governments to promote industrialisation and balanced regional development. They assist entrepreneurs by providing financial support, developing industrial infrastructure, facilitating investment in industrial projects, and offering technical and managerial guidance.

b. Investment Institutions

These financial institutions mobilise savings from the public and channel them into productive investments in securities and other financial assets. Major investment institutions include LIC, GIC, and mutual funds.

◊ **Life Insurance Corporation of India (LIC)**

Established in 1956, LIC provides life insurance services and mobilises public savings through insurance premiums. The funds collected are invested in government securities, infrastructure projects, housing schemes, and industrial enterprises. LIC also supports industrial development through investments in shares, debentures, and bonds, thereby contributing to capital formation and economic growth.

◊ **General Insurance Corporation of India (GIC)**

The General Insurance Corporation of India (GIC) provides general insurance services covering risks related to property, business, health, and other contingencies. In addition to insurance activities, it supports industrial and economic development by investing in securities, underwriting public issues, subscribing to shares and debentures, and extending financial assistance to industrial enterprises.

◊ **Mutual Funds**

Mutual funds pool funds from investors and invest them in diversified portfolios of securities. Managed by professional fund managers, they provide diversification, liquidity, and opportunities for wealth creation while supporting capital market development.

◊ **Unit Trust of India (UTI)**

UTI, India's first mutual fund institution, was established in 1964. It pioneered the mobilisation of public savings for investment purposes. Today, through UTI Mutual Fund, it continues to offer a wide range of investment schemes and remains a prominent participant in India's mutual fund industry, contributing to capital formation and investor participation in financial markets.

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II. Unorganised Financial Institutions

These include non-banking financial companies (NBFCs), which provide a wide range of financial services such as factoring, merchant banking, credit rating, and housing finance.

1.1.2.2 Financial Markets

These are institutional arrangements for dealing in various financial assets and credit instruments, such as shares, debentures, bonds, government securities, treasury bills, commercial papers, and other financial claims. In essence, financial markets provide a mechanism for the exchange trading of financial products. They channel funds from savers to borrowers, catering to the short-term and long-term credit requirements of individuals, firms, and institutions.

Role / Functions of Financial Markets

Financial markets are organized platforms where financial instruments are traded, thereby enabling efficient interaction between investors and borrowers. The functions of financial markets are as follows:

i. Provision of Attractive Investment and Financing Opportunities

Financial markets offer a wide range of investment opportunities to individuals, institutions, and other investors through various financial instruments such as shares, bonds, debentures, mutual funds, and government securities. Investors can choose investment avenues that align with their return expectations, risk preferences, and investment objectives. Similarly, borrowing entities like businesses, governments, and individuals can raise funds through equity, debt, and other market instruments to meet their short-term and long-term financial requirements.

ii. Providing Liquidity

Financial markets help to provide liquidity by enabling investors to buy and sell financial securities whenever required. Investors can easily convert their investments into cash without significant loss of value, and this liquidity, in turn, encourages further investment.

iii. Price Discovery

Financial markets facilitate the determination of prices for financial assets through the interaction of demand and supply forces. Efficient price discovery thus helps ensure that securities are fairly valued and resources are allocated effectively.

iv. Risk Diversification and Reduction

Financial markets provide investors with a wide range of investment opportunities, enabling them to spread their investments across different securities and sectors. This diversification of investment allows investors to reduce their investment risk and minimise the impact of losses arising from investing in a single security.

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v. Efficient Payment and Settlement System

Financial markets enable the smooth transfer of funds and securities among participants. Modern payment and settlement systems ensure that transactions are completed quickly, securely, and efficiently, thereby enhancing confidence in the financial system.

vi. Dissemination of Information

Financial markets help to provide investors with timely and relevant information regarding companies, securities, market trends, and economic conditions. This information enables investors to evaluate investment opportunities and make informed financial decisions.

vii. Encouraging Capital Formation

By channelling funds into productive sectors of the economy, financial markets promote capital formation. Increased capital formation enhances productive capacity, supports business growth, and contributes to long-term economic development.

Types of Financial Markets

Financial markets may be classified into different types based on the maturity period of financial instruments, whether securities are newly issued or already traded in the market, the nature of financial claims, the organisational structure of trading, the timing of settlement, the type of securities traded, and the degree of regulation.

1. Money Market and Capital Market

On the basis of the maturity period of financial instruments, financial markets are broadly classified into the money market and the capital market. The money market deals with short-term financial claims, having a maturity period of less than one year. It provides liquidity and short-term funds to businesses, banks, governments, and other institutions. The capital market deals with long-term financial claims, with a maturity period exceeding one year. It facilitates the raising of long-term funds through instruments such as shares, debentures, and bonds. In short, the money market is for short-term funds, while the capital market is for long-term funds.

2. Primary Market and Secondary Market

Financial markets may also be classified into primary and secondary markets based on whether securities are newly issued or already in circulation. The primary market is where new securities are issued and sold to investors for the first time. Companies and governments raise fresh capital through this market. The secondary market is where existing securities are traded among investors after their initial issue in the primary market. It provides liquidity and marketability to securities.

3. Debt Market and Equity Market

Financial markets are classified into debt markets and equity markets based on the type of financial claim. The debt market deals with fixed-income securities such as

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bonds, debentures, treasury bills, and commercial papers, while the equity market deals with ownership securities such as equity shares and preference shares.

4. Exchange-Traded Market and Over-the-Counter Market

Financial markets can also be classified according to their organisational structure. Exchange-traded markets operate through centralised exchanges with standardised rules and procedures. Securities are traded in a transparent and regulated environment within an exchange-traded market. In contrast, over-the-counter (OTC) markets are decentralised markets where transactions take place directly between parties and can be customised according to their requirements.

5. Cash (Spot) Market and Forward Market

Based on the timing of settlement, financial markets may be classified into cash (spot) markets and forward markets. Payment and delivery of securities take place immediately after the transaction in a cash/spot market. However, in a forward market, delivery and settlement occur on a predetermined future date. These markets are commonly used for hedging risks and managing price fluctuations.

6. Industrial Securities Market and Government Securities Market

Based on the nature of securities traded, markets are classified into industrial securities markets and government securities markets. The industrial securities market deals with securities issued by corporate and industrial enterprises. Equity shares, preference shares, debentures, and corporate bonds are examples of industrial securities. The government securities market deals with securities issued by central and state governments and other public sector entities. This market is also known as the gilt-edged securities market. These securities are generally regarded as highly secure investments.

7. Organised Market and Unorganised Market

On the basis of their degree of regulation and organisation, financial markets can be classified into organised and unorganised markets.

Organised markets operate under a well-defined legal and regulatory framework, supervised by authorities such as the Reserve Bank of India and the Securities and Exchange Board of India.

Unorganised markets include moneylenders, indigenous bankers, chit funds, and other informal financial intermediaries that operate outside the formal financial system. However, many of these are now subject to greater regulation than in the past.

8. Other Financial Markets

In addition to the above classifications, there are certain specialised financial markets.

a. Term Loan Market

The term loan market provides medium and long-term finance to industries and businesses for productive purposes. Funds are supplied by commercial banks, development financial institutions, and other financial intermediaries. This finance supports the establishment of new projects, expansion of existing enterprises,

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modernisation, technological upgrading, diversification of business activities, and infrastructure development.

b. Mortgage Market

The mortgage market deals with loans secured by immovable properties such as land, residential houses, and commercial buildings. Borrowers obtain funds by mortgaging their property as collateral, while lenders acquire a legal claim on the property until the loan is fully repaid.

c. Financial Guarantee Market

The financial guarantee market facilitates financing arrangements backed by guarantees from individuals, institutions, or agencies. Such guarantees enhance the creditworthiness of borrowers, helping them to secure finance more easily.

1.1.2.3 Financial Instruments

Financial instruments are also referred to as financial assets or financial securities. A financial instrument represents a legal claim on an individual or institution, entitling the holder to receive a specified amount of money and/or regular payments, such as interest or dividends, at a predetermined future date. A wide variety of investors operate in the financial markets, and companies and financial institutions issue different kinds of financial instruments to suit their diverse requirements.

Types of Financial Instruments

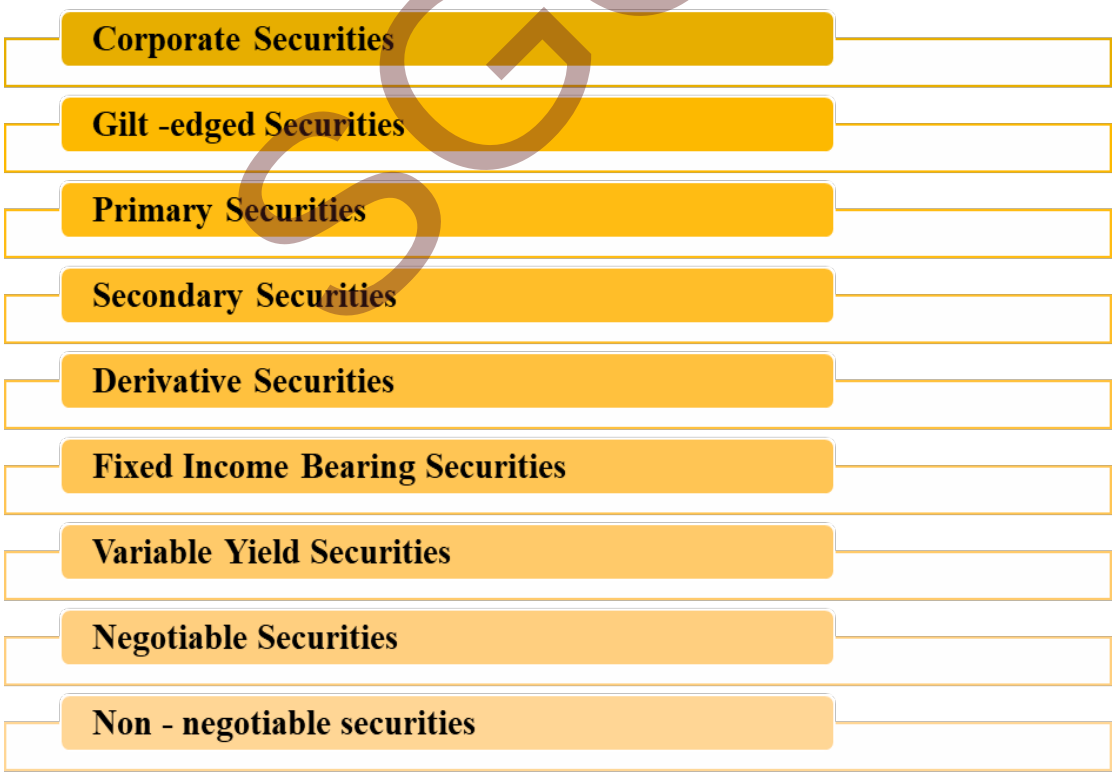


Fig 1.1.2 Types of Financial Instruments

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Financial instruments can be classified into different categories, as discussed below:

I. Corporate Securities

These are financial instruments issued by companies to raise capital for business operations and expansion activities. Corporate securities can be divided into ownership securities and creditorship securities.

A. Ownership Securities

Ownership securities are issued by companies to raise capital and represent ownership rights in the company. They are mainly of two types: equity shares and preference shares.

1. Equity Shares

Equity shares are ordinary shares that do not carry preferential rights, such as priority in receiving dividends and repayment of capital, which are typically attached to preference shares. The funds raised through such shares constitute a company's equity share capital, and the investors are known as equity shareholders. Equity shareholders are the true owners of the company and possess voting rights, allowing them to participate in its management. The dividend on equity shares is not fixed; it depends on the availability of profits. Equity shareholders have a residual claim on the company's income and assets, meaning they receive dividends and assets only after the claims of preference shareholders and creditors have been satisfied. Equity shares are typically non-redeemable during the company's lifetime unless bought back by the company. They represent risk capital, as equity shareholders bear the business risk. Furthermore, equity shares form the basis of ownership and control, granting shareholders influence over the company's management and policies.

Types of Equity Shares:

i. Blue-chip shares

These shares are issued by highly reputed, financially strong companies with an impressive track record of strong earnings and a stable dividend policy. These companies are usually leaders in their respective industries and enjoy a high level of investor confidence. These shares generally provide a low to moderate current yield and moderate to high capital gains. Here, current yield is the income an investor receives from a share in the form of dividends, expressed as a percentage of its current market price. For example, if the annual dividend per share is ₹20 and its current market price is ₹500, then the current yield of the share is 4%. Capital gain is the profit earned when the market price of a share increases above the price at which it was purchased.

ii. Growth shares:

Growth shares are issued by companies that possess significant opportunities for business growth and diversification through the reinvestment of retained earnings. These companies generally demonstrate above-average performance and strong future prospects. These shares offer a low current yield but provide high capital gain through

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the reinvestment of profits.

iii. Income shares:

These shares are issued by companies with fairly stable earnings but limited growth opportunities. They generally provide a high current yield. However, these shares have very little potential for capital gain.

iv. Defensive shares

These are the shares of companies whose performance is not significantly affected by fluctuations in general business conditions. These shares offer a moderate current yield and moderate capital gain.

v. Cyclical Shares

These are the shares of companies whose current yield and market prices move in line with the business cycle. The yield and share prices of these companies generally increase during boom periods. Conversely, during economic slowdowns or recessions, their yield and market values tend to decline. These shares are characterised by extreme price fluctuations and they offer a low to moderate current yield.

vi. Speculative Shares

These are shares whose prices are driven more by market expectations, rumours, or future growth prospects than by their current earnings or financial performance. They may experience sharp price increases or decreases within a short period. Investors purchase speculative shares with the expectation of earning substantial capital gains, even though such investments involve a high degree of risk. While speculative shares can generate exceptional returns, they can also result in significant losses if market expectations are not met.

2. Preference Shares

Preference shares carry a preferential right regarding the payment of a fixed dividend and the repayment of capital before equity shareholders in the event of liquidation. Preference shareholders generally do not have voting rights but receive greater security of income and capital than equity shareholders.

Types of Preference Shares:

i. **Cumulative Preference Shares:** These shares carry the right to receive unpaid dividends (or arrears of dividend) before any dividend is distributed to equity shareholders.

ii. **Non-Cumulative Preference Shares:** These shares do not carry the right to receive arrears of dividend. Therefore, if a dividend is not declared in a particular year, shareholders lose their right to receive that dividend, and it cannot be carried forward to future years.

iii. **Participating Preference Shares:** These shares give shareholders the right to receive an additional share in the company's surplus profits remaining after the

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payment of dividends to equity shareholders.

iv. **Non-Participating Preference Shares:**Non-participating preference shares are entitled only to their fixed dividend and do not have the right to participate in the surplus remaining after dividends have been distributed to equity shareholders.

v. **Convertible Preference Shares:**These are preference shares which carry a right to be converted into equity shares after a specified period.

vi. **Non-Convertible Preference Shares:**Non-convertible preference shares are those shares which cannot be converted into equity shares.

vii. **Redeemable Preference Shares:**These shares are those that the company can repay or redeem after a specified period, generally within twenty years from the date of issue. The repayment of the share capital is known as redemption.

viii. **Irredeemable Preference Shares:**Irredeemable preference shares are shares that are not redeemable during the lifetime of the company. Such shares can only be redeemed when the company is wound up. However, the Companies Act, 2013 prohibits the issue of irredeemable preference shares.

B. Creditorship Securities

Creditorship securities represent borrowed funds. When investors purchase such instruments, they lend money to the issuer, which may be a company, financial institution, or government. In return, the issuer agrees to repay the principal amount along with interest after a specified period. However, holders of creditorship securities do not have ownership rights in the organisation. They receive fixed or predetermined returns and generally face lower risk than equity investors. Debt instruments are widely used to raise funds for business expansion, government projects, and working capital requirements. Common examples include debentures, bonds, treasury bills, commercial bills, commercial papers, and certificates of deposit.

1. Debentures

Both companies and governments issue debentures to raise capital for their operations and development projects. A debenture refers to a document issued under the seal of a company acknowledging a debt borrowed from the public. It contains the terms for repayment of the principal amount and the payment of interest at regular intervals. Debenture holders are creditors of the company and receive a fixed rate of interest.

The different types of debentures are as follows:

i. **Secured Debentures:** These debentures are backed by the company's assets through the creation of a charge. In other words, these debentures are secured against the company's assets. If the company fails to meet its obligations, debenture holders can sell the company's assets to satisfy their claims. These debentures are also referred to as mortgaged debentures.

ii. **Unsecured or Naked Debentures**:Unlike secured debentures, unsecured debentures are not supported by any specific security or charge on the company's assets. These debentures are also referred to as naked debentures.

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iii. **Bearer Debentures:** These are debt instruments payable to the person who physically holds them. In the case of bearer debentures, the issuer does not maintain a record of the holder's name. Ownership of the instrument is determined simply by possession of the debenture certificate. Interest payments are usually made through attached coupons that the holder presents for payment. These debentures are negotiable instruments and can be transferred easily by mere delivery without any formal transfer procedure.

iv. **Registered Debentures:** Such debentures are issued in the name of a specific holder, and the details of the debenture holder are entered in the company's register of debenture holders. The holder's name also appears on the debenture certificate. Thus, the company recognises only the registered holder as the legal owner. Interest and principal payments are made only to the registered holder or to a person authorised by that holder. However, unlike bearer debentures, registered debentures cannot be transferred by simple delivery. Their transfer requires a formal procedure similar to the transfer of shares, including registration of the new holder's name in the company's records.

v. **Redeemable Debentures:**These debentures are those whose principal amount is repaid by the company after a specified period or on a predetermined date. These are the most common type of debentures issued by companies.

vi. **Irredeemable (Perpetual) Debentures:**These are debentures that do not have a fixed maturity date for the repayment of the principal amount. The company is not obligated to repay the principal during its lifetime, and repayment generally occurs only upon the winding up of the company. However, under the provisions of the Companies Act, 2013, the issue of such debentures is generally not permitted.

vii. **Convertible Debentures:** Convertible debentures can be converted into equity shares after a specified period and according to predetermined terms. They may be fully or partly convertible.

viii. **Non-Convertible Debentures:** These are debentures which cannot be converted into equity shares after the expiry of a specific period.

2. Corporate Bonds

A bond is a debt instrument through which the issuer borrows money from investors and promises to repay the principal amount on a specified maturity date, along with interest at a predetermined rate. As a bond is a bearer instrument, it can be transferred without a transfer deed. Bonds can be issued by private and corporate entities, as well as by the government. Bonds issued by corporate entities are referred to as corporate bonds. Corporate bonds may be secured or unsecured. While secured bonds are backed by a charge created on the specific assets of the company, unsecured bonds are not backed by specific assets of the company and rely solely on the issuer's creditworthiness. The maturity period of corporate bonds can range from a few years to several decades, depending on the issuer's funding needs. Since corporate bonds carry the risk that the issuing company may fail to meet its payment obligations, they are generally assigned credit ratings by agencies such as CRISIL, ICRA, and CARE Ratings. Corporate bonds are traded in the debt market and serve as an important source of long-term finance for

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companies while offering investors a fixed-income investment opportunity.

3. Certificates of Deposit (CDs)

These are negotiable money market instruments issued by scheduled commercial banks and financial institutions such as IFCI, IDBI, ICICI, and SIDBI to mobilise short-term funds. They are available to individuals, corporations, trust funds, and associations, among others. Certificates of Deposit (CDs) are issued in electronic (Demat) form or as a usance promissory note, offering investors a fixed return over a predetermined period.

CDs issued by banks typically have maturities ranging from 7 days to 1 year. Financial institutions like IDBI, ICICI, and IFCI are permitted to issue CDs with maturities from over 1 year up to 3 years. CDs are usually issued in a minimum denomination of ₹5 lakh and in multiples thereafter. They may be issued either at a discount to face value or with a floating interest rate. Their transferability, fixed tenure, assured returns, and regulation by the Reserve Bank of India (RBI) make them an attractive option for investors seeking short-term investment opportunities with moderate risk.

4. Commercial Papers (CPs)

Commercial Papers (CPs) are unsecured, short-term money market instruments issued by highly reputed, financially strong companies. In addition to companies, CPs are also issued by primary dealers and All-India financial institutions to meet their short-term funding requirements. They are issued in the form of a promissory note and are freely transferable by endorsement and delivery. These instruments are generally sold at a discount to their face value, with the difference between the issue price and face value representing the investor's return. Commercial Papers have a maturity period ranging from 7 days to 1 year (365 days). They are purchased by a wide range of investors, including individuals, banks, mutual funds, insurance companies, and other corporate entities seeking short-term investment opportunities.

5. Zero Coupon Bonds (ZCBs)

Zero Coupon Bonds (ZCBs) are debt instruments issued at a discount to their face value and redeemed at full face value upon maturity. The investor's return is the difference between the purchase price and the redemption value. For example, if a bond with a face value of ₹100 is issued at ₹80 and redeemed at ₹100 on maturity, the gain of ₹20 represents the investor's return. These are called zero coupon bonds because no interest or coupon payments are made during their tenure. ZCBs may be issued by governments, financial institutions, and corporate entities to raise funds. Their maturity period can range from less than one year to several decades, depending on the issuer and the purpose of the issue.

6. Deep Discount Bonds (DDBs)

These are long-term debt instruments issued at a substantial discount to their face value, often significantly below their redemption value. These bonds generally do not pay regular interest, providing returns through capital appreciation over time. Such bonds may be perceived as riskier than conventional bonds and are therefore offered at

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steep discounts. Investors are attracted to them due to their potential for high returns if held until maturity.

II. Government Securities

These include financial instruments issued by the Central Government, State Governments, semi-government bodies, and public sector undertakings to raise funds. Government securities are also referred to as Gilt-Edged Securities. The government borrows for both short-term and long-term needs. Short-term borrowings are raised through money market instruments such as Treasury Bills and call loans, while long-term borrowings are made through instruments like inscribed stock, promissory notes, and bearer bonds. These securities offer high safety and regular returns, making Gilt-Edged Securities highly suitable for conservative investors.

III. Primary Securities

These are financial instruments issued directly by the ultimate borrowers of funds, such as companies, governments, or business enterprises, to the ultimate savers or investors. Since these securities are issued directly by the borrowers, they are also known as direct securities. They represent a direct claim of investors on the issuing entity. Examples of primary securities include equity shares, preference shares, debentures, and bonds.

IV.Secondary Securities

These are financial instruments issued by financial intermediaries such as banks, insurance companies, mutual funds, and other financial institutions to savers. They are known as indirect securities because they are not issued by the ultimate borrowers of funds. Instead, financial intermediaries issue these securities to mobilise savings from the public and then invest or lend these funds to the ultimate borrowers. Examples of secondary securities include mutual funds, certificates of deposit, and commercial papers.

(V) Derivatives

These are financial instruments whose value is based on, or derived from, an underlying asset. This means that derivatives do not have an independent value of their own. The underlying asset may be securities, commodities, currencies, bullion, interest rates, market indices, or other assets. Common types of derivatives include forwards, futures, options, and swaps.

◊ Forwards

This is an agreement between two parties to buy or sell a specific asset at a predetermined price on a future date. The person who agrees to buy the asset (buyer) is said to hold a long position, while the person who agrees to sell the asset (seller) holds a short position. These contracts offer flexibility because the terms can be tailored to the needs of the parties involved. However, they are private agreements and are not traded on organised stock exchanges.

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◊ **Futures**

Here's the proofread text, focusing on clarity, flow, and UK English spelling:

These are standardised agreements to buy or sell an underlying asset at a predetermined price on a specified future date. The underlying assets may be shares, commodities, currencies, or debentures. Unlike forward contracts, futures are traded on organised stock exchanges, which fix all contract terms, including quantity, quality, lot size, duration, settlement date, and margin requirements. Futures contracts are also marked to market daily, meaning profits and losses are settled each day based on changes in market prices, thereby reducing the risk of default and ensuring greater transparency and liquidity.

◊ **Options**

These are agreements which give the holder the right, but not the obligation, to buy or sell an underlying asset at a predetermined price (strike price) on or before a specified future date. They are commonly used to protect against price fluctuations. A call option gives the right to buy an asset, while a put option gives the right to sell it. A double option provides both buying and selling rights. The holder can choose whether or not to exercise the option depending on market conditions.

◊ **Swaps**

A swap is a derivative agreement in which two parties exchange financial obligations or cash flows based on an underlying asset. These are private arrangements between parties to exchange cash flows. A swap combines characteristics of forward contracts and is generally customised to meet the needs of the parties involved. Swaps require two parties with opposite financial requirements and are widely used for managing financial risks and reducing borrowing costs. The main types of swaps are interest rate swaps (where interest payment obligations are exchanged), currency swaps (where cash flows in different currencies are exchanged), commodity swaps (which are based on commodity prices), and equity swaps (which are based on stock or index returns).

VI. Negotiable Securities

These are financial instruments that can be freely transferred from one person to another and traded in the financial market. Ownership can be transferred through delivery, endorsement, registration, or electronic transfer via depositories. Their key feature is liquidity, as investors can easily buy and sell them before maturity. Examples include shares, debentures, government securities, bonds, and other marketable securities. Negotiability enhances marketability and facilitates the efficient flow of capital in financial markets.

VII. Non-Negotiable Securities

These are instruments whose ownership cannot be freely transferred through simple endorsement and delivery. Transfer, if permitted, is subject to specific legal procedures and restrictions, and in some cases may not be allowed at all. Such securities are generally held until maturity or redemption and are not actively traded in secondary

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markets. Examples include fixed deposits, Public Provident Fund (PPF) accounts, National Savings Certificates (NSCs), and certain savings schemes. These instruments are preferred by investors seeking safety and stable returns rather than liquidity.

1.1.2.4 Financial Services

Financial services encompass the diverse offerings of financial institutions and intermediaries, facilitating the management, investment, transfer, and utilisation of money and other financial assets. These services enable individuals, businesses, and governments to meet their financial needs through savings, investments, borrowing, risk management, and financial planning. They include banking, insurance, leasing, mutual funds, merchant banking, stockbroking, credit rating, venture capital financing, and financial advisory services. Through these services, funds are mobilised from surplus units (savers) to deficit units (borrowers), thereby promoting economic growth and development. Thus, financial services support the efficient functioning of the financial system by linking investors, borrowers, and financial markets.

Features of Financial Services

a. Intangibility

Financial services are intangible as they cannot be seen, touched, or physically possessed like goods. Customers can only experience the benefits of services such as banking, insurance, or investment management.

b. Inseparability

Financial services are produced and consumed simultaneously. The service provider and the customer often need to interact directly for the service to be delivered effectively.

c. Perishability

Perishability means that financial services cannot be stored or inventoried for future use. If a service is not utilised at a particular time, it is lost and cannot be recovered later.

d. Heterogeneity / Variability

The quality and nature of financial services vary depending on the service provider, customer requirements, and circumstances. Therefore, no two service experiences are exactly the same.

e. Customer Orientation

Financial services are designed to satisfy the specific needs and preferences of customers. Financial institutions often customise their products and services to meet individual or business requirements.

f. Information-Based

Financial services are highly dependent on information. The industry involves collecting, processing, sharing, and utilising information to provide various financial

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products and services. Accurate and timely information is a crucial resource in the creation and delivery of financial services.

Role / Functions of Financial Services

Financial services refer to the activities and functions associated with the financial system, including the purchase and sale of securities, borrowing and lending of funds, investment activities, facilitation of payments and settlements, and the management of financial risks. The different functions of financial services are as follows:

i Mobilisation of Funds

Financial services facilitate the mobilisation of savings from investors such as individuals, institutions, and corporate entities through various financial instruments such as shares, bonds, debentures, mutual funds, and deposits.

ii Efficient Utilisation of Funds

Financial services ensure the effective allocation and utilisation of funds mobilised through various services such as merchant banking, credit rating, factoring, securitisation, and financial advisory services. For example, financial services like merchant banking assist companies in activities such as mergers and acquisitions, enabling optimal use of financial resources.

iii Provision of Need-Based Financial Services

Financial institutions offer customised services to meet the diverse requirements of individuals and businesses. Entrepreneurs can obtain venture capital, lease financing, and factoring services, while individuals can access housing finance, insurance, personal loans, and credit cards. Companies raising capital can also avail themselves of issue management and advisory services from merchant bankers.

iv Provision of Regulated and Secure Services

Financial services provided in the Indian financial markets are regulated by the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and the Insurance Regulatory and Development Authority of India (IRDAI). This regulation helps to ensure transparency, investor protection, and the stability of the financial system.

v Promotion of Economic Development

By mobilising savings and directing them towards productive investments, financial services contribute to capital formation, industrial growth, employment generation, and overall economic development. Thus, a well-developed financial services sector acts as a key indicator of a strong and growing economy.

Types of Financial Services

Financial Services may be classified into two types: (A) Asset/Fund-based Services and (B) Fee-based/Advisory Services.

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A. Fund-Based Financial Services

These are services in which the financial institution directly commits or invests its own funds. In other words, these services involve the funds of the financial institutions. In return for providing financial services, the financial institution earns income through interest, lease rentals, premiums, or other returns on the funds deployed.

1. Equipment Leasing / Lease Finance

This is an arrangement under which the owner of an asset grants another party the right to use the asset for a specified period in exchange for periodic rental payments. The owner of the asset is referred to as the lessor, while the party who obtains the right to use the asset is referred to as the lessee. It is important to note that ownership of the asset remains with the lessor, and the lessee merely enjoys the benefits of its use. Leasing arrangements are of vital use to businesses as they allow them to utilise costly machinery, equipment, or vehicles without owning them. This saves businesses from making substantial investments in fixed assets.

2. Hire Purchase and Consumer Credit

Hire Purchase refers to a method of financing in which a finance company allows a customer to acquire goods by paying the purchase price in instalments over an agreed period. While possession of the asset is transferred immediately, ownership remains with the financier until the final instalment is paid. Consumer credit is a method of financing provided to individuals for the purchase of durable consumer goods such as cars, motorcycles, refrigerators, and household appliances. Here, the buyer pays a part of the purchase price immediately at the time of delivery of the asset and pays the balance, along with interest, over a specific period. This arrangement enables consumers to enjoy the benefits of the asset while spreading the cost over time.

3. Housing Finance

It is the financial assistance provided by banks and housing finance institutions for the purchase, construction, renovation, or improvement of residential properties. These loans are generally repaid over a long period through equated monthly instalments (EMIs). Housing finance plays an important role in promoting home ownership and improving living standards.

4. Venture Capital Financing

This is a form of long-term financing provided to new and innovative business ventures that possess high growth potential but involve a significant amount of risk. In addition to providing financial assistance, venture capitalists also offer managerial expertise, technical guidance, and strategic advice to entrepreneurs. In return, they acquire an equity stake in the enterprise and share both the risks and rewards associated with its success. Once the enterprise reaches the profitability stage, the venture capitalists sell their stakes for a huge premium.

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5. Bill Discounting

This is a short-term financing facility through which financial institutions provide immediate funds to businesses by purchasing trade bills before their maturity date at a discounted value. The business receives instant liquidity instead of waiting for the credit period to expire. This service improves cash flow, facilitates smooth business operations, and helps firms meet their short-term financial requirements.

6. Insurance Services

Insurance refers to a contractual agreement under which an insurer (i.e., the insurance company) undertakes to compensate the insured (or the policyholder) for losses arising from specified risks in return for a premium. The risks covered may include fire, theft, accident, illness, disability, or death. Insurance provides financial security by transferring risk from individuals and businesses to insurance companies and helps to reduce uncertainty in business activities.

7. Factoring

This is a fund-based financial service in which a business converts its credit sales into immediate cash by selling its accounts receivable to a specialised financial institution known as a factor. A factor is an institution that purchases receivables from businesses and provides a range of services related to their management and collection. Besides providing short-term finance against receivables, the factor undertakes functions such as maintaining sales ledgers, collecting outstanding debts, monitoring creditworthiness, and offering protection against bad debts. Factoring helps businesses improve liquidity, reduce the administrative burden of debt collection, and focus on their core operations. Depending on the agreement, factoring may be with recourse, where the business bears the risk of bad debts, or without recourse, where the factor assumes the credit risk.

B. Fee-Based (Non-Fund-Based) Financial Services

These are services where financial institutions do not directly invest their funds. Instead, they act as intermediaries, advisors, or facilitators and earn income in the form of fees, commissions, or service charges.

1. Issue Management

This involves planning, coordinating, and managing the process of raising capital through the issue of securities such as shares, debentures, and bonds. It comprises pre-issue activities such as the preparation of prospectuses, pricing, underwriting, and regulatory compliance, and post-issue activities such as the allotment of securities and listing on stock exchanges. These services are generally provided by merchant bankers.

2. Merchant Banking Companies

These companies provide a wide range of financial advisory and issue management services to corporate clients. Their activities include underwriting securities, managing public issues, loan syndication, project counselling, mergers and acquisitions, corporate

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restructuring, and portfolio management. They assist companies in raising capital and making strategic financial decisions.

3. Corporate Counselling

This involves providing professional advice and guidance to business organisations on financial, managerial, and strategic matters. It helps companies to address operational challenges, improve performance, formulate growth strategies, and strengthen their market position. Such services are particularly useful during periods of expansion, diversification, restructuring, or financial difficulty.

4. Loan Syndication

This is the process of arranging large loans for corporate entities or government organisations through a group of lenders. A lead bank or merchant banker coordinates the entire process, bringing together multiple financial institutions to participate in the loan. This arrangement enables the sharing of risk among lenders while ensuring the availability of large amounts of capital to borrowers.

5. Corporate Restructuring

This refers to the process of making significant changes in the financial, operational, ownership, or organisational structure of a company with the objective of improving its efficiency, profitability, competitiveness, and long-term viability. Mergers, acquisitions, takeovers, amalgamations, demergers, consolidations, and financial restructuring are some of the major forms of corporate restructuring. Such measures help companies adapt to changing business conditions and enhance their competitive position.

6. Credit Rating

This is the process by which a rating agency evaluates the creditworthiness and repayment capacity of a company, government, or financial instrument. Ratings are assigned by the agency based on an assessment of financial strength, business performance, and risk factors. These ratings, in turn, help investors to assess the risk level associated with an investment and facilitate informed decision-making in the financial market.

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1.1.3 Interaction among the Components of the Financial System

The Indian Financial System is an integrated framework consisting of various financial institutions, financial markets, financial instruments, financial services, and regulators. All these components work together to facilitate the efficient allocation of financial resources in the economy. These components are interdependent; the effective functioning of one influences the performance of the others. Their continuous interaction ensures the smooth flow of funds from savers to investors and supports economic growth and development.

Financial institutions such as commercial banks, insurance companies, mutual funds, development banks, and non-banking financial companies (NBFCs) mobilise savings from individuals and organisations. These institutions then channel the collected funds into various financial markets where borrowers and investors interact. Financial markets provide the platform through which financial instruments like shares, bonds, debentures, treasury bills, and mutual fund units are issued and traded. These instruments serve as vehicles for transferring funds between surplus and deficit units in the economy.

Financial services such as merchant banking, stockbroking, credit rating, portfolio management, underwriting, leasing, and factoring help investors and businesses to access financial markets and instruments more effectively. Thus, they play a supportive role by facilitating transactions and improving market efficiency.

Regulators such as the RBI, SEBI, IRDAI, and PFRDA oversee institutions, markets, instruments, and services to ensure orderly functioning, investor protection, and systemic stability.

The interaction among these components creates a continuous cycle of savings, investment, and capital formation. Financial institutions supply funds to financial markets, which in turn provide liquidity and investment opportunities through financial instruments. Financial services ensure the smooth execution of transactions. Any change in one component affects the others. For instance, a rise in interest rates by banks may influence investment decisions in financial markets, while fluctuations in capital markets may affect the investment strategies of financial institutions. Thus, the components of the Indian Financial System operate as a closely connected network that promotes efficient resource allocation, financial stability, economic development, and the overall growth of the nation.

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1.1.4 Recent Developments in the Indian Financial System

The Indian financial system has undergone substantial transformation over the past decades. These include various developments such as financial sector reforms, technological advancements, regulatory improvements, and increased financial inclusion. Reforms introduced on the recommendations of the Narasimham Committee, such as the deregulation of interest rates, the introduction of prudential norms, capital adequacy requirements, and improved risk management practices, have strengthened the banking and financial sectors. These reforms have improved efficiency, transparency, competitiveness, and stability in the financial system and have paved the foundation for its modernisation and growth. The following are some of the major recent developments in the Indian financial system.

1. Expansion of Digital Banking and Payment Systems

The introduction of internet banking, mobile banking, and digital payment platforms has transformed the way financial transactions are conducted, demonstrating how technological innovation has revolutionised the Indian financial system. The development of the Unified Payments Interface (UPI) has enabled instant fund transfers and cashless transactions across the country. In addition, digital payment systems such as QR

code payments, Immediate Payment Service (IMPS), National Electronic Funds Transfer (NEFT), and Real Time Gross Settlement (RTGS) have significantly improved the speed and convenience of financial transactions. The widespread adoption of digital banking has ultimately helped to reduce transaction costs, improve customer service, and promote financial inclusion.

2. Growth of Financial Inclusion

Financial inclusion has become a major objective of the Indian financial system. Several initiatives have been launched to ensure that banking and financial services are accessible to all sections of society, especially rural and economically weaker sections. The use of Aadhaar-based identification and Direct Benefit Transfer (DBT) mechanisms has improved the delivery of government subsidies and welfare benefits to beneficiaries. Small Finance Banks, Payments Banks, and Banking Correspondents have further expanded the reach of financial services to underserved areas, thereby promoting inclusive economic development.

3. Development of Capital Markets

The Indian capital market has witnessed remarkable growth and modernisation. The introduction of electronic trading systems, dematerialisation of securities, online settlement mechanisms, and advanced risk management systems has increased market efficiency. The growth of stock exchanges, mutual funds, corporate bond markets, and alternative investment vehicles has expanded investment opportunities for individuals and institutions. Furthermore, the capital market reforms implemented by the Securities and Exchange Board of India (SEBI) have strengthened investor protection and enhanced market transparency. As a result, capital markets have become an important source of long-term finance for businesses and infrastructure projects.

4. Strengthening of the Regulatory Framework

Another major development pertains to the strengthening of the regulatory framework governing the Indian financial system. This framework has become more effective and comprehensive. Regulatory institutions such as the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI), and the Pension Fund Regulatory and Development Authority (PFRDA) have introduced several measures to ensure financial stability and protect the interests of investors and consumers. Measures such as enhanced disclosure requirements, stricter corporate governance standards, improved supervision, and stronger risk management practices have contributed to the soundness of the financial system.

5. Improvement in Corporate Governance and Transparency

Regulatory authorities have introduced stricter disclosure requirements, enhanced auditing standards, and stronger accountability mechanisms. These measures have led to increased transparency, reduced information asymmetry, and strengthened investor confidence. Better corporate governance has contributed to the stability and credibility of the financial system.

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6. Emergence of Financial Technology (FinTech)

Financial Technology, commonly known as FinTech, has emerged as a major force in the Indian financial sector. FinTech companies use technology to provide innovative financial products and services such as digital payments, online lending, investment management, insurance services, and wealth management solutions. FinTech innovations have enhanced customer experience, reduced operational costs, and increased competition within the financial sector. The use of artificial intelligence, big data analytics, cloud computing, and blockchain technology has significantly improved the efficiency and accessibility of financial services.

7. Introduction of New Financial Instruments

The Indian financial system has witnessed the introduction of several innovative financial instruments such as Exchange Traded Funds (ETFs), Sovereign Gold Bonds (SGBs), Infrastructure Investment Trusts (InvITs), Real Estate Investment Trusts (REITs), Municipal Bonds, Green Bonds, and Masala Bonds. These instruments have broadened the range of investment opportunities available in the market and facilitated resource mobilisation for infrastructure development, environmental sustainability, and economic growth.

8. Growth of Mutual Funds and Collective Investment Schemes

The mutual fund industry has undergone rapid growth in recent years. Increasing financial awareness, professional fund management, and systematic investment plans (SIPs) have encouraged retail participation in financial markets. Mutual funds provide investors with diversification, liquidity, and professional management of investments. The growth of the mutual fund sector has enhanced capital market participation and contributed significantly to the mobilisation of household savings into productive investments.

9. Development of the Corporate Bond Market

The corporate bond market has emerged as an important source of long-term financing for companies. Regulatory reforms have facilitated easier issuance and trading of corporate bonds. The development of electronic trading platforms, credit enhancement mechanisms, and improved disclosure standards are the major reasons behind the increased investor participation in the bond market. A well-developed corporate bond market reduces excessive dependence on banks and contributes to the diversification of funding sources for businesses.

10. Promotion of Sustainable and Green Finance

Environmental sustainability has become an important consideration in financial decision-making these days. Green finance initiatives encourage investments in environmentally sustainable projects such as renewable energy, energy efficiency, and climate-resilient infrastructure. The issuance of green bonds and the integration of Environmental, Social, and Governance (ESG) factors into investment decisions reflect the growing importance of sustainable finance in the Indian financial system.

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11. Increased Foreign Participation in Financial Markets

India has attracted substantial foreign investment through Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI). Liberalised investment policies, improved market infrastructure, and stronger regulatory mechanisms have improved the attractiveness of Indian financial markets to global investors. Increased foreign participation has contributed to capital inflows, market liquidity, and economic growth.

Recap

- ◊ The financial system refers to a set of integrated networks of financial institutions, markets, instruments, and services that work together to facilitate the transfer, allocation, and management of funds efficiently and effectively.
- ◊ A financial system plays a crucial role in the economic development of a country by facilitating the flow of funds from savers to investors. It acts as an intermediary between those with surplus funds and those who require funds for productive purposes.
- ◊ Financial institutions are intermediaries that mobilise savings from savers and channel them into productive activities that generate better returns.
- ◊ Financial markets are institutional arrangements for dealing in different kinds of financial assets and credit instruments such as shares, debentures, bonds, government securities, treasury bills, commercial papers, and other financial claims. In other words, financial markets provide a mechanism for the exchange trading of financial products.
- ◊ A financial instrument is a legal claim on an individual or institution that entitles the holder to receive a specified amount of money and/or regular payments, such as interest or dividends, at a predetermined future date.
- ◊ Financial services refer to the various services provided by financial institutions and intermediaries to facilitate the management, investment, transfer, and utilisation of money and other financial assets.

Objective Questions

1. Which component of the financial system facilitates the buying and selling of securities?
2. What is the market for short-term funds called?

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3. What is the market for long-term funds known as?
4. Which financial institution primarily accepts deposits from the public?
5. What instrument represents ownership in a company?
6. Which financial instrument acknowledges a company's debt?
7. What is a financial instrument whose value is derived from an underlying asset called?
8. What is the term for a system where ownership of an asset is transferred after payment of the final instalment?
9. Which fund-based financial service involves the purchase of receivables by a financial institution?
10. Which derivative contract gives the holder the right but not the obligation to buy or sell an asset?

Answers

1. Financial Market
2. Money Market
3. Capital Market
4. Bank
5. Share
6. Debenture
7. Derivative
8. Hire Purchase
9. Factoring
10. Option

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Self-Assessment Questions

1. What is Financial System? Explain its functions
2. Briefly explain the various financial instruments
3. Discuss the functions of Financial Markets.
4. Elaborate the various fund based financial services.

5. Explain the structure of Financial Institutions.
6. Discuss the recent developments in the Indian Financial System.

Assignments

1. The Indian Financial System acts as a bridge between savers and investors. Analyse how its various components contribute to the efficient allocation of financial resources in the economy.
2. Evaluate the role of financial instruments in meeting the diverse needs of investors and borrowers within the Indian Financial System
3. How do financial services support individuals and businesses in achieving their financial objectives? Analyse with suitable examples.

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Unit 2
Financial Markets

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ gain insight into the concept of Financial Markets.
- ◊ explain the different types of financial markets
- ◊ understand the concept of primary market and secondary market
- ◊ familiarise the different market intermediaries

Prerequisite

Anjali is a young entrepreneur who has recently started a small technology-based business. After saving ₹75,000 from her earnings, she wants to invest a part of her savings in securities to earn a return. At the same time, XYZ Ltd, an established company, plans to expand its production capacity and requires substantial funds. So, how can Anjali's savings reach a company like XYZ Ltd that needs funds? The answer lies in the financial markets.

Financial markets provide a platform through which individuals, businesses, and other entities can raise, invest, and transfer funds through different financial instruments. Financial markets are broadly classified into the Money Market and Capital Market. The Money Market deals with short-term funds and financial instruments, generally having a maturity period of up to one year. The Capital Market deals with long-term funds and includes the market for securities such as shares and bonds.

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Let us imagine that Anjali invests a portion of her savings in short-term financial instruments such as Treasury Bills or Commercial Papers. Such transactions take place in the Money Market, where short-term funds are borrowed and invested. Now, suppose XYZ Ltd decides to raise long-term funds by issuing new shares to the public. This transaction takes place in the Capital Market. Anjali purchases some of these newly issued shares. This is known as the Primary Market, where companies issue new securities to raise fresh capital from investors.

After some time, Anjali decides to sell her shares to another investor. The transaction takes place in the Secondary Market, where securities that have already been issued are bought and sold among investors. While the primary market helps companies raise new funds, the secondary market provides liquidity and facilitates the continuous trading of securities.

The smooth functioning of these markets requires the support of various market intermediaries. Stockbrokers help investors buy and sell securities, depositories hold securities in electronic form, depository participants provide investors access to depository services, banks facilitate the transfer of funds, and clearing corporations assist in the clearing and settlement of transactions. These intermediaries help make financial market transactions more organised, efficient, and secure.

The above story illustrates how financial markets connect investors who have surplus funds with companies and other entities that require funds. The Money Market meets short-term financial requirements, while the Capital Market facilitates long-term financing. Within the capital market, the Primary Market enables companies to raise fresh capital, whereas the Secondary Market facilitates the trading of existing securities. Market intermediaries support the smooth functioning of these markets.

This unit discusses the classification of financial markets, the Primary Market, the Secondary Market, and the various intermediaries involved in financial market transactions.

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Keywords

Financial Markets, Primary market, Secondary market, Intermediaries

Discussion

1.2.1 Financial Markets

Meaning of Financial Markets

A financial market refers to an organised system, arrangement, or platform that facilitates the exchange of financial instruments. These instruments include shares, debentures, deposits, loans, corporate bonds, government securities, and other financial products. Financial markets play a pivotal role in channelling funds from investors to borrowers and promoting the efficient allocation of financial resources within the economy.

1.2.2 Classification of Financial Markets

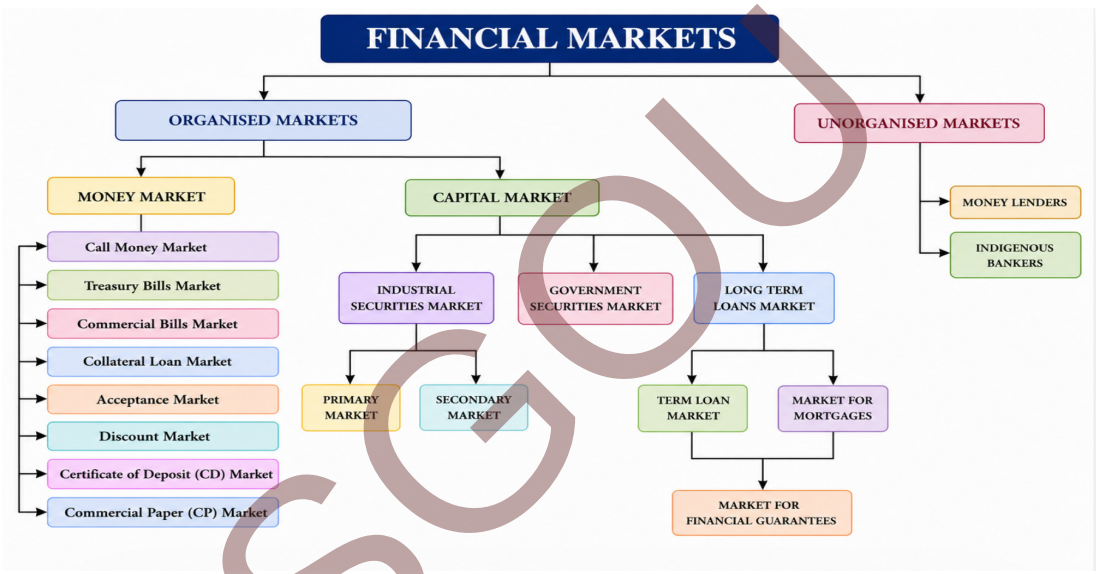


Fig 1.2.1 Classification of Financial Markets

Financial markets can be broadly classified into two categories: organised markets and unorganised markets.

◊ Organised Markets

These markets operate under a well-defined legal and regulatory framework. They are regulated and supervised by statutory authorities such as the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. Standardised rules and procedures govern trading, settlement, disclosure, and investor protection. As their operations are closely monitored by regulatory authorities, organised markets enjoy greater public confidence and contribute significantly to economic development. They comprise institutions such as commercial banks, cooperative banks, development financial institutions, stock exchanges, mutual funds, insurance companies, and other regulated financial intermediaries.

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◊ **Unorganised Markets**

These markets are generally not subject to strict government control. Dealings often take place based on informal agreements, personal relationships, and local customs. Key participants include moneylenders, indigenous bankers, chit funds, nidhis, pawnbrokers, and private finance companies. They meet the financial requirements of individuals, small traders, farmers, and small businesses that may not otherwise have easy access to formal financial institutions. Although unorganised markets offer quick and flexible access to funds, they often lack transparency, charge higher interest rates, and provide limited legal protection to borrowers and investors.

1.2.2.1 Organised Markets

Organised markets can be divided into two broad categories: the money market and the capital market.

A. Money Market

Meaning of Money Market

The money market is the segment of the financial market that deals with short-term funds and financial instruments with a maturity period of up to one year. It facilitates the borrowing and lending of short-term funds among various participants, helping them to meet temporary liquidity requirements. The Reserve Bank of India (RBI) is the regulator of the money market. The RBI regulates and supervises the money market, using it as an important tool for implementing monetary policy and controlling liquidity in the economy. Major participants in the money market include the Reserve Bank of India (RBI), commercial banks, cooperative banks, financial institutions, mutual funds, insurance companies, corporations, government agencies, and other market intermediaries.The RBI regulates and supervises the money market and uses it as an important tool for implementing monetary policy and controlling liquidity in the economy.

Features of Money Market

- ◊ The money market deals in short-term funds and financial instruments with a maturity period of up to one year.
- ◊ It facilitates the borrowing and lending of short-term funds to meet temporary liquidity requirements.
- ◊ The primary objective of the money market is to ensure liquidity and efficient short-term fund management in the economy.
- ◊ The Reserve Bank of India (RBI), commercial banks, financial institutions, mutual funds, corporations, and government agencies are the major participants in the money market.
- ◊ Governments, banks, and corporate entities are the major borrowers, while banks, mutual funds, financial institutions, and corporations are the major investors in the money market.
- ◊ Treasury Bills, Commercial Papers, Certificates of Deposit, Call Money, and

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Repurchase Agreements are the principal financial instruments traded in the money market.

- ◊ Money market investments are generally characterised by high liquidity, low risk, and low returns.
- ◊ The money market plays a crucial role in the implementation of monetary policy.
- ◊ The Reserve Bank of India (RBI) is the primary regulatory authority, supervising the functioning of the money market.

Functions of the Money Market

1. Provides Liquidity

The money market offers liquidity to banks, financial institutions, corporations, and governments by enabling them to borrow and lend funds for short periods. It assists organisations in addressing temporary cash shortages and efficiently managing their working capital requirements.

2. Facilitates Monetary Policy Implementation

The money market serves as a vital channel through which the Reserve Bank of India (RBI) implements monetary policy. The RBI regulates economic activity and maintains financial stability by influencing short-term interest rates and controlling the supply of money and credit.

3. Promotes Efficient Utilisation of Surplus Funds

The money market allows institutions and businesses with temporary surplus funds to invest them in short-term instruments. This ensures that idle funds are productively utilised and earn returns while remaining readily accessible when needed.

4. Supports Short-Term Financing

The market provides a mechanism for governments, banks, and corporate entities to obtain short-term funds for operational expenses, seasonal requirements, and temporary financial needs. This ensures the smooth functioning of economic and business activities.

Money Market Instruments

The various money market instruments are as follows:

i. **Commercial Bills:** These are negotiable credit instruments originating from genuine trade transactions. They represent an unconditional order by the seller directing the buyer to pay a specified sum on a predetermined future date.

ii. **Treasury Bills (T-Bills):** These are short-term sovereign debt instruments issued by the government to manage temporary fiscal imbalances and finance short-term expenditure requirements. T-Bills are issued at a discount to their face value.

iii. **Certificates of Deposit (CDs):** These are marketable money market instruments issued by commercial banks and financial institutions, acknowledging the receipt of funds for a fixed tenure at a predetermined rate of return.

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iv. **Commercial Papers (CPs)**: These are unsecured, negotiable promissory notes issued by highly reputable, financially sound companies to raise short-term funds for working capital and other operational financing needs.

v. **Repurchase Agreements (Repos):** A Repo is a short-term borrowing transaction in which participants such as the Reserve Bank of India (RBI), commercial banks, financial institutions, primary dealers, mutual funds, and others sell securities with an agreement to repurchase them at a specified price on a future date. Here, the securities serve as collateral for the loan.

vi. **Inter-Bank Participation Certificates (IBPCs):** Inter-Bank Participation Certificates (IBPCs) are short-term money market instruments that enable banks to share loans and transfer funds among themselves. They help banks manage liquidity efficiently and optimise the use of their financial resources.

4. Components of Money Market

The Money Market comprises the following sub-markets:

a. Call Money Market

It is an important segment of the money market that deals with the borrowing and lending of short-term funds by commercial banks and financial institutions. When funds are borrowed or lent for a period of one day (overnight), this is referred to as "call money". If funds are borrowed or lent for a period of more than one day but less than 14 days, it is called "notice money". Unlike call money, the borrower receives notice before repayment is demanded. This market helps banks and other eligible institutions manage temporary liquidity shortages and surpluses. Commercial banks, cooperative banks, primary dealers, and other authorised financial institutions are the major participants in the call money market, which helps banks manage their short-term liquidity requirements.

b. The Treasury Bills (T-Bills) Market

This segment of the money market deals in the sale and purchase of Treasury Bills, or T-Bills. T-Bills are issued by the RBI on behalf of the Government of India to meet its short-term financial requirements. T-bills are issued at a discount to their face value but are redeemed at par on maturity. The difference between these values is the return earned by the investor. They are considered one of the safest money market instruments because they carry the sovereign guarantee of the Government of India. T-Bills are currently issued with maturities of 91 days, 182 days, and 364 days. Treasury Bills are purchased by commercial banks, financial institutions, mutual funds, insurance companies, corporate bodies, and individual investors. The T-Bills market provides the government with short-term funds while offering investors a highly liquid and low-risk investment avenue.

c. Commercial Bills Market

This market deals in the buying and selling of bills of exchange. A commercial bill arises out of a genuine commercial transaction. It is a written instrument drawn by the seller on the buyer for the value of goods sold on credit. These bills are accepted by

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the buyer and can be discounted with banks before maturity, enabling businesses (or sellers) to obtain immediate funds. This market helps provide short-term finance to traders and business enterprises, promoting smooth trade and commerce. Commercial banks are the major participants in this market. It helps convert trade receivables into cash, improves working capital management, and facilitates the efficient flow of credit within the economy.

d. Collateral Loan Market

It is a specialized segment of the money market where loans are granted against the security of financial assets such as shares, stocks, bonds, and government securities. These loans are generally for short periods, ranging from a few weeks to several months. Commercial banks are the primary lenders in this market, while stockbrokers, traders, and business enterprises are the borrowers. The pledged securities act as collateral and are returned when the loan is repaid. If the borrower defaults, the lender acquires the right to sell or retain the collateral to recover the outstanding amount.

e. Acceptance Market

This is the market where banker's acceptances are sold and discounted. Banker's acceptances are created as a result of trade transactions. A banker's acceptance is a bill of exchange or draft drawn by a business firm on a bank and accepted by the bank, thereby guaranteeing payment of a specified amount on a future date. These instruments are widely used in domestic and international trade because they carry the creditworthiness of the accepting bank. Banker's acceptances can be easily sold or discounted before maturity, providing liquidity to traders and businesses.

f. Discount Market

This is the market where short-term credit instruments like commercial bills, treasury bills, and banker's acceptances are bought and sold at a discount before their maturity date. Businesses that receive bills of exchange from buyers can obtain immediate funds by discounting these bills with banks or financial institutions without waiting until the due date. The discount market thus provides liquidity to businesses and facilitates smooth trade and commercial transactions.

g. Certificate of Deposit (CD) Market

This is the market for dealing in certificates of deposit. These are negotiable money market instruments issued by banks and eligible financial institutions to raise short-term funds. CDs offer fixed returns and are transferable in the secondary market. They are generally issued in large denominations and have maturities ranging from 7 days to 3 years, depending on the issuer.

h. Commercial Paper (CP) Market

These are unsecured promissory notes issued at a discount, with a maturity period ranging from 7 days to one year. The Commercial Paper market enables financially

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strong companies, primary dealers, and financial institutions to raise short-term funds directly from investors.

B. Capital Market

1. Meaning

The capital market is the market that facilitates the borrowing and lending of long-term funds. Unlike the money market, which caters to short-term financing needs, the capital market provides funds for long-term investments such as business expansion, infrastructure development, and the acquisition of fixed assets. Mutual funds, insurance companies, foreign institutional investors, corporate entities, and individual investors are the major participants in the capital market.

2. Features of Capital Market

- ◊ The capital market deals in long-term funds and securities with a maturity period exceeding one year.
- ◊ It facilitates the transfer of savings from investors to businesses and governments requiring long-term capital.
- ◊ Companies, corporations, public sector undertakings, financial institutions, and governments are the primary borrowers of funds in the capital market.
- ◊ Major investors include individual investors, mutual funds, insurance companies, pension funds, banks, and foreign portfolio investors (FPIs).
- ◊ Instruments traded in the capital market include equity shares, preference shares, debentures, bonds, government securities, and mutual fund units.
- ◊ The capital market provides investment opportunities with relatively higher risk and higher return potential.
- ◊ Capital market operations are regulated primarily by the Securities Exchange Board of India (SEBI).

3. Functions of the Capital Market

The capital market performs the following functions:

i. **Mobilisation of Savings:** The capital market mobilises savings from individuals and institutions, channelling them into productive investments. It encourages people to invest their surplus funds in financial securities rather than keeping them idle.

ii. **Facilitates Capital Formation:**The capital market facilitates the provision of long-term funds to businesses and governments. These funds are, in turn, used by businesses for expansion, modernisation, infrastructure development, and other productive purposes, thereby contributing to capital formation.

iii. **Promotes Economic Growth:**The capital market supports industrial development, employment generation, and economic growth by channelling financial resources to productive sectors of the economy.

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iv. **Provides Investment Opportunities:**The capital market offers a variety of investment avenues such as shares, bonds, debentures, and mutual funds to investors. These opportunities enable investors to earn returns and diversify their savings according to their risk preferences.

v. **Ensures Efficient Allocation of Resources:**The capital market allocates funds to enterprises and projects that have better growth prospects and productive potential. This efficient allocation of financial resources enhances productivity and contributes to overall economic development.

4. Components of the Capital Market

The Capital Market comprises the following markets:

i. **Industrial Securities Market:**This is the segment of the capital market that deals with securities issued by corporate enterprises to raise long-term funds. Equity shares, preference shares, debentures, and corporate bonds are the major corporate securities traded in the industrial securities market. This market helps companies to mobilise capital from investors for business expansion, modernisation, diversification, and other long-term financial requirements. The industrial securities market consists of a primary market and a secondary market. The primary market is where new securities are issued, and the secondary market is where existing securities are traded among investors.

ii. **Gilt-Edged Securities Market:**This refers to the market for government securities. Gilt-edged securities are issued by the Central Government, State Governments, and certain government-backed institutions to raise long-term funds. These securities are considered highly secure investments with minimal default risk as they carry the sovereign guarantee of the government. Common instruments traded in this market include Government Securities (G-Secs) and Treasury Bills.

Table 1.2.1 Difference between Money Market and Capital Market

Basis of Comparison	Money Market	Capital Market
1. Meaning	It is the segment of financial market where short-term funds and securities are borrowed and lent.	It is the segment of the financial market where long-term funds and securities are issued and traded.
2. Nature of Market	It is informal and less organized.	It is formal, organized, and regulated.
3. Primary Function/ Aim	It aims to meet short-term credit and liquidity needs of businesses, financial institutions, and governments.	It aims to meet long-term financing and investment needs of businesses and governments.
4. Time Period / Maturity Period of Instruments	It deals with instruments having a maturity of up to one year.	It deals with instruments having a maturity of more than one year.

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5. Examples of Financial Instruments	Treasury Bills, Commercial Papers, Certificates of Deposit, Trade Credit, Call Money, Repurchase Agreements are the major money market instruments	Shares (Equity), Preference Shares, Debentures, Bonds, Euro Issues are the major capital market instruments.
6. Major Participants	Central Bank, Commercial Banks, Financial Institutions, Bill Brokers, Acceptance Houses are the major participants in the money market.	Stock Exchanges, Commercial Banks, Insurance Companies, Mutual Funds, Investment Banks, Corporate Firms are the major participants in the capital market.
7. Risk Factor	Low risk due to short maturity period and high liquidity.	Comparatively higher risk because of longer investment horizons and market fluctuations.
8. Return on Investment	Lower returns are expected from investments in instruments	Higher returns are expected compared to money market instruments.
9. Liquidity	Provides very high liquidity because funds are invested for short periods and instruments mature quickly.	Provides relatively lower liquidity because funds are invested for longer periods and investors may need to sell securities in the market before maturity.
10.Merit/Contribution	This market enhances liquidity and smooth functioning of the financial system.	It helps to mobilize savings and channels them into productive long-term investments.
11. Marketability of Securities	High marketability due to short-term nature.	Moderate to high marketability depending on the type of security.

1.2.3 Primary Market

1.2.3.1 Meaning of Primary Market

The primary market is the segment of the capital market where new securities and financial instruments are issued for the first time. Consequently, it is also referred to as the New Issues Market (NIM). It represents a crucial source for raising capital, enabling organisations to generate fresh funds by issuing securities such as equity shares, preference shares, debentures, government securities, and corporate bonds.

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Central and State Governments, Public Sector Enterprises, banks, financial institutions, and private sector public limited companies raise capital or funds through the primary market. These entities periodically issue new securities to obtain the capital required to meet their financial needs and support their operations and development.

In this market, securities are sold directly by the issuing organisation to investors. As a result, the issuer receives the funds and provides new securities to the investors. The primary market therefore plays a vital role in capital formation and economic growth by channelling savings into productive investments. After being issued in the primary market, these securities are generally traded in the secondary market, such as stock exchanges, bond markets, or derivatives exchanges.

1.2.3.2 Features of the Primary Market

- ◊ The primary market is where new securities are issued.
- ◊ In the primary market, securities are sold directly by the issuing company or institution to investors.
- ◊ Major issuers of financial instruments in the primary market include companies, corporations, financial institutions, and governments.
- ◊ Major investors operating in the primary market include retail investors, institutional investors, mutual funds, insurance companies, banks, and foreign investors.
- ◊ Shares, debentures, bonds, and other securities are some of the major financial instruments issued in the primary market.
- ◊ The main objective is to mobilise savings and provide long-term funds to issuers.
- ◊ Funds flow directly from investors to issuers in the primary market.
- ◊ Securities are issued through various methods such as Initial Public Offer (IPO), Follow-on Public Offer (FPO), Rights Issue, Bonus Issue, Private Placement, and ESOPs.
- ◊ Primary market operations are regulated by SEBI to ensure transparency and investor protection.
- ◊ Primary market operations are supported by merchant bankers, underwriters, registrars, bankers to the issue, and depositories.
- ◊ The primary market contributes directly to capital formation in the economy.

1.2.3.3 Functions of the Primary Market

1. Origination

This function involves the investigation, evaluation, and processing of new project proposals before securities are floated in the market. This activity begins well before the actual issue is offered to investors. It is generally carried out by merchant bankers. Commercial banks, all-India financial institutions, and private organisations may provide merchant banking services. Today, financial institutions and private firms also

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provide this service. Although origination is a vital function, the ultimate success of an issue largely depends on the efficiency and conditions of the market.

2. Underwriting

Underwriting is a contractual arrangement in which an underwriter agrees to purchase a specified number of shares, debentures, or other securities if the public does not subscribe to the entire issue. When an issue is fully subscribed, the underwriter has no obligation. However, if some securities remain unsold, the underwriter must buy them. Therefore, underwriting can be regarded as a guarantee for the marketability of shares and securities. In India, underwriting services are provided by both institutional underwriters, such as LIC, UTI, and IDBI, and non-institutional underwriters, who are mainly brokers.

3. Distribution

This function involves the sale of securities to the final or ultimate investors. It is performed by specialised intermediaries such as brokers and agents, who maintain regular and direct contact with investors. Their role is to ensure that the issued securities efficiently reach the ultimate buyers.

1.2.3.4 Methods of Issuing Securities in the Primary Market

The following are the different methods of issuing securities in the primary market.

1. Public Issue

This refers to an issue of securities made to the general public for subscription. It enables new investors to become shareholders of the company. A public issue may be an Initial Public Offer (IPO) or a Further Public Offer (FPO).

Initial Public Offer (IPO)

An IPO is the first public issue of securities by an unlisted company. Through an IPO, the company offers its shares to the public for the first time and obtains listing on a stock exchange. IPOs can be made through the fixed price method, the book-building method, or a combination of both.

Further Public Offer (FPO)

A Further Public Offer (FPO), or Follow-on Public Offer, is a public issue made by a company that is already listed on a stock exchange. Through an FPO, a listed company raises additional capital by issuing new securities to the public. In other words, an FPO is the subsequent public offer of securities of a listed company.

The methods of offering a public issue (IPO/FPO) can be of two types: (i) Offer through Prospectus and (ii) Offer for Sale.

Offer through Prospectus

Under this method, the company invites the public to subscribe to its securities

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through a prospectus containing important information about the company, its business, management, capital structure, and the details of the issue. The prospectus helps investors make informed investment decisions. The issue may be priced through the fixed price method, where the price is predetermined, or through the book-building method, where the final price is determined based on investor demand.

Offer for Sale

This refers to the outright sale of shares through intermediaries like issue houses, brokers, etc. In this method, the shares are not offered directly to the public. Instead, the intermediaries, after buying all the shares, resell them to the investing public. The company is relieved of the responsibility for marketing and allotment of shares.

2. Private Placement

It refers to the issue of securities to a selected group of investors rather than to the general public. As it involves fewer regulatory formalities and lower issue costs, it is considered a quicker and less expensive method of raising funds. Financial institutions, mutual funds, investment banks, and high-net-worth investors are common participants in private placements. Private placements may be of two types: Preferential Issues and Qualified Institutions Placements.

i Preferential Issue

This is a type of private placement in which a listed company issues securities to a select group of persons on a preferential basis. Such an issue requires approval from shareholders through a special resolution and must comply with SEBI pricing guidelines.

ii Qualified Institutions Placement (QIP)

This is a method through which a listed company raises funds by issuing or allotting equity shares or securities convertible into equity shares to Qualified Institutional Buyers on a private placement basis. Such an issue also requires approval from shareholders through a special resolution and must comply with SEBI pricing guidelines.

3. Rights Issue

A rights issue means offering additional shares to the existing shareholders of a company in proportion to their current shareholding. It gives existing shareholders the first right to subscribe to new shares before they are offered to others. Rights shares help companies raise additional capital while protecting the ownership interests of existing shareholders.

4. Bonus Issue

A bonus issue is the issue of additional shares to existing shareholders free of cost by capitalising the company's accumulated reserves and surplus. Since no fresh funds are raised, it merely converts reserves into share capital. Bonus shares increase the number of shares held by shareholders without requiring any additional investment from them.

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5. Employee Stock Option Plan (ESOP)

This scheme gives employees the option to purchase shares of the company at a predetermined price on a future date. The primary objective of an ESOP is to reward, motivate, and retain employees by giving them an ownership interest in the company. The option granted under an ESOP is non-transferable and can be exercised only by the employee to whom it is granted.

1.2.4 Secondary Market

1.2.4.1 Meaning

The Secondary Market is the market where securities that have already been issued in the Primary Market are bought and sold. In other words, it deals with the trading of existing or old securities among investors after their initial issue in the primary market. Transactions in this market take place between investors rather than between the issuing company and investors.

1.2.4.2 Components of Secondary Market

The secondary market consists of various segments or components that facilitate the trading of different financial instruments. These include:

- **Cash/Equity Market** where shares, debentures, mutual funds, ETFs, and other securities are traded.
- **Equity Derivatives Market** which deals in futures and options derived from underlying assets.
- **Debt Market** which enables the trading of bonds and other debt instruments.
- **Corporate Bond Market** where companies raise funds through the issue and trading of corporate bonds.
- **Forex Market** which facilitates the exchange of foreign currencies, and the **Commodity Derivatives Market**, where commodities such as gold, silver, and agricultural products are traded through standardised contracts.

1.2.4.3 Types of Secondary Market

The Secondary Market includes both stock exchanges and the over-the-counter (OTC) market, providing liquidity and a platform for the continuous trading of securities.

1. Stock Exchange Market (Organised Market)

This is a regulated and organised marketplace where previously issued securities are traded through recognised stock exchanges. Transactions are conducted according to established rules and regulations under the supervision of regulatory authorities such as SEBI. In this market, only listed securities can be traded. Buyers and sellers interact through registered stockbrokers rather than dealing directly with one another. Stock exchanges provide a transparent platform for trading, facilitate efficient price discovery, and ensure investor protection. The key features of this market include a high degree

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of regulation, transparency, liquidity, standardised trading procedures, and strong safeguards for investors. Its primary role is to facilitate efficient trading and ensure fair pricing and liquidity of securities.

Major examples of stock exchange markets in India are:

- ◊ **National Stock Exchange (NSE):** Established in 1875, it is the oldest in Asia. Its index is SENSEX (30 stocks)
- ◊ **The Bombay Stock Exchange (BSE):** Established in 1992, it pioneered screen-based trading. Its index is NIFTY 50
- ◊ **Metropolitan Stock Exchange of India (MSE):** A SEBI-recognised national stock exchange providing electronic trading in equities, derivatives, and currency markets.

Functions of a Stock Exchange

The functions of a Stock Exchange are as follows:

i. **Economic Barometer:** A stock exchange acts as a barometer of the economy, as changes in economic conditions are reflected in share prices. Rising prices indicate growth, while falling prices may signal a recession. A stock exchange is also known as a pulse of the economy or an economic mirror as it reflects the economic conditions of a country.

ii. **Pricing of Securities:**The stock exchange determines the value of securities through demand and supply. The valuation of securities helps investors, creditors, and the government in making financial decisions.

iii. **Safety of Transactions:**The stock exchange ensures safe trading by permitting transactions only in listed securities and requiring listed companies to comply with prescribed rules and regulations.

iv. **Liquidity:**The stock exchange provides a ready market for buying and selling securities, enabling investors to convert their investments into cash whenever required. This encourages investment in long-term securities by ensuring easy marketability.

v. **Spreading of Equity Cult:**The stock exchange encourages investment in equity shares by promoting fair trading practices, regulating new issues, and creating investor awareness.

vi. **Providing Scope for Speculation:**The stock exchange permits healthy speculation, which helps maintain liquidity and ensures active trading in securities.

vii. **Better Allocation of Capital and Promotion of Savings and Investment:**The stock exchange facilitates the allocation of funds to profitable and efficient companies by enabling them to raise capital more easily. It also encourages people to save and invest in corporate securities by providing attractive investment opportunities, thereby channelling savings into productive uses.

2. Over-the-Counter (OTC) Market

This is a decentralized market where securities are traded directly between buyers and sellers, bypassing a formal stock exchange. Consequently, the OTC market deals

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with securities not listed on stock exchanges. Transactions in the OTC market are negotiated through a network of dealers, brokers, financial institutions, or electronic trading platforms. Unlike stock exchanges, OTC markets offer greater flexibility in trading arrangements and in negotiating transaction terms. However, they are generally characterized by lower transparency and less stringent regulatory requirements.

Table 1.2.2 Difference between Primary Market and Secondary Market

Basis	Primary Market	Secondary Market
1. Meaning	It is the market where new securities are issued for the first time.	It is the market where existing securities are bought and sold among investors.
2. Purpose	It helps companies or governments to raise fresh capital	It helps to provide liquidity and facilitate trading of securities.
3.Participants	Company (issuer) and investors.	Investors/traders only.
4. Flow of Funds	The funds or capital or the money goes directly to the issuing company.	Money goes to the seller of the security and not the company.
5. Price Determination	Price is fixed by the issuer or through book-building.	Price is determined by the forces of market demand and supply.
6. Frequency of Sale	Securities are sold only once by the issuer.	Securities can be bought and sold repeatedly.
7. Intermediaries	Merchant bankers, underwriters, and registrars play an important role.	Stock brokers and stock exchanges facilitate trading.
8. Organised Market	There is no specific physical trading platform; securities are issued directly by the issuer.	Trading takes place through organized stock exchanges.
9. Location	No fixed place	Stock exchanges
10. Also known as	New issue market	Stock Market

1.2.5 Intermediaries

Financial intermediaries are institutions or organizations that act as a connecting link between investors and the securities market. They are responsible for facilitating functions such as buying, selling, holding, transferring, and settling securities in the securities markets, thereby ensuring the smooth functioning of the stock market. From the time a security is purchased until it is sold, various intermediaries perform specific functions under the supervision of SEBI. These intermediaries help reduce transaction costs, improve market efficiency, protect investors, and ensure transparency in securities transactions. Intermediaries can be divided into two categories: Primary Market Intermediaries and Secondary Market Intermediaries.

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1.2.5.1 Primary Market Intermediaries

1. Merchant Bankers / Lead Managers

Merchant bankers, also known as lead managers, are the principal intermediaries in the primary market. They act as a link between companies issuing securities and the investing public, managing the entire issue process. This includes preparing the prospectus, obtaining regulatory approvals, determining the timing and pricing of the issue, coordinating with other intermediaries, and ensuring compliance with SEBI regulations. In addition to these issue management functions, merchant bankers also provide corporate advisory services such as project counselling, financial planning, capital restructuring, mergers and acquisitions, underwriting arrangements, and investment advice to their clients. Their expertise helps companies raise funds efficiently and ensures the successful marketing of securities.

2. Underwriters to the Issue

These are financial institutions, banks, investment companies, or other approved entities that guarantee the subscription of a public issue. They undertake to purchase any unsubscribed portion of shares or debentures issued by a company if the public fails to subscribe fully. This assurance provides issuing companies with confidence that the required capital will be raised. By reducing the risk of under-subscription, underwriters contribute to the success of new issues and enhance investor confidence in the primary market.

3. Brokers to the Issue

These intermediaries are appointed by companies to market and distribute securities among potential investors. Brokers distribute application forms, provide information about the issue, encourage investor participation, and assist in broadening the investor base. Although the appointment of brokers is not compulsory, their experience, market knowledge, and access to investors make them valuable in ensuring wider distribution and successful subscription of securities.

4. Registrars to the Issue and Share Transfer Agents (R&T Agents)

They perform the administrative and record-keeping functions associated with a public issue. The responsibilities of R&T Agents include collecting and processing application forms, maintaining records of applications and funds received, assisting in the basis of allotment, issuing allotment letters and refund orders, and dispatching share certificates or facilitating demat credits. Additionally, they maintain records of security holders and handle matters related to transfer, transmission, redemption, and other investor services.

5. Bankers to the Issue

These are scheduled commercial banks appointed to collect application forms and application money from investors on behalf of the issuing company. They receive subscriptions through designated branches, maintain records of funds collected, transfer the proceeds to the issuer, and facilitate refunds where necessary. Their involvement ensures the safe handling of investors' money and the smooth processing of financial transactions related to the issue.

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1.2.5.2 Secondary Market Intermediaries

1. Stock Brokers

A stockbroker is a registered intermediary authorised by a stock exchange to buy and sell securities on behalf of investors. Stockbrokers act as a vital link between investors and the securities market, as individual investors cannot trade directly on stock exchanges. Their main functions include: executing purchase and sale orders; providing trading platforms; maintaining client accounts; offering market information and research; and ensuring compliance with stock exchange regulations. They play a crucial role in facilitating market transactions, enhancing liquidity, and enabling investors to participate efficiently in the securities market.

2. Depositories

A depository is an institution that holds securities such as shares, debentures, and bonds in electronic or dematerialised form. It eliminates the need for physical certificates and ensures the safe custody of securities. The primary functions of a depository include: holding securities electronically; facilitating the transfer of ownership; enabling dematerialisation and rematerialisation of securities; and reducing risks associated with the loss, theft, or forgery of certificates. In India, National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL) are the two recognised depositories.

3. Depository Participants (DPs)

A Depository Participant (DP) acts as an agent of a depository. It serves as the interface between investors and the depository. Investors cannot directly access depository services and must open a demat account through a DP. The main functions of DPs include: opening and maintaining demat accounts; processing requests for dematerialisation and rematerialisation; facilitating the transfer of securities; and providing account statements to investors. Thus, DPs play a significant role in ensuring easy access to depository services and promoting the smooth settlement of securities transactions.

4. Clearing Corporations and Clearing Houses

A clearing corporation or clearing house is an intermediary that ensures the successful settlement of securities transactions executed on stock exchanges. It acts as a central counterparty by becoming the buyer to every seller and the seller to every buyer. The major functions of Clearing Corporations and Clearing Houses are: determining settlement obligations; guaranteeing the settlement of trades; managing counterparty risk; and facilitating the transfer of funds and securities.

5. Custodians

A custodian is a financial institution that holds and safeguards securities and other financial assets on behalf of investors, particularly institutional investors such as mutual funds, insurance companies, and pension funds. Custodians provide services such as: safekeeping of securities; settlement of transactions; collection of dividends and

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interest; monitoring corporate actions; and maintaining records of investments. Their role is essential in ensuring the security of investors' assets and supporting the efficient administration of investment portfolios.

6. Registrars and Transfer Agents (RTAs)

These are specialised intermediaries responsible for maintaining records of investors and facilitating the transfer and transmission of securities. Their functions include: maintaining shareholder databases; processing transfers of securities; handling dividend payments; managing corporate actions such as bonus issues and stock splits; and updating investor records. RTAs play an important role in ensuring accurate record-keeping and smooth communication between companies and investors.

7. Portfolio Managers

A portfolio manager manages investment portfolios on behalf of clients, aligning with their financial objectives and risk preferences. They provide professional services such as investment planning, security selection, portfolio monitoring, diversification, and risk management.

8. Investment Advisers and Research Analysts

These professionals offer advice and research-based recommendations regarding investments in securities. Their primary functions include analysing financial markets, evaluating securities, preparing research reports, and advising investors on suitable investment opportunities. They play a significant role in helping investors understand the risks and returns associated with different securities.

9. Credit Rating Agencies

A credit rating agency assesses and rates the creditworthiness of companies, financial institutions, and debt instruments such as bonds and debentures. These agencies evaluate the financial strength of issuers, assess default risk, assign credit ratings, and provide information to investors regarding the safety of debt investments. Credit rating agencies play an important role in reducing information asymmetry, improving market transparency, and assisting investors in making informed investment decisions.

10. Merchant Bankers

A merchant banker is a financial intermediary that provides various services such as issue management, underwriting of securities, corporate restructuring, merger and acquisition advisory services, and financial consultancy. Although more prominent in the primary market, they also support activities related to the secondary market through advisory and investment services.

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Recap

- ◊ A financial market refers to an organised system, arrangement, or platform that facilitates the exchange of financial instruments.
- ◊ Financial markets may be broadly divided into organised and unorganised markets.
- ◊ The organised markets are divided into two segments: the money market and the capital market.
- ◊ The money market is the segment of the financial market that deals with short-term funds and financial instruments having a maturity period of up to one year.
- ◊ The capital market is the market that facilitates the borrowing and lending of long-term funds.
- ◊ The primary market is the segment of the capital market where new securities and financial instruments are issued for the first time.
- ◊ The secondary market is where securities that have already been issued in the primary market are bought and sold.
- ◊ The secondary market includes both stock exchanges and the over-the-counter (OTC) market.
- ◊ A stock exchange market is a regulated and organised marketplace where previously issued securities are traded through recognised stock exchanges.
- ◊ Transactions are conducted according to established rules and regulations under the supervision of regulatory authorities such as SEBI.
- ◊ The Over-the-Counter (OTC) market is a decentralised market where securities are traded directly between buyers and sellers without the use of a formal stock exchange.
- ◊ Financial intermediaries are institutions or organisations that act as a connecting link between investors and the securities market.
- ◊ Financial intermediaries are responsible for facilitating functions like buying, selling, holding, transferring, and settling securities in the securities markets.
- ◊ Financial intermediaries may be primary market intermediaries or secondary market intermediaries.

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Objective Questions

1. Which market deals with short-term funds and financial instruments?
2. Which market deals with long-term funds and securities?
3. In which market are securities issued for the first time?
4. In which market are existing securities bought and sold?
5. Which institution regulates the securities market in India?
6. What is the first public issue of shares called?
7. What is the subsequent public issue of shares by a listed company called?
8. What is the issue of shares to existing shareholders called?
9. Name any depository operating in India?
10. What is the document issued by a company inviting the public to subscribe to its securities called?

Answers

1. Money Market
2. Capital Market
3. Primary Market
4. Secondary Market
5. SEBI
6. IPO
7. FPO
8. Rights Issue
9. NSDL
10. Prospectus

Self-Assessment Questions

1. Explain the functions of Capital Market.
2. Discuss the components of money market.
3. What do you mean by Secondary Market? List the main features of secondary market.

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4. Differentiate between capital market and money market.
5. Explain the major money market intermediaries.
6. Explain the main functions of primary market
7. Differentiate between primary market and secondary market

Assignments

1. How do financial markets contribute to the efficient allocation of resources?
2. Examine the role of intermediaries such as merchant bankers and brokers to the issue in the primary market.
3. A commercial bank is facing a temporary shortage of funds for three months. Which segment of the financial market would be most suitable and why?
4. Compare the role of the money market and capital market in meeting the financial needs of businesses.

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2 BLOCK

Secondary Market

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Unit 1
Stock Exchange And Trading Mechanism

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ explain the concept of stock exchange and the basic mechanism of trading in securities.
- ◊ describe the role and functions of stock exchanges,
- ◊ identify and describe major stock exchanges in India.
- ◊ get an idea about major stock market indices.

Prerequisite

Neha is a young entrepreneur, who has been running a successful clothing business. To expand her business, she decides to raise money by offering shares to the public. At the same time, Arun, a salaried employee, wants to invest some of his savings by purchasing shares of companies. But how can Arun buy Neha's company shares safely and conveniently? This is where the stock exchange plays an important role.

Neha first needs to get her company's securities listed on a stock exchange, while Arun can purchase the listed securities through the stock market. The stock exchange provides an organised platform where buyers and sellers can trade securities. In India, investors can trade securities through major stock exchanges such as the BSE and NSE. They can also follow stock market indices, such as the Sensex and Nifty, to understand the general movement of the stock market.

Today, Arun does not have to visit a stockbroker personally to buy or sell shares. Through online trading, he can place orders using a computer or mobile phone. Behind these transactions, several institutions work together. SEBI regulates

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the securities market and oversees the functioning of stock exchanges and market intermediaries to promote fair and orderly markets. Depositories such as NSDL and CDSL hold securities in electronic form and facilitate their transfer between investors.

Thus, the journey of a security from listing to buying, selling, electronic holding, and transfer involves several important institutions and processes. Stock exchanges provide the trading platform, indices help investors understand market movements, online trading makes transactions convenient, SEBI provides regulatory oversight, and depositories enable the electronic holding and transfer of securities.

This unit discusses the role and functions of stock exchanges, listing of securities, stock exchanges in India, major stock market indices, online trading, the role of SEBI in regulating stock exchanges, and depositories.

Keywords

Stock Exchanges, Listing of Securities, Stock Market Indices, Online Trading, SEBI, Depositories

Discussion

On 28 April 1992, the Indian stock market witnessed one of the biggest financial scandals in its history. The securities scam associated with stockbroker Harshad Mehta exposed weaknesses in the functioning of the capital market and led to a sharp fall in share prices. Thousands of investors suffered losses, highlighting the importance of organised and regulated stock exchanges in ensuring transparency, investor protection and fair-trading practices. The incident also resulted in major reforms in the Indian securities market and strengthened the regulatory framework governing stock exchanges.

Today, stock exchanges play a central role in the financial system by providing a structured and regulated marketplace for the buying and selling of securities. They facilitate investment, provide liquidity and contribute to the efficient allocation of financial resources in the economy.

2.1.1 Meaning of Stock Exchange

A stock exchange is an organised market for the buying and selling of second-hand listed securities. It deals with various types of securities such as government bonds, municipal bonds, shares, debentures and units of mutual funds. Investors can buy or sell outstanding securities at prevailing market prices through the stock exchange.

Stock exchanges are the most important segment of the secondary market where existing securities are traded. They are organised markets in which a formal mechanism

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exists to bring buyers and sellers together. Trading is carried out through authorised members of the exchange, such as brokers and dealers, who execute transactions on behalf of investors.

Traditionally, stock exchanges operated through a physical trading floor where brokers met to buy and sell securities. The trading floor was often divided into different sections for government securities, debentures, specified shares and non-specified shares. Although modern stock exchanges largely function through electronic trading systems, their basic role remains unchanged.

2.1.2 Definitions of stock exchange

According to the Securities Contracts (Regulation) Act, 1956, a stock exchange is:"Any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities."

According to Pyle, “Security exchanges are marketplaces where securities that have been issued are bought and sold for investment or speculation."

According to Hartley Withers, "A Stock Exchange is something like a vast warehouse where securities are listed and traded."

According to Husband and Dockeray," Securities or stock exchanges are privately organised markets created to facilitate trading in securities."

2.1.3 Features of Stock Exchange

1. Centralised Marketplace

A stock exchange serves as a centralised marketplace for trading securities. Buyers and sellers do not directly negotiate with each other; instead, transactions are conducted through authorised brokers who act as intermediaries. This arrangement ensures orderliness, efficiency and transparency in the trading process.

2. Fair Open Market Price

A stock exchange enables buyers and sellers to interact in a competitive environment, resulting in the determination of fair market prices. Since numerous participants simultaneously place buy and sell orders, securities are traded at prices that reflect prevailing market conditions and investor expectations.

3. Auction Market

A stock exchange functions as an auction market where buyers compete to purchase securities at the lowest possible price, while sellers seek to obtain the highest possible price. The interaction of these competing interests leads to efficient price discovery and fair valuation of securities.

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4. Market Rules and Regulations

Every stock exchange operates according to a well-defined set of rules and regulations. These rules govern trading practices, listing requirements, settlement procedures and the conduct of members. Such regulations ensure discipline and reduce the possibility of unfair practices in the market.

5. Price Fluctuations

The prices of securities continuously fluctuate according to the forces of demand and supply. Changes in company performance, economic conditions, industry prospects and investor sentiment influence the movement of security prices. Consequently, market prices may rise or fall throughout the trading day.

6. Open to Small and Large Investors

Stock exchanges provide investment opportunities to both small and large investors. Individuals with modest savings as well as large institutional investors can participate in the market. This inclusiveness broadens the investor base and promotes capital market development.

7. Element of Risk

Investment in securities involves risk because prices are influenced by numerous factors, including corporate performance, industry conditions, government policies, economic developments and investor behaviour. Therefore, investors may earn profits when prices increase or incur losses when prices decline.

8. Wide Choice of Securities

Stock exchanges offer investors a wide variety of investment alternatives. Investors can select securities according to their financial objectives, risk tolerance and return expectations. The availability of different categories of securities enables diversification and better investment planning.

A stock exchange is an organised and regulated marketplace that facilitates the trading of securities in the secondary market. By providing a centralised trading platform, ensuring fair price discovery, maintaining market discipline and offering liquidity to investors, stock exchanges perform an essential role in the functioning of modern financial systems. Their ability to connect investors with investment opportunities contributes significantly to capital formation, economic growth and financial stability.

2.1.4 Functions and Role of Stock Exchange

1. Ensuring Liquidity of Capital

One of the most important functions of a stock exchange is to provide liquidity to investments. Investors can easily convert securities into cash whenever required because a ready market exists for listed securities. This feature encourages greater participation in financial markets. During the economic uncertainty caused by the COVID-19 pandemic in 2020, many investors were able to liquidate their investments

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quickly through stock exchanges to meet financial needs, demonstrating the importance of liquidity.

2. Providing a Continuous Market for Securities

A stock exchange provides a continuous and organised market where securities can be traded regularly. The securities remain tradable even though ownership changes frequently. This continuous trading facility ensures that investors can buy or sell securities without waiting for a specific buyer or seller. The introduction of electronic trading systems by the National Stock Exchange in 1994 significantly improved market accessibility and trading efficiency in India.

3. Evaluation of Securities

Stock exchanges help determine the market value of securities through the interaction of demand and supply forces. The prevailing market price reflects investors' assessment of a company's financial performance, future prospects and overall economic conditions. For example, the share prices of several technology companies increased substantially during the digital transformation period following 2020, reflecting investor confidence in the sector.

4. Mobilisation of Savings

Stock exchanges encourage individuals to invest their surplus funds in productive activities rather than keeping them idle. Small savings from millions of investors are channelled into business enterprises and development projects. This process supports industrial growth and economic progress. The rapid increase in retail investor participation in India after 2020 demonstrates how stock exchanges can mobilise household savings into capital markets.

5. Facilitating Capital Formation

Stock exchanges play a significant role in capital formation by encouraging investment and making it easier for companies to raise funds. When investors know that securities can be traded easily in the future, they are more willing to subscribe to new issues. A notable example is the initial public offering of Life Insurance Corporation of India in 2022, which became one of India's largest public issues and highlighted the role of stock markets in raising substantial capital.

6. Ensuring Safety in Dealings

Transactions on stock exchanges are governed by strict legal and regulatory frameworks. These regulations reduce the possibility of fraud, manipulation and unfair practices. In India, market activities are supervised by the Securities and Exchange Board of India, which was established in 1992 to protect investors and regulate securities markets. The strengthening of regulatory mechanisms after the 1992 securities transactions transparency significantly improved.

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7. Listing of Securities

Stock exchanges provide listing facilities to companies that satisfy prescribed requirements. Listing enhances the credibility of companies and increases investor confidence because listed companies must comply with disclosure and governance standards. Companies seeking listing are required to provide detailed financial information, enabling investors to make informed decisions.

8. Providing a Platform for Public Debt

Governments frequently require large sums of money to finance infrastructure projects, social welfare programmes and economic development initiatives. Stock exchanges provide a platform for the trading of government securities and bonds. In recent years, the Government of India has increasingly used government securities markets to finance infrastructure expansion and public investment programmes.

9. Acting as a Clearing House of Business Information

Listed companies regularly publish annual reports, financial statements and corporate announcements. Stock exchanges disseminate this information to investors, analysts and the general public. Such disclosures improve market transparency and assist investors in evaluating investment opportunities. The mandatory disclosure requirements introduced by SEBI have considerably enhanced corporate transparency in India.

10. Smoothening Price Movements

Through continuous trading and the interaction of numerous buyers and sellers, stock exchanges help moderate excessive price fluctuations. Although prices may rise or fall due to changing market conditions, organised trading mechanisms contribute to orderly market behaviour. Circuit breakers introduced in Indian stock exchanges after periods of market volatility help prevent extreme price movements and maintain market stability.

11. Investor Protection

Investor protection is a key function of stock exchanges. Mechanisms such as investor grievance redressal systems, arbitration facilities, investor education programmes and compensation funds safeguard investor interests. Following several financial scandals globally and in India, investor protection measures have been continuously strengthened to improve trust in capital markets.

12. Barometer of Economic Progress

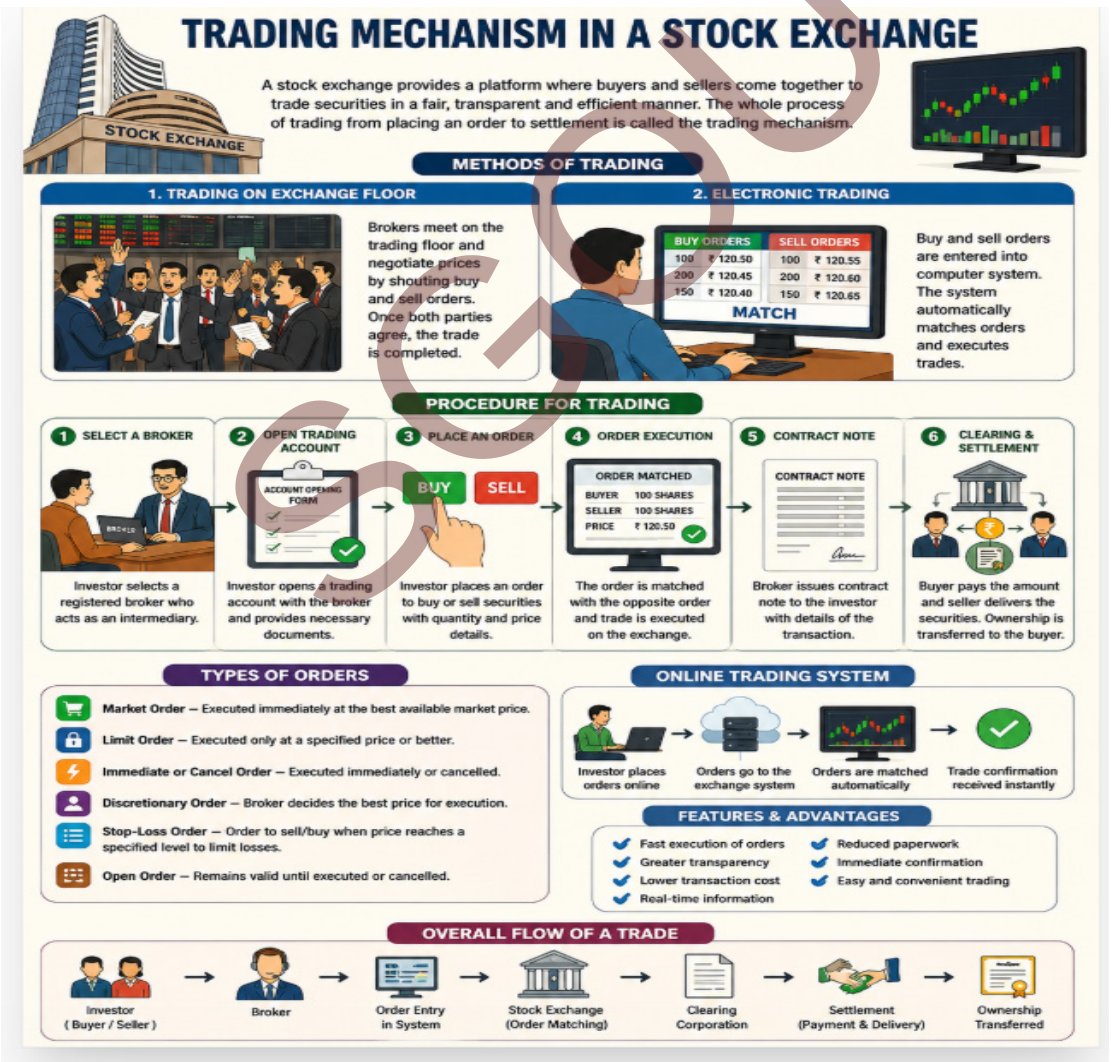
Stock exchanges are often regarded as indicators of a country's economic health. Rising stock market indices generally reflect business expansion, higher corporate profitability and positive economic expectations, while declining indices may indicate economic slowdown or uncertainty. For example, the sharp decline in stock markets during the early stages of the COVID-19 pandemic in 2020 reflected widespread economic concerns, while the subsequent recovery signalled improving economic prospects.

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2.1.5 Trading Mechanism in a Stock Exchange

Imagine that an investor sitting in Kollam wants to buy shares of a company, while another investor in Jaipur wants to sell the same shares at that very moment. They may never meet each other, yet the transaction can be completed within seconds. How does this happen? The answer lies in the trading mechanism of a stock exchange. A stock exchange does not merely provide a marketplace for securities; it also provides a systematic procedure through which buying and selling transactions are carried out safely, efficiently and transparently. Over the years, the trading system has evolved from crowded trading floors filled with brokers shouting buy and sell orders to sophisticated electronic platforms where transactions are completed with a few clicks.

The trading mechanism refers to the procedure followed for buying and selling securities through a stock exchange. It includes placing orders, matching buyers and sellers, executing trades, clearing transactions and settling payments and deliveries. The objective of the trading mechanism is to ensure that securities are traded in an organised manner and that every transaction is completed smoothly without disputes.



2.1.5.1 Methods of Trading in Stock Exchanges

There are two basic methods of trading in stock exchanges:

1. Trading on the Exchange Floor

Traditionally, stock exchanges operated through a physical trading floor. Investors were not permitted to enter the trading floor directly. They had to conduct transactions through authorised brokers who were members of the stock exchange. The trading floor was divided into different sections known as trading posts, where various securities were bought and sold. Brokers or their authorised representatives met at these trading posts and negotiated prices on behalf of their clients. Once both parties agreed on the price and quantity, the transaction was completed. Although this method was widely used for many decades, it gradually declined with the introduction of computerised trading systems.

2. Electronic Trading / Online Trading

Today, most stock exchanges operate through electronic trading systems. Instead of brokers physically meeting on a trading floor, computers automatically match buy and sell orders. Electronic trading became popular because it is faster, more transparent and more convenient. Investors can place orders through online trading platforms, and transactions are completed within seconds. The introduction of screen-based trading by the National Stock Exchange in the mid-1990s revolutionised the Indian securities market by making trading more efficient and accessible.

After understanding the different methods of trading in stock exchanges, it is necessary to learn how an actual trade is executed. Every purchase or sale of securities follows a specific procedure involving investors, brokers, stock exchanges, and depositories. The following is the procedure for trading in a stock exchange.

2.1.5.2 Procedure for Trading in a Stock Exchange

1. Selection of a Broker

The first step in trading is selecting a stockbroker. Since investors cannot directly trade on the stock exchange, they must transact through a registered broker. A broker acts as an intermediary between the investor and the stock exchange. The broker also provides information regarding securities, market trends and investment opportunities.

2. Opening a Trading Account

After selecting a broker, the investor opens a trading account. The broker verifies the client's identity and financial details before allowing trading activities. This account enables the investor to place buy and sell orders through the broker.

3. Placing an Order

Once the account is opened, the investor places an order to buy or sell securities. The order specifies the company, number of shares and price conditions. The broker records the order and forwards it to the stock exchange trading system for execution. Investors

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can place different types of orders depending on their requirements. Different types of Orders in stock trading are as follows:

a. Market Order (At Best Order)

A market order is executed immediately at the best available market price. The investor does not specify any price and accepts the prevailing market rate.

b. Limit Order

A limit order is executed only at a price specified by the investor or at a more favourable price. This helps investors control the price at which they buy or sell securities.

c. Immediate or Cancel Order

This order must be executed immediately at the specified price. If immediate execution is not possible, the order is automatically cancelled.

d. Discretionary Order

Under this order, the investor gives the broker the freedom to decide the most suitable price for buying or selling securities.

e. Limited Discretionary Order

The broker is allowed to exercise discretion, but only within the price range and time limit fixed by the investor.

f. Open Order

An open order remains valid until it is executed or cancelled by the investor.

g. Stop-Loss Order

A stop-loss order is used to limit losses. It automatically triggers a sale or purchase when the security reaches a specified price level. This order is commonly used by investors to protect themselves against sudden market fluctuations.

h. Fixed Price Order

In this order, the investor clearly specifies the exact price at which the securities must be purchased or sold

4. Executing the Order

The broker enters the order into the trading system. If a matching order is available, the transaction is executed immediately. If one investor wishes to buy 100 shares at a particular price and another investor is willing to sell at the same price, the system automatically matches the orders and completes the trade.

5. Contract Note

After the transaction is completed, the broker issues a contract note to the investor. The contract note serves as legal proof of the transaction and contains details such as:

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- ◊ Name of the security
- ◊ Number of shares traded
- ◊ Price of securities
- ◊ Brokerage charges
- ◊ Date and time of transaction

6. Clearing and Settlement

After the trade is executed, the transaction enters the clearing and settlement stage.

During this stage:

- ◊ The buyer pays the required amount.
- ◊ The seller delivers the securities.
- ◊ The clearing house ensures that both obligations are fulfilled.

Once the process is completed, ownership of the securities is transferred to the buyer. Clearing and settlement form the final stage of a securities transaction. Clearing involves determining the obligations of buyers and sellers after a trade has taken place. This function is generally performed through clearing corporations and depositories. Settlement refers to the actual transfer of securities and funds between buyers and sellers. Modern stock markets follow electronic settlement systems, making the process faster and safer than traditional paper-based methods. To improve market efficiency and reduce speculation, the **rolling settlement** system was introduced. Under this system, each trade is settled after a fixed number of working days from the date of the transaction.

For example, in a T+2 settlement cycle:

- ◊ T represents the trading day.
- ◊ Settlement is completed two working days after the trade.

This system replaced the earlier account-period settlement method and brought greater transparency and efficiency to the market. The following are the advantages of rolling settlement:

- ◊ Reduces excessive speculation.
- ◊ Enhances market transparency.
- ◊ Speeds up settlement of transactions.
- ◊ Minimises settlement risks.
- ◊ Improves market liquidity.
- ◊ Provides faster conversion of securities into cash.

2.1.6 Online Trading System

A major transformation in Indian stock markets occurred with the introduction of online trading during 1995–96.

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Under the online trading system:

- ◊ Investors place orders through computers or mobile applications.
- ◊ Orders are transmitted electronically to the stock exchange.
- ◊ Buy and sell orders are matched automatically.
- ◊ Trade confirmations are received instantly.
- ◊ Investors can monitor market prices in real time.

The system displays the best available buying and selling prices, making trading more transparent and efficient.

The procedure for executing trades through the online trading system involves the following steps:

1. Investor Approaches the Broker

The investor approaches a registered stockbroker and views the current market quotations displayed on the broker's trading terminal. The system continuously displays the best buy and best sell quotations for each security. The best buy quotation is the highest price offered by buyers, whereas the best sell quotation is the lowest price quoted by sellers.

2. Placement of the Order

After analysing market prices, the investor instructs the broker to buy or sell a specified quantity of shares at a desired price. The broker enters the order into the computerised trading system, which immediately transmits it to the central computer of the stock exchange.

3. Automatic Matching of Orders

The stock exchange's mainframe automatically compares buy and sell orders available in the system. When matching price quotations are found, the order is converted into a trade. Quantity matching is not always necessary. For example, if there is a purchase order for 100 shares at ₹120 and a sales order for 500 shares at ₹120, the system executes the purchase of 100 shares, while the remaining 400 shares continue to remain in the order book.

4. Communication of Trade Confirmation

Once the trade is executed, the details are immediately communicated to the concerned brokers through their trading terminals. The brokers then inform their clients about the successful execution of the transaction.

5. Netting and Settlement Information

At the end of the trading session, all transactions are consolidated and netted by the system on a broker-wise and security-wise basis. The net obligations of each broker are calculated and communicated electronically, forming the basis for the settlement process.

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To gain a better understanding of online trading, it is necessary to explore the special features that distinguish it from traditional trading methods. The major features of the online trading system are as follows:

a. Modification and Cancellation of Orders

The online trading system allows investors to modify or cancel their orders at any time before the orders are matched and executed. Once a trade is completed, no modification or cancellation is permitted. This feature provides flexibility and helps investors respond quickly to changing market conditions.

b.Anonymity of Brokers

The identity of the broker who places an order or participates in a trade is not disclosed to other market participants. This anonymity ensures fairness, eliminates bias, and promotes an impartial trading environment.

c.Facility for Special Trading Conditions

Investors can specify special conditions while placing orders, such as price limits and execution requirements. This enables them to execute transactions according to their investment objectives and risk preferences.

d. Faster Execution of Orders

Orders are processed and executed electronically within seconds, reducing delays and enabling investors to take advantage of market opportunities promptly.

e. Greater Transparency

The system provides real-time information on prices, market movements, and trade status, ensuring transparency and helping investors make informed decisions.

f. Reduced Paperwork

Online trading eliminates the need for physical documents and manual record-keeping, making the trading process simpler and more efficient.

g. Lower Transaction Costs

The use of electronic systems reduces operational expenses and brokerage costs, making trading more economical for investors.

h. Immediate Confirmation of Trades

Investors receive instant confirmation of executed trades through the trading platform, ensuring accuracy and convenience.

i. Easy Access to Market Information

The system provides investors with up-to-date market data, stock quotations, research reports, and other relevant information from any location.

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j. Improved Investor Convenience

Online trading enables investors to buy and sell securities from their homes or offices at any time during market hours, offering greater flexibility and convenience.

2.1.7 Ready Delivery Contracts and Forward Delivery Contracts

As part of the trading mechanism in the stock market, transactions may be classified according to the time and manner of settlement. Based on this criterion, stock exchange contracts are broadly classified into Ready Delivery Contracts and Forward Delivery Contracts. These contracts determine when securities are delivered and when payment is made between the parties involved in the transaction.

Figure 2.1.2 Ready delivery contract and forward delivery contract



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1. Ready Delivery Contracts

In the case of ready delivery contracts, securities are delivered immediately, and payment is made in cash. These contracts are also known as cash trading. Such transactions are settled either on the same day or within a short period. Traditionally, the settlement period was three days in the Calcutta Stock Exchange and seven days in the Madras and Bombay Stock Exchanges.

Ready delivery contracts may be settled in either of the following ways:

- ◊ By actual delivery of securities bought or sold, with the full price being paid or received.
- ◊ Without actual delivery of securities, by adjusting the difference in prices between the two members involved in the transaction.

Ready delivery contracts may be entered into for dealings in both cleared and uncleared securities. Suppose an investor purchases 100 shares of a company at ₹500 per share and takes delivery of the shares immediately by paying the full amount. This is a ready delivery contract. Similarly, if two parties settle only the price difference without actual transfer of shares, it is also treated as a ready delivery contract. An investor agrees to buy shares at ₹500 per share but later settles the contract when the market price becomes ₹520. Instead of transferring the shares, only the price difference of ₹20 per share is paid between the parties. Sometimes traders are interested only in earning profits from price movements rather than taking actual delivery of shares. To avoid the formal transfer of securities and large cash payments, they settle only the gain or loss arising from the change in market price.

2. Forward Delivery Contracts

Forward dealings or forward delivery contracts are settled on fixed settlement days occurring at monthly intervals. Such contracts may be carried forward to the next settlement period if both parties agree. In other words, the settlement date of the contract may be postponed. This postponement is technically known as carry over or Badla. Forward dealings can be undertaken only in those securities that are included in the forward list of the stock exchange. These contracts are mainly used for speculative purposes. The carry over or badla facility is available on payment of a premium known as the badla charge. When the badla charge is paid by buyers to sellers, it is called contango. When it is paid by sellers to buyers, it is known as backwardation. An investor expects the price of a share to increase in the coming month and enters into a forward contract today. Instead of settling the transaction immediately, both parties agree to settle it on a future settlement date. If the investor wishes to postpone settlement further, the contract may be carried forward by paying the applicable badla charge.

Forward delivery contracts can be settled in any one of the following ways:

1. By Actual Delivery of Securities

The buyer takes delivery of the securities and makes payment according to the terms of the contract. A buyer agrees to purchase 500 shares under a forward contract and, on the settlement date, receives the shares and pays the agreed price.

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2. By Revising the Transaction through a Neutralising Purchase or Sale

The original transaction is reversed by entering an opposite transaction before the settlement date, thereby neutralising the position. An investor who earlier agreed to buy shares under a forward contract sells the same quantity before settlement, thereby cancelling the original position.

3. By Carrying Over the Transaction to the Next Settlement Day

The settlement is postponed to the next settlement period with the consent of both parties and payment of the necessary badla charge. A trader is unwilling to settle the contract in the current settlement period and therefore carries forward the transaction to the next settlement date by paying the required premium.

2.1.8 Settlement of stock exchange

The settlement of stock exchange transactions may take place through the following methods:

a. Spot Delivery Settlement

Under this method, the delivery of securities and payment for them are effected on the date of the contract itself or on the next day. An investor purchases shares today and receives delivery either on the same day or the following day.

b. Hand Delivery Settlement

Under this method, the delivery of securities and payment are effected within the period stipulated in the agreement or within 14 days from the date of the contract, whichever is earlier. Most transactions are settled on this basis. Shares purchased on 1 June may be delivered and paid for any time before 14 June.

c. Clearing Settlement

Under this method, transactions are cleared and settled through the clearing house. Securities that are frequently traded and actively demanded are generally settled through the clearing house. Shares of a widely traded company are settled through the clearing house rather than directly between buyers and sellers.

d. Special Delivery Settlement

Under this method, the delivery of securities and payment may take place after 14 days from the date of the contract, subject to permission from the governing board of the stock exchange. In exceptional circumstances, the stock exchange may permit settlement of a transaction after the normal settlement period has expired.

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2.1.9 Listing of Securities

Listing of securities means permission to quote shares and debentures officially on the trading floor of a stock exchange. Not every security issued by companies can be traded on a stock exchange. The stock exchanges prescribe certain standards and conditions which a company must fulfil before its securities can be listed for trading. In short, listing refers to the formal admission of a company's securities (shares, debentures, bonds) to trading on a recognised stock exchange after fulfilling the exchange's prescribed eligibility criteria and entering into a Listing Agreement.

2.1.9.1 Requirements for Listing

Any company intending to get its securities listed on a stock exchange has to fulfil certain conditions and submit the required information to the exchange.

The following information must be filed with the stock exchange for getting a security listed:

1. Memorandum and Articles of Association.
2. Copies of all Prospectuses or Statements in lieu of Prospectus.
3. Copies of Balance Sheets, Audited Accounts, and agreements with promoters, underwriters, brokers, etc.
4. Letters of consent from the Controller of Capital Issues, now replaced by SEBI.
5. Details of shares and debentures issued and shares forfeited.
6. Details of bonus shares issued and dividends declared.
7. Brief history of the company.
8. Agreements with Managing Directors and other managerial personnel.
9. An undertaking regarding compliance with the provisions of the Companies Act, Securities Contracts (Regulation) Act, 1956, and the rules made thereunder.
10. A list of the ten largest holders of each class of securities of the company.

The stock exchanges are empowered to withdraw or suspend the admission granted for trading if there is any breach of the prescribed conditions.

The securities listed are classified into:

(a) Cleared Securities

(b) Non-Cleared Securities

Cleared securities enjoy forward trading facilities, whereas non-cleared securities are traded only on a cash basis and are included in the cash list. If shares are fully paid-up and enjoy listing privileges for a specified period, the stock exchange may grant them the status of cleared securities. Such securities should be widely distributed among the public and must attract sufficient public interest.

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Figure 2.1.3 Classification of listed securities

Shares of Tata Consultancy Services (TCS) and Infosys Ltd. are examples of cleared securities. These companies are actively traded on stock exchanges, enjoy high investor demand, and can be easily bought or sold due to their high liquidity and marketability. Therefore, they benefit from forward trading facilities and attract a large number of investors. Another Example Is Shares of a small regional textile company and a little-known engineering company with very low trading volumes. These shares are traded infrequently, have limited investor interest, and generally do not enjoy forward trading facilities. As a result, they have lower liquidity and are usually traded only on a cash basis.

2.1.9.2 Objectives of Listing

The main objectives of listing of securities are:

1. To ensure proper supervision and control of dealings in securities.
2. To protect the interests of shareholders and investors.
3. To avoid concentration of economic power.
4. To provide marketing facilities for securities.
5. To ensure liquidity of securities.
6. To regulate dealings in securities.
7. To ensure that promoters have a reasonable stake in the company.

2.1.9.3 Advantages of Listing

1. Publicity of Securities

Listed securities receive wide publicity through newspapers, stock exchange quotations, financial websites, and other media. The market prices of securities are

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regularly published, enabling investors to become familiar with them. The names of listed companies also gain recognition among investors and the public.

2. Protection of Investors' Interests

Listed securities are traded according to established rules and regulations. Listed companies are required to provide complete information regarding their assets, liabilities, financial position, and business operations. Such disclosure helps investors make informed investment decisions after analysing the financial statements of the companies.

3. Ensures Liquidity

Listed securities enjoy a ready market on the stock exchange. Many buyers and sellers are available at all times, making it easier for investors to buy or sell securities. Competitive market prices further enhance the liquidity of listed securities.

4. Better Goodwill

Companies whose securities are listed on stock exchanges enjoy greater goodwill and reputation in the market. Listed securities are generally considered more reliable and trustworthy. Banks and financial institutions also readily accept such securities as collateral for granting loans.

5. Easy Mobilisation of Capital

Listed companies can raise additional capital more easily from the public because investors have greater confidence in listed securities. The reputation gained through listing facilitates future issues of shares and debentures.

6. Fair Price Determination

Regular trading on stock exchanges helps in determining fair market prices for securities based on demand and supply conditions. This ensures transparency in pricing.

7. Greater Public Confidence

Listing increases public confidence in a company because listed companies are subject to continuous supervision and disclosure requirements. Investors feel more secure while investing in listed securities.

Thus, listing of securities is an important mechanism that provides marketability, liquidity, investor protection, transparency, and credibility to securities traded on stock exchanges.

2.1.9.4 Disadvantages of Listing

1. Strict Regulatory Control

Once the shares are listed on a stock exchange, the company comes under the strict supervision and control of SEBI and the stock exchange. The company must comply

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with various rules, regulations, and disclosure requirements, which may reduce its operational flexibility.

2. Increased Administrative Expenditure

Listing results in many shareholders. The company is required to send notices of Annual General Meetings, Annual Reports, dividend notices, and other communications to all shareholders. This increases administrative and printing expenses.

3. Compulsory Disclosure of Information

Listed companies are required to submit and disclose important financial and operational information to the stock exchange regularly. Such disclosures may reveal strategic information that competitors can access.

4. High Cost of Listing

Companies must incur substantial expenditure in the process of listing securities. Expenses include listing fees, compliance costs, professional services, documentation, and ongoing regulatory requirements.

5. Continuous Compliance Burden

A listed company must continuously comply with the provisions of the Companies Act, SEBI regulations, and stock exchange requirements. Failure to comply may result in penalties, suspension, or delisting of securities.

6. Risk of Market Speculation

The market price of listed securities fluctuates continuously due to demand and supply forces. Excessive speculation may affect the market value and reputation of the company.

7. Possibility of Loss of Control

When shares are widely distributed among the public, promoters may face the risk of dilution of control over the company, particularly when a significant portion of shares is acquired by outside investors.

8. Pressure to Maintain Performance

Listed companies are constantly monitored by investors, analysts, and regulatory authorities. Poor financial performance may adversely affect the market price of securities and the company's reputation.

2.1.10 MAJOR STOCK EXCHANGES IN INDIA

Stock exchanges provide an organised market for the purchase and sale of securities such as shares, debentures, bonds, exchange traded funds (ETFs) and derivatives. They act as an important link between investors and companies. Investors can buy and sell securities through stock exchanges, while companies can raise long-term capital from the public. Stock exchanges provide liquidity, transparency, price discovery and

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investor protection. They also contribute to economic growth by mobilising savings into productive investments.

India has a well-developed securities market regulated by the Securities and Exchange Board of India (SEBI). Among the recognised stock exchanges in India, the Bombay Stock Exchange (BSE) and the National Stock Exchange of India (NSE) are the two major exchanges that account for the majority of securities trading in the country. The Over-the-Counter Exchange of India (OTCEI) also occupies an important place in the history of the Indian capital market because it introduced innovative electronic trading facilities and provided an alternative market for smaller companies.

2.1.10.1 Bombay Stock Exchange (BSE)

Bombay Stock Exchange (BSE) was established in 1875 as the Native Share and Stock Brokers' Association. It is the oldest stock exchange in Asia and one of the leading stock exchanges in India. Located on Dalal Street, Mumbai, BSE has played a significant role in the growth and development of the Indian capital market. Over the years, the exchange has transformed itself from a traditional floor-based trading system into a modern electronic marketplace.

Today, BSE provides a nationwide trading platform through advanced technology and electronic trading systems. Investors from different parts of the country can participate in securities trading through registered brokers and trading members. BSE provides trading facilities in equity shares, debt securities, mutual funds, exchange-traded funds, currency derivatives and equity derivatives.

Management of BSE

The Bombay Stock Exchange functions under the regulatory supervision of the Securities and Exchange Board of India (SEBI). The overall management of the exchange is vested in its Board of Directors. The Board formulates policies and ensures the efficient functioning of the exchange. The Chief Executive Officer is responsible for the day-to-day administration and management of exchange operations.

Objectives of BSE

The major objectives of BSE are:

1. To protect the interests of investors.
2. To promote fair, transparent and ethical trading practices.
3. To provide an organised and regulated market for securities.
4. To facilitate capital formation and industrial growth.
5. To ensure liquidity and marketability of securities.
6. To disseminate market information to investors.
7. To strengthen investor confidence in the securities market.

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Trading System of BSE

BSE operates through the BSE On-Line Trading (BOLT) System. It is a fully automated screen-based trading platform that enables investors to buy and sell securities electronically. Orders entered by trading members are automatically matched by the system based on price and time priority. If an investor in Bengaluru places an order to purchase shares of Infosys through a broker, the BOLT system automatically matches the order with a corresponding sell order available in the market. This process ensures speed, transparency and efficiency in securities trading. The electronic trading system eliminates geographical barriers and allows investors throughout India to participate in the market on equal terms.

Market Segments of BSE

BSE provides trading facilities through various market segments:

1. Equity Segment

This segment facilitates trading in shares of listed companies. Investors can buy and sell shares of companies such as Reliance Industries, Infosys, Tata Consultancy Services and HDFC Bank through this segment.

2. Debt Segment

This segment facilitates trading in bonds, debentures and other fixed-income securities issued by companies and government institutions.

3. Derivatives Segment

This segment enables trading in derivative instruments such as futures and options contracts. These instruments are used for hedging risks and investment purposes.

4. Mutual Fund and ETF Segment

This segment allows investors to trade units of exchange-traded funds and mutual fund products available on the exchange platform.

BSE Sensex

The benchmark index of BSE is the S&P BSE Sensex. Introduced in 1986, the Sensex consists of 30 financially strong and actively traded companies representing major sectors of the Indian economy. It serves as an indicator of market performance and investor sentiment. When the share prices of major companies such as Reliance Industries, ICICI Bank and Infosys increase significantly, the Sensex generally moves upward, indicating positive market conditions. Conversely, a fall in the prices of major constituent companies results in a decline in the Sensex.

Investor Services

BSE provides several services for investors. These include investor education programmes, grievance redressal mechanisms, dissemination of market information,

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corporate announcements and awareness initiatives. These services help investors make informed investment decisions and improve confidence in the securities market.

2.1.10.2 National Stock Exchange of India (NSE)

The National Stock Exchange of India (NSE) was incorporated in 1992 and commenced trading operations in 1994. It was established to provide a modern, efficient and transparent securities market. NSE introduced India's first fully automated screen-based trading system and revolutionised securities trading in the country.

NSE has emerged as one of the largest stock exchanges in India and provides a nationwide electronic trading platform. The exchange offers trading facilities in equity shares, debt instruments, derivatives, currency derivatives, exchange-traded funds and other financial products.

Objectives of NSE

The important objectives of NSE are:

1. To establish a nationwide trading facility for securities.
2. To provide equal access to investors across the country.
3. To ensure fairness, efficiency and transparency in trading.
4. To use advanced technology in securities trading.
5. To provide efficient clearing and settlement systems.
6. To maintain high standards of market integrity and investor protection.

NEAT Trading System

The trading system of NSE is known as the National Exchange for Automated Trading (NEAT). It is a fully automated screen-based trading system that enables trading members across India to trade simultaneously. An investor in Chennai placing an order to buy shares of Tata Motors and an investor in Delhi placing an order to sell the same shares can complete the transaction through the NEAT system without physically visiting the exchange. The system automatically matches the orders and executes the trade.

Market Segments of NSE

NSE operates through different market segments.

1. Capital Market Segment

This segment facilitates trading in equity shares and related securities. Most listed companies are traded through this segment.

2. Wholesale Debt Market Segment

This segment deals with government securities, corporate bonds and other debt instruments.

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3. Derivatives Market Segment

This segment facilitates trading in futures and options contracts based on stocks, indices, currencies and other underlying assets.

4. Currency Derivatives Segment

This segment provides trading facilities in currency derivative contracts involving major currencies.

Features of NSE

1. Nationwide electronic trading facility.
2. Fully automated screen-based trading system.
3. Equal access to investors throughout India.
4. Real-time dissemination of market information.
5. Efficient risk management framework.
6. Fast and transparent order execution.
7. Efficient clearing and settlement mechanism.
8. High liquidity and market efficiency.

Working of NSE

NSE does not have a traditional trading floor. All trading activities take place through a computerised network. Trading members enter orders electronically through their terminals. Orders are automatically matched by the trading system according to price and time priority. After trades are executed, the clearing and settlement process is carried out through the clearing corporation associated with the exchange. This process ensures smooth transfer of securities and funds between buyers and sellers.

Advantages of NSE

1. Provides a nationwide trading platform.
2. Ensures equal access to investors.
3. Facilitates transparent trading.
4. Offers high liquidity.
5. Enables quick execution of trades.
6. Provides efficient settlement facilities.
7. Reduces transaction costs.
8. Strengthens investor confidence.

2.1.10.3 Over the Counter Exchange of India (OTCEI)

The Over-the-Counter Exchange of India (OTCEI) was incorporated in 1990 and commenced operations in 1992. It was promoted by leading financial institutions such as UTI, IDBI, IFCI, LIC, GIC, SBI Capital Markets and Canbank Financial Services.

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The primary objective of OTCEI was to provide an alternative trading platform for small and medium-sized companies that found it difficult to obtain a listing on traditional stock exchanges. OTCEI introduced a computer-based trading system and promoted transparency in securities transactions. It provided smaller companies with access to capital markets and helped investors participate in the growth of emerging enterprises.

Companies seeking listing on OTCEI were required to be sponsored by approved institutions. These sponsors evaluated the financial and technical viability of companies before recommending them for listing. This process enhanced investor confidence and improved the quality of listed securities.

Sponsor Institutions of OTCEI

The Over-the-Counter Exchange of India (OTCEI) was promoted by a group of leading financial institutions in India. These institutions are known as **Sponsor Institutions** because they played a major role in establishing and developing the exchange. They provided financial support, expertise and credibility to the exchange during its formation.

The major sponsor institutions of OTCEI were:

1. Unit Trust of India (UTI)
2. Industrial Development Bank of India (IDBI)
3. Industrial Finance Corporation of India (IFCI)
4. Life Insurance Corporation of India (LIC)
5. General Insurance Corporation of India (GIC)
6. SBI Capital Markets Limited
7. Canbank Financial Services Limited

Although OTCEI played an important role in the development of electronic trading in India, its importance gradually declined after the rapid growth of NSE and BSE. At present, trading activity on OTCEI is limited. However, its contribution to the modernisation of the Indian securities market remains significant.

2.1.11 Major Stock Market Indices in India

A stock market index is a statistical measure that reflects the performance of a selected group of securities listed on a stock exchange. It indicates the general direction of the stock market and helps investors, analysts, fund managers and policymakers assess market trends. Since it is not possible to monitor thousands of listed securities individually, stock market indices provide a convenient method of measuring overall market performance.

An index is constructed by selecting representative securities from different sectors of the economy. While constructing an index, certain principles are followed. The selected securities should represent various industries, be actively traded, and have

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significant market capitalisation. The number of securities included in an index should be proportional to the size and importance of the market. Each security is assigned a weight according to its free-float market capitalisation so that its influence on the index reflects its relative importance in the market.

The value of an index rises when the prices of most constituent securities increase and falls when their prices decline. Therefore, stock market indices are widely regarded as indicators of investor confidence, market sentiment and economic performance.

The major stock market indices in India are:

1. S&P BSE Sensex
2. Nifty 50
3. Nifty 500
4. BSE 500
5. BSE 100
6. BSE 200
7. BSE Information Technology (BSE IT)
8. BSE Capital Goods (BSE CG)
9. BSE Fast Moving Consumer Goods (BSE FMCG)
10. Nifty Next 50
11. Nifty Bank

Among these indices, the S&P BSE Sensex and Nifty 50 are the most popular and widely followed. These two indices are known as benchmark indices because they are commonly used to measure the overall performance of the Indian stock market.

2.1.11.1 S&P BSE Sensex

The S&P BSE Sensex is the benchmark index of the Bombay Stock Exchange (BSE). The term "Sensex" is derived from the words "Sensitive Index". Introduced in 1986, it is the oldest stock market index in India and is widely regarded as the barometer of the Indian securities market. The Sensex consists of 30 large, well-established and financially sound companies representing major sectors of the Indian economy. These companies are selected based on factors such as market capitalisation, liquidity, trading frequency and sectoral representation. Companies such as Reliance Industries, Tata Consultancy Services, Infosys, HDFC Bank, ICICI Bank and Larsen & Toubro have been among the important constituents of the index.

The Sensex is calculated using the free-float market capitalisation method. Under this method, only those shares that are available for trading by the public are considered for index calculation. Shares held by promoters, governments and strategic investors are excluded. This method provides a more realistic measure of market movements and reflects the actual investable market capitalisation. The base year of the Sensex is 1978–79 and the base value is 100. During trading hours, the value of the Sensex is

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continuously calculated and disseminated to investors, providing real-time information about market conditions.

The Sensex performs several important functions. It measures overall market movements and investor sentiment. A rise in the share prices of major constituent companies such as Reliance Industries, Infosys and HDFC Bank generally causes the Sensex to rise, indicating positive market conditions. Similarly, a decline in these shares may lead to a fall in the index, reflecting market weakness. The Sensex is also widely used as a benchmark for evaluating the performance of mutual funds, portfolio managers and investment schemes. In addition, it serves as the basis for various derivative products such as index futures and options.

2.1.11.2 Nifty 50

The Nifty 50 is the benchmark index of the National Stock Exchange of India (NSE). The name "Nifty" is derived from the words "National" and "Fifty". Since its launch in 1996, it has become one of the most widely followed stock market indices in India. The Nifty 50 consists of 50 large and actively traded companies representing different sectors of the economy. These companies are selected based on market capitalisation, liquidity and trading activity. The index provides broad representation of the Indian economy and serves as an important indicator of market performance. Companies such as Reliance Industries, HDFC Bank, ICICI Bank, Infosys, Tata Consultancy Services, Bharti Airtel and State Bank of India form part of the Nifty 50. Since these companies account for a significant portion of the total market capitalisation of listed companies, changes in their share prices have a substantial impact on the movement of the index.

The Nifty 50 is maintained by NSE Indices Limited and is calculated using the free-float market capitalisation method. The base date of the index is 3 November 1995, and the base value is 1000. The Nifty 50 is widely used for benchmarking investment portfolios, index funds, Exchange Traded Funds (ETFs) and derivative products. If major constituent companies such as Reliance Industries, Infosys and HDFC Bank experience an increase in their share prices, the Nifty 50 generally rises, indicating favourable market conditions. Conversely, a decline in the prices of these companies may result in a fall in the index.

2.1.11.3 Nifty 500

The Nifty 500 is a broad-based index maintained by NSE. It consists of 500 companies listed on the exchange and covers large-cap, mid-cap and small-cap companies. As a result, it provides comprehensive representation of the Indian equity market. The index includes companies from various sectors such as banking, information technology, healthcare, manufacturing, energy, telecommunications and consumer goods. Since it covers many companies, the Nifty 500 provides a more complete picture of overall market performance than narrower indices.

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2.1.11.4 BSE 500

BSE 500 is maintained by BSE. It consists of 500 companies representing different sectors of the economy. The index includes large, medium and small companies and covers a significant portion of the total market capitalisation of companies listed on BSE. The BSE 500 is widely used by researchers, analysts and institutional investors to evaluate the performance of the overall stock market.

2.1.11.5 BSE 100

The BSE 100 is a broad-based index consisting of 100 selected companies listed on BSE. The constituent companies represent various sectors of the economy and provide wider market coverage than the Sensex.

The index enables investors to analyse broader market trends and understand the performance of a larger group of companies than those included in the Sensex.

2.1.11.6 BSE 200

The BSE 200 consists of 200 companies listed on BSE and provides broader representation of the Indian securities market. The index includes companies from different industries and market capitalisation categories, thereby offering a more diversified view of market performance.

2.1.11.7 BSE Information Technology (BSE IT)

The BSE Information Technology Index is a sectoral index that measures the performance of companies operating in the information technology sector. Since leading IT companies such as Infosys and Tata Consultancy Services form part of this sector, the index reflects the growth and performance of the Indian information technology industry. The index helps investors evaluate trends and opportunities in the technology sector.

2.1.11.8 BSE Capital Goods (BSE CG)

The BSE Capital Goods Index measures the performance of companies engaged in the manufacture of machinery, industrial equipment and engineering products. Companies involved in infrastructure development and industrial production significantly influence this index. The index serves as an indicator of industrial growth and capital investment activity in the economy.

2.1.11.9 BSE Fast Moving Consumer Goods (BSE FMCG)

The BSE FMCG Index tracks the performance of companies producing daily-use consumer products such as food items, beverages, personal care products and household goods. Companies such as Hindustan Unilever and ITC have been among the prominent constituents of this sector. Since FMCG products are consumed regularly regardless of economic conditions, the index is often considered a useful indicator of consumer demand and spending patterns.

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2.1.11.10 Nifty Next 50

The Nifty Next 50 consists of 50 companies that rank immediately after the Nifty 50 in terms of market representation. These companies are generally large and growing organisations with strong future potential. Many companies included in this index eventually become constituents of the Nifty 50 as their market capitalisation and trading activity increase. Therefore, the index is often viewed as a representation of future market leaders.

2.1.11.11 Nifty Bank

The Nifty Bank, popularly known as Bank Nifty, is a sectoral index that measures the performance of major banking companies listed on NSE. The index includes leading banks such as HDFC Bank, ICICI Bank, State Bank of India, Axis Bank and Kotak Mahindra Bank. As the banking sector plays a crucial role in economic development, the performance of Bank Nifty is often regarded as an indicator of the health of the financial system. When major banks report higher profits and improved business performance, their share prices generally rise, causing the index to increase. Conversely, difficulties faced by the banking sector may lead to a decline in the index.

Table 2.1.1 Major indices in India

Sl. No.	Index	Stock Exchange	Number of Companies	Nature of Index	What it Represents
1	S&P BSE Sensex	BSE	30	Benchmark Index	Measures the performance of 30 large, financially sound and actively traded companies representing major sectors of the Indian economy.
2	Nifty 50	NSE	50	Benchmark Index	Measures the performance of 50 leading companies listed on NSE and reflects the overall movement of the Indian stock market.
3	Nifty Next 50	NSE	50	Broad Market Index	Consists of companies that rank immediately after the Nifty 50 and are considered potential future large-cap leaders.
4	Nifty 100	NSE	100	Broad Market Index	Combines Nifty 50 and Nifty Next 50 companies to provide wider coverage of large-cap companies.

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5	Nifty 500	NSE	500	Broad Market Index	Represents large-cap, mid-cap and small-cap companies and provides a comprehensive view of the Indian equity market.
6	Nifty Bank (Bank Nifty)	NSE	Major Banking Companies	Sectoral Index	Measures the performance of leading banking companies and reflects the health of the banking sector.
7	BSE 100	BSE	100	Broad Market Index	Covers 100 selected companies from various sectors and provides wider market representation than the Sensex.
8	BSE 200	BSE	200	Broad Market Index	Represents a larger group of companies across different sectors and market capitalisation categories.
9	BSE 500	BSE	500	Broad Market Index	Covers a substantial portion of the total market capitalisation of companies listed on BSE.
10	BSE Information Technology (BSE IT)	BSE	IT Sector Companies	Sectoral Index	Measures the performance of companies engaged in information technology and software services.
11	BSE Capital Goods (BSE CG)	BSE	Capital Goods Companies	Sectoral Index	Tracks the performance of companies involved in engineering, machinery and industrial equipment.
12	BSE Fast Moving Consumer Goods (BSE FMCG)	BSE	FMCG Companies	Sectoral Index	Measures the performance of companies producing consumer goods such as food products, personal care products and household items.

Major Global Indices (for reference)

Dow Jones Industrial Average (DJIA) – USA
S&P 500 – USA
NASDAQ Composite – USA
FTSE 100 – United Kingdom
Nikkei 225 – Japan
Hang Seng Index – Hong Kong

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2.1.12 Role of SEBI in Regulating Stock Exchanges

The Securities and Exchange Board of India (SEBI) is the statutory regulator of India's securities market. Its role is to regulate stock exchanges and other market participants, protect investors, and promote the orderly development of the securities market.

The major roles of SEBI in regulating stock exchanges include:

1. **Regulation of Stock Exchanges** – SEBI regulates the functioning of stock exchanges and lays down rules and standards for their operations.
2. **Investor Protection** – SEBI takes measures to safeguard investors against fraudulent and unfair practices in the securities market.
3. **Registration and Supervision of Intermediaries** – It regulates and supervises intermediaries such as stockbrokers, merchant bankers, portfolio managers and other market participants.
4. **Prevention of Unfair Trade Practices** – SEBI takes action against activities such as market manipulation, fraudulent trading practices and other unfair practices.
5. **Prevention of Insider Trading** – SEBI frames and enforces regulations to prevent trading based on unpublished price-sensitive information.
6. **Ensuring Transparency and Disclosure** – SEBI requires listed companies to make appropriate and timely disclosures so that investors have access to relevant information for investment decisions.
7. **Monitoring Trading Activities** – SEBI monitors trading activities in stock exchanges to identify irregularities and ensure fair and orderly trading.
8. **Regulation of Listing and Delisting** – SEBI prescribes regulatory requirements relating to the listing and delisting of securities and protects the interests of investors during these processes.
9. **Grievance Redressal** – SEBI provides mechanisms through which investors can raise complaints relating to securities-market transactions and seek appropriate redressal.
10. **Development of the Securities Market** – Along with its regulatory and investor-protection functions, SEBI works towards the orderly development of India's securities market by introducing appropriate regulatory measures and improving market practices.

2.1.13 Depositories -Meaning

Until the mid-1990s, investors in India held shares in the form of paper certificates. Whenever shares were bought, sold or transferred, investors had to complete several formalities and wait for the certificates to be delivered and verified. There was always a risk of certificates being lost, damaged or forged. To overcome these difficulties and make securities transactions faster and safer, the Depository System was introduced in

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India in 1996. The Depository System is a system in which shares, debentures, bonds and other securities are held in electronic form instead of physical certificates. When an investor purchases shares of Infosys, the shares are credited directly to the investor's Demat Account rather than being issued as paper certificates. This makes the ownership and transfer of securities simple, quick and secure.

A Depository is an institution that holds securities electronically and facilitates the transfer of ownership whenever securities are bought or sold. It functions much like a bank, which keeps money on behalf of customers. When an investor purchases shares of Tata Consultancy Services, the depository records the ownership in the investor's Demat Account and transfers the ownership electronically whenever the shares are sold.

Investors do not deal directly with the depository. Instead, they access depository services through Depository Participants (DPs), who act as intermediaries between investors and the depository. Just as a customer uses a bank branch to access banking services, an investor uses a DP to open and operate a Demat Account. Since securities are held and traded electronically without the use of physical certificates, the system is also known as the Scripless Trading System.

2.1.13.1 Objectives of the Depository System/Role of depository

1. To reduce the time required for the transfer of securities

Electronic transfers are completed much faster than physical transfers. When an investor purchases shares through a stock exchange, the securities are credited electronically to the Demat Account without waiting for physical certificates.

2. To avoid settlement risks

The depository system removes risks such as loss, theft, forgery and damage of physical certificates. Since securities are maintained electronically, ownership records remain safe and accurate.

3. To enhance liquidity and efficiency

Electronic trading enables investors to buy and sell securities quickly. Faster settlement improves the efficiency of the capital market and allows investors to convert securities into cash more easily.

4. To reduce paperwork and transaction costs

The system minimises documentation and administrative procedures. Investors no longer need to handle paper certificates or complete lengthy transfer formalities.

5. To provide safety and convenience

Securities held in electronic form are secure and can be accessed easily through a Demat Account, making investment management more convenient.

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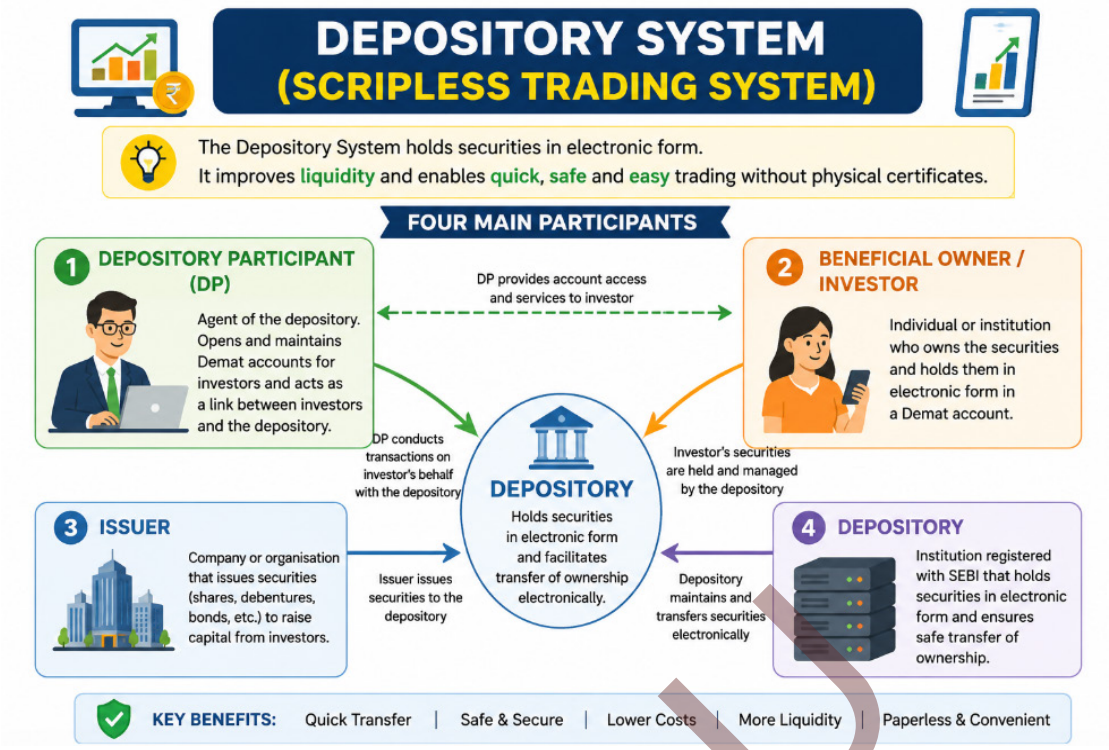


Figure 2.1.4 Constituents of the Depository System

2.1.13.2 Constituents of the Depository System

The Depository System improves the liquidity of investments in securities by enabling quick and easy transfer of ownership. There are four main participants in the Depository System:

a. Depository Participant (DP)
b. Beneficial Owner (Investor)
c. Issuer
d. Depository

Each participant performs a specific role to ensure the smooth functioning of the depository system.

a. Depository Participant (DP)

A Depository Participant (DP) is an agent of the depository and acts as a link between the depository and investors. An investor who wishes to use depository services must open a Demat Account with a DP, just as a customer opens a bank account to use banking services.

If an investor wants to hold shares electronically, the investor opens a Demat Account with a DP such as a bank or financial institution. The DP maintains records of the investor's securities and facilitates transactions on behalf of the investor. Both the depository and the DP must be registered with the Securities and Exchange Board

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of India (SEBI). SEBI grants approval only when adequate systems, safeguards and security measures are in place to protect investors' records and transactions. The procedure for opening a demat account is as follows:

- ◊ Select a suitable DP based on cost, convenience and quality of service.
- ◊ Complete the prescribed account opening form.
- ◊ Sign an agreement with the DP outlining the rights and responsibilities of both parties.
- ◊ Submit proof of identity, proof of address and passport-sized photographs.

There is no restriction on the number of Demat Accounts an investor may open. An investor may maintain accounts with one or more DPs.The following institutions may act as Depository Participants:

- ◊ Banks
- ◊ Financial institutions
- ◊ Custodians
- ◊ Clearing corporations
- ◊ Stockbrokers
- ◊ Non-banking financial companies (NBFCs)
- ◊ Registrars and share transfer agents

b.. The Beneficial Owner

A Beneficial Owner is the actual owner of securities whose name is recorded in the records of a depository. The investor holds securities in electronic form through a Demat Account and enjoys all the rights and responsibilities associated with those securities. When an investor purchases shares and stores them in a Demat Account, the investor becomes the beneficial owner of those shares. Although the depository is shown as the registered owner for record-keeping purposes, the investor remains the real owner and is entitled to receive dividends, bonus shares, voting rights and other benefits. The beneficial owner has the right to buy, sell, transfer, pledge or rematerialize securities and is also responsible for complying with all rules relating to the ownership of those securities.

c. The Issuer

The Issuer is the company or organisation that issues securities such as shares, debentures and bonds to investors. It maintains records relating to the ownership of securities and works closely with the depository system to facilitate electronic holding and transfer of securities. For example, when a company issues shares to raise capital, it acts as the issuer. If investors choose to hold these shares in electronic form, the issuer coordinates with the depository to update ownership records accordingly. The following are the Responsibilities of the Issuer:

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1. Agreement with the Depository

Every issuer whose securities can be held in dematerialised form must agree with the depository. This agreement enables the issuer and the depository to work together for maintaining electronic records of securities.

2. Share Registry Work

The issuer is responsible for maintaining records relating to the ownership and transfer of securities. This work may be carried out either by the company itself or through a registered Share Transfer Agent.

3. Redressal of Investor Grievances

The issuer must resolve complaints and grievances of investors within 30 days from the date of receipt of the complaint. The issuer must also keep the depository informed about the number and nature of complaints resolved and pending.

4. Dematerialisation of Securities

When an investor wishes to convert physical share certificates into electronic form, the investor submits the certificates through a Depository Participant. The Depository Participant forwards the details to the depository and the issuer. After verifying the certificates, the issuer cancels the physical certificates and updates its records by replacing the investor's name with the name of the depository as the registered owner. The investor is then recorded as the beneficial owner in the depository's records.

5. Maintenance of Dematerialised Records

The issuer must maintain proper records of all securities that have been converted into electronic form.

6. Daily Reconciliation of Records

The issuer must reconcile the records of dematerialised securities with the total securities issued by the company daily. This ensures that all records remain accurate and up to date.

7. Online Connectivity

The issuer must maintain continuous electronic communication with the depository to ensure smooth processing of transactions and timely exchange of information.

8. Providing Information to the Depository

The issuer must regularly provide important information to the depository, including:

- ◊ Book closure dates
- ◊ Record dates
- ◊ Dividend payment dates
- ◊ Interest payment dates
- ◊ Annual General Meeting dates

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- ◊ Redemption dates of debentures
- ◊ Conversion dates of debentures and warrants
- ◊ Call money dates

This information helps the depository provide accurate services to investors.

9. Audit and Verification

The issuer must submit quarterly audit reports to the stock exchanges. The audit ensures that the issued capital, listed capital and dematerialised capital are properly reconciled and recorded. The audit report also confirms whether requests for dematerialisation have been processed within 21 days. If there is any delay, the reasons must be clearly explained.

10. Reporting Differences

If any difference is found between the issued capital, listed capital and dematerialised capital, the issuer must immediately inform the depository and the stock exchanges.

d. The Depository

A Depository is an institution that holds securities in electronic form in the same way that a bank holds money. It enables the transfer of securities through electronic book entries without the physical movement of share certificates. The depository acts as a registered owner only for the purpose of transferring securities, while the actual ownership remains with the beneficial owner. It functions as a custodian and safeguards the securities of investors. Before the introduction of the depository system, investors had to store large numbers of physical share certificates, which involved risks such as loss, theft and damage. The depository system has eliminated these problems by providing a secure and convenient electronic platform for holding securities. The settlement of securities through electronic book entries is known as the Book Entry Transfer Settlement System. At present, India has two depositories:

1. National Securities Depository Limited (NSDL)
2. Central Depository Services (India) Limited (CDSL)

1. National Securities Depository Limited (NSDL)

The introduction of the depository system brought a major change to the Indian securities market by replacing paper-based transactions with electronic transactions. To support this transformation, National Securities Depository Limited (NSDL) was established as India's first depository, promoted by the Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and the National Stock Exchange (NSE). It was established to provide electronic depository facilities for securities traded in the capital market. The Government of India introduced the Depositories Ordinance in September 1995. Subsequently, the Securities and Exchange Board of India (SEBI) issued guidelines for depositories in May 1996. SEBI registered NSDL on 7 June 1996, and it became the first depository in India. NSDL has a minimum net worth of ₹100 crore. It holds securities in electronic form and carries out transactions through Depository Participants (DPs), who act as intermediaries between investors and NSDL.

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A Depository Participant may be a bank, financial institution, custodian, registered stockbroker or non-banking financial company, subject to approval by both NSDL and SEBI.

To become a DP of NSDL, the participant must satisfy the prescribed eligibility requirements and pay the necessary fees and security deposits.

Functioning of NSDL

NSDL provides its services through various business partners, including:

- ◊ Depository Participants (DPs)
- ◊ Issuing Companies
- ◊ Registrars and Share Transfer Agents (RTAs)
- ◊ Clearing Corporations and Clearing Houses of Stock Exchanges

Investors can access NSDL's services by opening a Demat Account with any authorised Depository Participant. When a company wishes to offer dematerialisation facilities to its shareholders, it enters into an agreement with NSDL and establishes an electronic connection with the depository. Clearing members maintain clearing accounts within the depository system to receive and deliver securities during the settlement process. Clearing Corporations and Clearing Houses are electronically connected to NSDL for smooth settlement of stock exchange transactions.

NSDL is connected electronically with all its business partners through advanced communication networks. This integrated settlement system is known as the National Electronic Settlement and Transfer (NEST) System.

NSDL Certification Programme

To ensure high-quality depository services, NSDL introduced a Certification Programme for Depository Participants. The programme helps employees understand depository procedures, rules and operational requirements. NSDL requires every DP branch to have at least one employee who has successfully completed this certification programme.

2. Central Depository Services (India) Limited (CDSL)

Central Depository Services (India) Limited (CDSL) commenced operations in February 1999.CDSL was promoted by the Bombay Stock Exchange (BSE) in association with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank and Union Bank of India. CDSL was established with the objective of providing secure, reliable and cost-effective depository services to all participants in the securities market.

Most major stock exchanges in India relate to CDSL, enabling investors across the country to hold and transfer securities electronically.

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CDSL allows investors to hold a wide range of securities such as:

- Equity shares
- Bonds
- Debentures
- Commercial papers
- Mutual fund units
- Certificates of deposit

As a result, investors can maintain almost all their investments through a single Demat Account.

Features of CDSL

1. Wide Network

CDSL has a large network of Depository Participants across numerous cities and towns, making its services easily accessible to investors.

2. Online Depository Services

Its centralised database system enables Depository Participants to provide online services efficiently and accurately.

3. Affordable Charges

CDSL follows a low-cost pricing policy to make depository services affordable for investors and market participants.

4. Internet Access

Investors can access information relating to their Demat Accounts through internet-based services provided by registered Depository Participants.

5. Contingency Arrangements

CDSL has backup systems and contingency facilities that enable uninterrupted operations even during technical problems.

6. Investor Helpline

CDSL provides prompt support and guidance through its investor and DP helpline services.

7. Electronic Record Keeping

CDSL maintains electronic records of ownership of securities, eliminating the need for physical certificates.

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8. Electronic Settlement

CDSL facilitates electronic settlement of securities transactions and supports the smooth functioning of stock exchanges across India.

2.1.13.3 Facilities Offered by the Depository System

The Depository System provides several facilities that make investment safer, quicker and more convenient. The following are the major facilities:

1. Dematerialisation of securities.
2. Rematerialisation of securities.
3. Electronic settlement of trades.
4. Electronic credit of securities allotted through public issues, rights issues and bonus issues.
5. Pledging or hypothecation of dematerialised securities.
6. Freezing of Demat Accounts.
7. Safe custody of securities.
8. Nomination facility.

These facilities help investors manage their securities efficiently while reducing paperwork, delays and risks associated with physical certificates.

Dematerialisation

Dematerialisation is the process of converting physical share certificates into electronic form and crediting them to an investor's demat account maintained with a Depository Participant (DP). Instead of keeping paper share certificates safely at home, the investor can hold all securities electronically in a demat account. This reduces the risk of loss, theft, damage by fire, delays in transfer, fake certificates, and bad deliveries. To encourage safe and paperless trading, SEBI introduced several measures to promote dematerialisation. From January 15, 1998, institutional investors were required to trade specified shares only in dematerialised form. Later, SEBI made demat trading compulsory for shares of companies listed on stock exchanges. To hold shares electronically, an investor opens a beneficiary account with a DP connected to the depositories NSDL or CDSL. Opening a demat account is similar to opening a bank account, where the account safely stores securities instead of money.

Steps Involved in Dematerialisation

1. (a) Opening a Demat Account

An investor who wishes to hold shares electronically first opens a beneficiary account with a Depository Participant (DP) of his choice. If an investor receives paper share certificates after purchasing shares, he can open a demat account so that all future transactions can be carried out without handling physical certificates.

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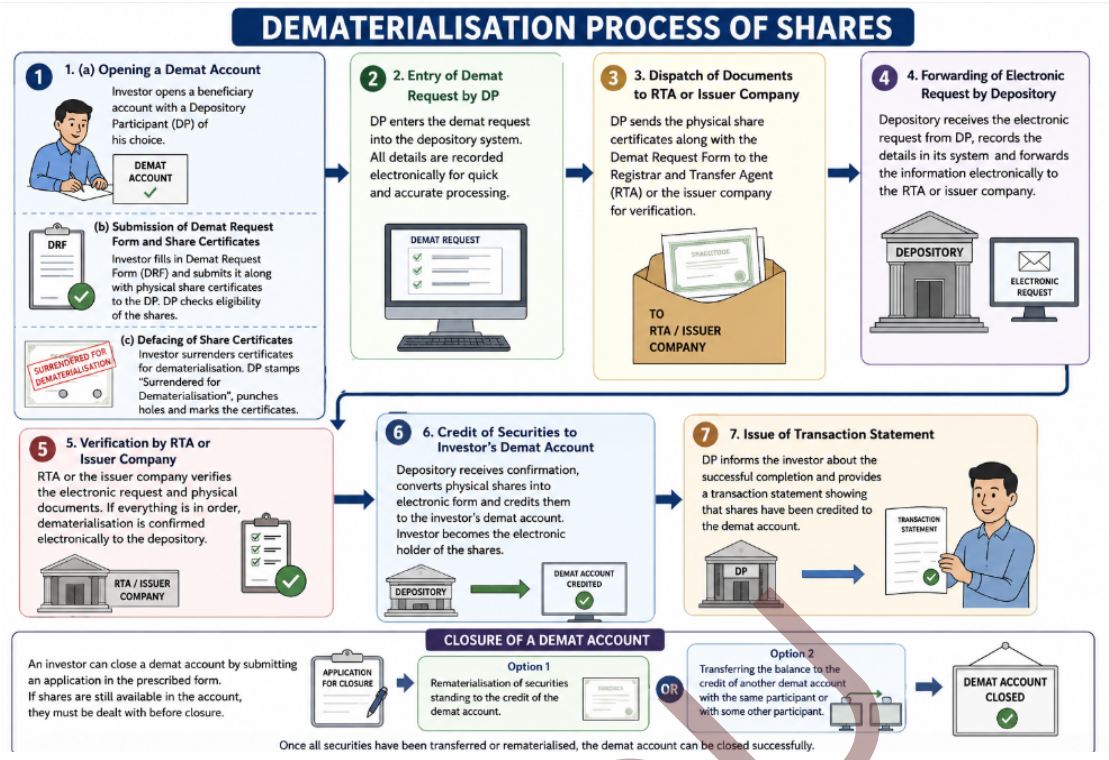


Figure 2.1.5 Dematerialisation process of shares

(b) Submission of Demat Request Form and Share Certificates

After opening the account, the investor fills in a Demat Request Form (DRF) and submits it along with the physical share certificates to the DP. The DP checks whether the shares are eligible for dematerialisation before processing the request.

(c) Defacing of Share Certificates

To ensure that the same certificates are not used again, the investor surrenders the certificates for dematerialisation. The DP stamps the certificates with the words "Surrendered for Dematerialisation", punches holes through them, and marks them appropriately before sending them for further verification.

2. Entry of Demat Request by DP

The Depository Participant enters the dematerialisation request into the depository system. Once the investor submits the documents, the DP records all the details electronically so that the request can be processed quickly and accurately.

3. Dispatch of Documents to RTA or Issuer Company

The DP sends the physical share certificates along with the Demat Request Form to the Registrar and Transfer Agent (RTA) or the company that issued the shares. This allows the company to verify the ownership and authenticity of the certificates.

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4. Forwarding of Electronic Request by Depository

The depository receives the electronic request from the DP, records the details in its system, and forwards the information electronically to the RTA or the issuing company for verification.

5. Verification by RTA or Issuer Company

The RTA or the company checks both the electronic request and the physical certificates. If the investor's name and share details match the company's records, the request is approved. Once everything is found to be correct, confirmation of dematerialisation is sent electronically to the depository.

6. Credit of Securities to Investor's Demat Account

After receiving confirmation, the depository converts the physical shares into electronic form and credits them to the investor's demat account. The investor now becomes the electronic holder of the shares and no longer needs the paper certificates.

7. Issue of Transaction Statement

Finally, the DP informs the investor about the successful completion of the process and provides a transaction statement showing that the shares have been credited to the demat account. Just as a bank sends an account statement after a deposit, the DP provides proof of the electronic credit of shares.

Closure of a Demat Account

An investor can close a demat account by applying in the prescribed form. If shares are still available in the account, they must be dealt with before closure. The investor may either convert the electronic shares back into physical certificates through rematerialisation or transfer the shares to another demat account maintained with the same DP or a different DP. Once all securities have been transferred or rematerialised, the demat account can be closed successfully.

Rematerialisation

Rematerialisation is the process of converting securities held in electronic (demat) form back into physical share certificates. An investor who wishes to convert demat holdings into physical form must submit a Rematerialisation Request Form (RRF) to the Depository Participant (DP). The DP forwards the request to the depository, which informs the Registrar and Transfer Agent (RTA) or issuer company. After verification, the registrar prints new physical share certificates and dispatches them to the investor. The rematerialisation process is generally completed within 30 days. The following are the steps involved in the rematerialisation Process:

The investor submits a Rematerialisation Request Form (RRF) to the Depository Participant (DP).

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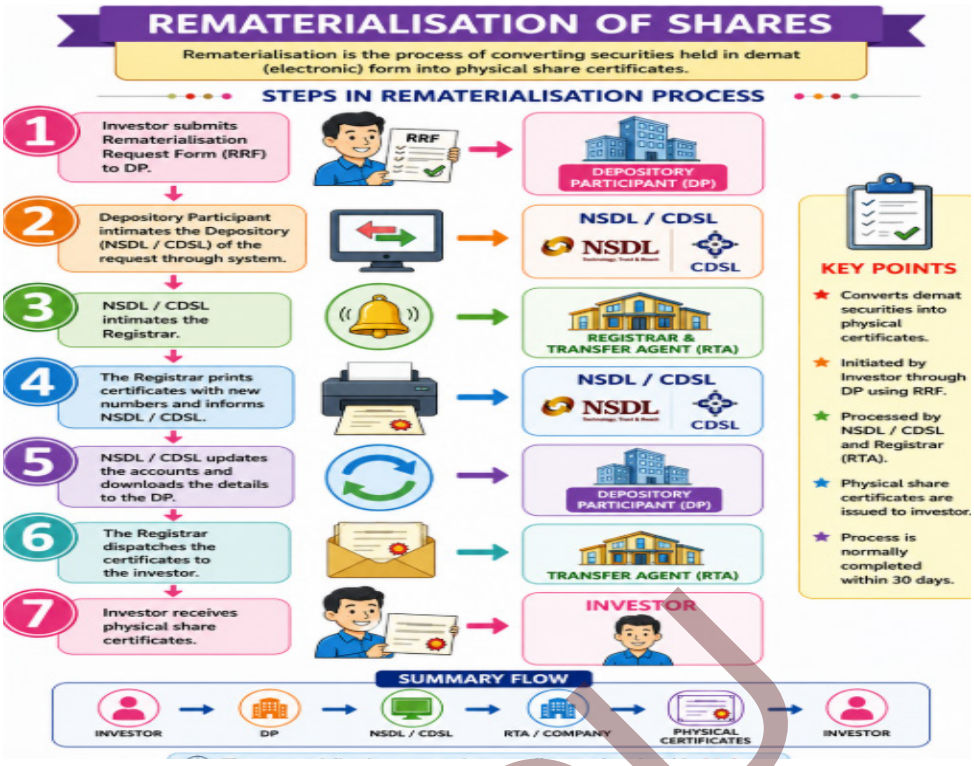


Figure 2.1.6 Rematerialisation process

The Depository Participant verifies the request and forwards it electronically to the depository (NSDL/CDSL).

The depository informs the Registrar and Transfer Agent (RTA) or issuer company about the rematerialisation request.

The Registrar verifies the details, prints new physical share certificates with fresh certificate numbers, and informs the depository.

The depository updates its records and communicates the details to the Depository Participant.

The Registrar dispatches the physical share certificates to the investor.

Table 2.1.2 Difference between Dematerialisation and Rematerialisation

Basis	Dematerialisation	Rematerialisation
Meaning	Conversion of physical securities into electronic form.	Conversion of electronic securities into physical certificates.
Direction of Conversion	Physical → Electronic	Electronic → Physical
Form of Securities After Conversion	Held in a Demat account.	Held as physical certificates.
Request Form Used	Demat Request Form (DRF).	Remat Request Form (RRF).

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Purpose	To facilitate electronic holding and trading of securities.	To obtain securities in physical form.
Involvement of Depository	Securities are credited to the investor's Demat account.	Securities are debited from the investor's Demat account.
Physical Certificates	Physical certificates are surrendered and cancelled.	New physical certificates are issued.
Trading Convenience	Enables easy and faster trading.	Trading becomes less convenient compared to electronic form.
Risk of Loss or Damage	Eliminates risk of loss, theft, or damage.	Physical certificates may be lost, stolen, or damaged.
Outcome	Investor receives securities in electronic form.	Investor receives securities in physical form.

Recap

- ◊ Stock exchange and trading mechanism is the organized system where securities are bought and sold through recognized exchanges using brokers and electronic platforms under regulated procedures.
- ◊ Role and Functions of Stock Exchanges are to provide liquidity, facilitate capital formation, enable price discovery, and ensure safe and transparent trading of securities.
- ◊ Listing of Securities is the official process of registering a company's shares on a stock exchange so that they can be publicly traded.
- ◊ Stock Exchanges in India are regulated financial marketplaces such as NSE and BSE where securities are traded under SEBI regulations.
- ◊ Major Stock Market Indices are statistical measures like Sensex and Nifty that represent the overall performance of selected leading stocks in the market.
- ◊ Online Trading is the system of buying and selling securities through internet-based platforms using demat and trading accounts in real time.
- ◊ A depository is an institution that holds securities such as shares, debentures, and bonds in electronic form and facilitates their transfer.
- ◊ National Securities Depository Limited (NSDL) is India's first depository, established to provide safe and efficient electronic holding and transfer of securities.

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- ◊ Central Depository Services Limited (CDSL) is a depository that offers electronic storage and transfer of securities, making trading and settlement easier for investors.
- ◊ Dematerialisation is the process of converting physical share certificates into electronic form and crediting them to the investor's Demat account.
- ◊ Rematerialisation is the process of converting securities held in electronic form back into physical share certificates.

Objective Questions

1. What system organises the buying and selling of securities?
2. What provides liquidity in the market?
3. What process allows companies to register shares for public trading?
4. Which authority regulates stock exchanges in India?
5. Name a major stock exchange in India.
6. Name a major stock market index in India.
7. What system allows buying and selling through the internet?
8. What is the process of discovering market prices called?
9. Which institution holds securities in electronic form?
10. Which account is used to hold securities electronically?
11. What is the intermediary between investors and a depository called?

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Answers

1. Stock exchange
2. Stock exchange
3. Listing
4. SEBI
5. NSE
6. Sensex
7. Online trading

8. Price discovery
9. Depository
10. Demat Account
11. Depository Participant

Self-Assessment Questions

1. Explain the meaning of stock exchange and trading mechanism in simple terms.
2. Describe the role and functions of stock exchanges in the capital market.
3. What is the listing of securities? Explain its importance.
4. Explain stock exchanges in India with examples.
5. What are major stock market indices? Explain with examples like Sensex and Nifty
6. Explain the role of SEBI in regulating stock exchanges
7. Explain the consititents of a depository system

Assignments

1. Analyse how stock exchanges contribute to the economic development of a country through capital formation and liquidity.
2. Evaluate the importance of listing of securities for both companies and investors in modern capital markets.
3. Analyse the impact of online trading systems on traditional trading mechanisms in stock exchanges.
4. Examine how major stock market indices like Sensex and Nifty reflect market trends and investor sentiment.
5. Compare dematerialisation and rematerialisation and explain the procedure involved in each process.

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Unit 2
Speculators And Types Of Speculative Transactions

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ differentiate between investment and speculation.
- ◊ identify the various types of speculators.
- ◊ comprehend different speculative transactions and their impact on stock market operations.
- ◊ explain the concept of insider trading and identify various forms of Unpublished Price-Sensitive Information (UPSI).

Prerequisite

Rahul is a young investor who regularly follows the stock market. He notices that the prices of shares keep changing every day. When he expects the price of a share to rise, he buys shares hoping to sell them later at a higher price. When he expects prices to fall, he may sell securities with the intention of buying them back at a lower price. His friend Vijay, who also participates in the stock market, follows a different approach and makes transactions based on his expectations of future price movements.

Both Rahul and Vijay are trying to earn profits from changes in the prices of securities. Their activities are different from those of investors who purchase shares mainly for long-term investment. Such participants are known as speculators, and they may adopt different methods while participating in the stock market.

Now imagine that another person, Kiran, works for a company and learns confidential information that the company

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is going to announce an important business decision. Before the information is made public, Kiran buys the company's shares expecting their price to increase after the announcement. Unlike Rahul and Vijay, Kiran has access to unpublished price-sensitive information, giving him an unfair advantage over other investors. Such activity raises an important question about insider trading and the need for proper regulation of the securities market.

Thus, the stock market brings together different participants who engage in securities transactions for different purposes. While investors generally participate with the objective of earning returns over time, speculators seek to benefit from fluctuations in security prices. At the same time, the use of unpublished price-sensitive information for trading raises concerns relating to insider trading and the need for fair and transparent market practices.

This unit discusses more about the different types of speculators, speculative transactions in stock exchanges, and the concept of insider trading.

Keywords

Speculation, Speculator, Insider Trading, Stock Market

Discussion

2.2.1 Speculation

Speculation means buying or selling securities with the expectation of making a profit from future price changes. A person who engages in speculation is mainly interested in whether the market price will rise or fall soon. A speculator is a person who trades in securities anticipating price movements and is willing to take on higher risk in exchange for the possibility of higher returns. For example, if Dhruvin believes that the share price of a company may increase soon, he buys the shares and waits for the price to rise. Once the price increases, he sells the shares and earns a profit. Similarly, if he expects prices to fall, he may sell the securities to avoid losses or benefit from the fall in price.

It is often difficult to make a clear distinction between investment and speculation because both involve putting money into securities with the hope of future gains. Investment requires some degree of speculation about future performance, and speculation also involves investing money. The main difference lies in the purpose, risk involved, and the period for which the securities are held.

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Differences Between Investment and Speculation

1. Risk

Risk means the possibility of losing money in a financial transaction. An investor usually studies the company carefully before investing and aims to keep the capital reasonably safe while earning a steady return. Although investments are generally considered safer, no investment is completely free from risk because economic and market conditions can change unexpectedly.

A speculator knowingly accepts a higher level of risk in the hope of earning greater profits within a short period. Instead of focusing mainly on the company's long-term strength, the speculator pays closer attention to market movements and price fluctuations. Therefore, investment involves lower risk, whereas speculation involves higher risk.

2. Capital Gain

The main objective of investment is to earn a stable return over time through dividends, interest, and gradual growth in value. Before investing, an investor carefully analyses the company and its prospects.

A speculator, on the other hand, is mainly interested in making quick profits from changes in market prices. The focus is not on regular income but on buying at a lower price and selling at a higher price within a short period. Therefore, investment aims at stable returns, while speculation aims at quick capital gains.

3. Time

Investment generally involves holding securities for a long period. An investor is willing to wait patiently for wealth to grow over several years.Speculation is usually short-term in nature. A speculator frequently buys and sells securities to take advantage of rapid price changes in the market. Therefore, investment is long-term, whereas speculation is short-term.

An investor continuously evaluates the actual value and future potential of a security. A speculator is more concerned with market action and daily price movements. In many situations, successful investment includes some well-informed speculation.

Detailed differences between speculation and investment are shown in Table 2.3.1

Table 2.2.1 Difference between speculation and Investment

Basis	Investment	Speculation
Meaning	Purchase of securities to earn regular income and long-term growth.	Purchase or sale of securities to earn quick profits from price changes.
Objective	To earn stable returns and build wealth over time.	To make quick profits from market fluctuations.
Risk	Involves relatively low risk.	Involves high risk.

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Return	Focuses on regular and steady returns.	Focuses on high returns in a short period.
Time Period	Long-term holding of securities.	Short-term holding of securities.
Decision Basis	Based on careful analysis and investigation.	Based mainly on market trends and price movements.
Concern	Concerned with the company's performance and fundamentals.	Concerned with market action and price changes.
Capital Safety	Gives importance to the safety of capital.	Capital safety is less important than profit opportunities.
Trading Frequency	Securities are bought and sold occasionally.	Securities are bought and sold frequently.
Nature	Conservative approach.	Aggressive approach.

2.2.2 Types of speculators

Speculators are people who buy and sell securities to earn profits from changes in market prices. In the stock market, four main types of speculators are commonly found. They are Bull, Bear, Stag, and Lame Duck. These names are taken from the animal world because their behaviour resembles the characteristics of these animals.

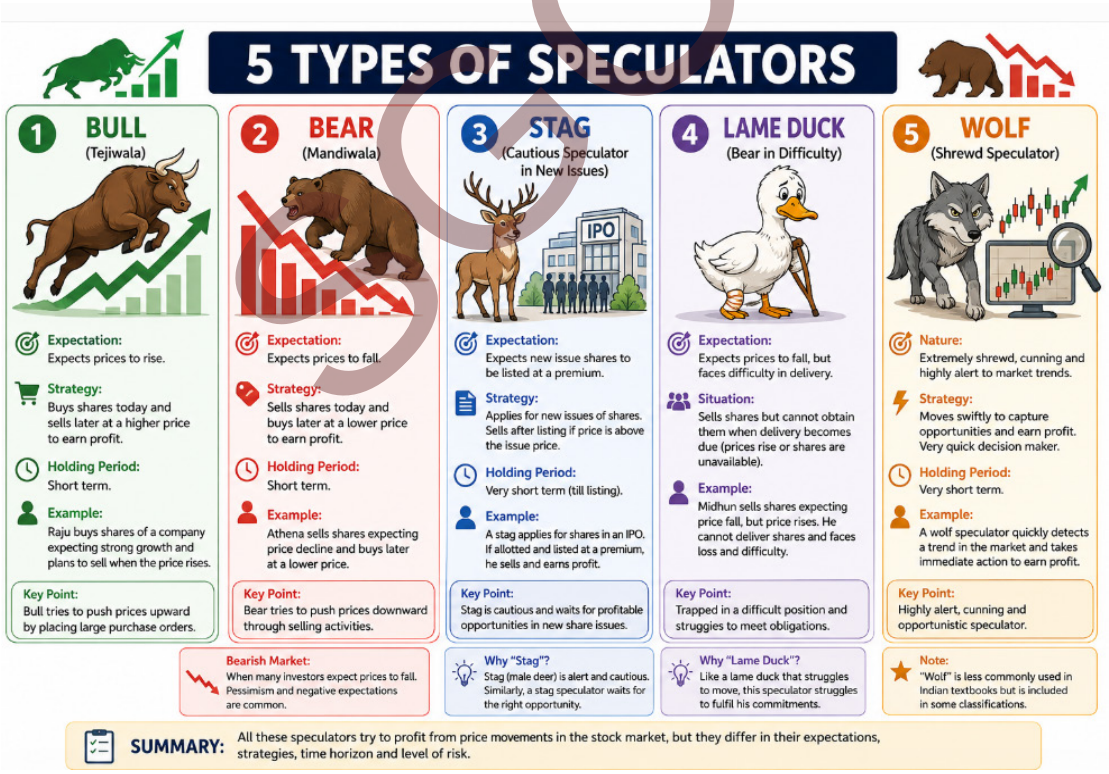


Figure 2.2.1 Kinds of speculators

1. Bull

A Bull, also known as a Tejiwala, is a speculator who expects the prices of securities to rise in the future. Believing that prices will increase, the bull purchases shares and other securities with the intention of selling them later at a higher price and earning a profit. For example, suppose Raju believes that the share price of a company will increase in the coming weeks because of strong business growth. He buys the shares today and plans to sell them when the price rises. His profit comes from the difference between the purchase price and the selling price. A bull usually does not intend to hold the securities for a long time. Instead, he is interested in making profits from price increases. The term "bull" is used because a bull attacks by lifting its victim upward with its horns. Similarly, a bull speculator tries to push market prices upward by placing large purchase orders**.**

2. Bear

A Bear, also known as a Mandiwala, is a speculator who expects the prices of securities to fall in the future. Anticipating a fall in prices, the bear sells securities today with the intention of buying them back later at a lower price. If Athena expects the share price of a company to decline because of poor financial performance. She sells the shares now and plans to purchase them later at a lower price. The difference between the selling price and the lower purchase price becomes her profit. A bear generally does not own the securities at the time of selling. He relies on future price declines to earn profits. Just as a bear attacks by pressing its victim downward, a bear speculator tries to push market prices downward through selling activities. When many investors expect prices to fall, the market is called a bearish market. In such a market, pessimism and negative expectations are common. Sometimes bears may spread negative rumours to create selling pressure and force prices down. This practice is known as a bear raid.

3. Stag

A Stag is a cautious speculator who mainly deals in new issues of shares. A stag applies for shares in newly issued companies with the expectation that the shares will be listed at a premium in the stock market. When a popular company launches an Initial Public Offering (IPO), a stag applies for a large number of shares. If shares are allotted and the market price rises above the issue price, the stag quickly sells them and earns a profit. Unlike bulls and bears, a stag does not actively trade in the stock market every day. He depends mainly on obtaining allotments in new share issues. Since many IPOs are heavily oversubscribed, a stag often applies for many shares to increase the chances of receiving an allotment. The term "Stag" comes from the animal stag (a male deer). In the stock market, a stag is considered a cautious and alert speculator who waits for profitable opportunities, just as a stag carefully watches its surroundings before making a move.

4. Lame Duck

A Lame Duck is a bear speculator who faces difficulty in fulfilling his commitment to deliver securities. This situation arises when the bear has sold securities expecting

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prices to fall but is unable to obtain the securities when delivery becomes due. For example, Midhun sells shares expecting the price to decline. But instead of falling, the price rises sharply, and the shareholders are unwilling to sell their shares. As a result, Midhun cannot obtain the securities required for delivery and faces financial difficulties. Such a speculator is called a Lame Duck because he is trapped in a difficult position and struggles to meet his obligations, just like a lame duck struggling to move.

5. Wolf

An extremely shrewd, cunning speculator who is highly alert to market trends and moves swiftly to capture opportunities. This term is used less commonly in Indian textbooks but appears in some classifications alongside Bulls, Bears, and Stags. It is a less common type of speculator.

2.2.3 Speculative transactions in Stock Exchanges

Speculative transactions are transactions undertaken with the objective of earning profits from changes in the prices of securities rather than from regular income such as dividends. Speculators closely watch market movements and attempt to take advantage of price fluctuations. Some speculative transactions are legal, while others are considered unethical or illegal because they manipulate market conditions.

1. Cornering

Cornering is the process by which an individual or a group acquires almost the entire supply of a particular security available in the market. By controlling most of the shares, the speculator creates an artificial shortage. Suppose a company has 1,00,000 shares available for trading. A group of speculators purchases and takes delivery of 90,000 shares. At the same time, bear speculators who had earlier sold shares expecting prices to fall must deliver those shares on the settlement date. Since only a small number of shares remain available in the market, the bears are unable to obtain them easily. The speculators controlling the shares can then demand a very high price. As a result, the bears suffer heavy losses and may become lame ducks. Cornering is illegal because it creates artificial scarcity and disturbs the normal functioning of the market.

2. Rigging the Market

Rigging the market refers to the creation of artificial demand for a security to increase its market price. A group of bull speculators may continuously buy shares of a company trading at ₹200 per share. Other investors notice the increased demand and assume that the company has excellent growth prospects. They also start purchasing the shares. As demand increases, the price rises to ₹300 per share. The speculators then sell their holdings and earn substantial profits. The price increase occurs because of artificial demand rather than genuine business performance. Rigging is considered an unfair market practice because it misleads investors.

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3. Blank Transfers

A blank transfer is a method of transferring securities without mentioning the name of the transferee in the transfer deed. The transferor signs the document, but the buyer's name is left blank. Suppose Ravi purchases shares and plans to sell them again within a short period. Instead of completing a fresh transfer deed every time, the shares are transferred through a blank transfer form. This simplifies repeated transfers but also encourages excessive speculation. Blank transfers are undesirable because they encourage unhealthy speculation, help avoid stamp duty, facilitate tax evasion, and allow individuals to gain control over companies without revealing their identity.

4. Margin Trading

Margin trading is a popular speculative technique in which investors trade using borrowed funds. Suppose Amar has only ₹20,000 but wishes to purchase shares worth ₹1,00,000. He deposits ₹20,000 with his broker as margin. The broker finances the remaining amount. If the share price rises by 20%, Amar earns a substantial profit on a much larger investment. If the price falls by 20%, his losses are also magnified. Thus, margin trading increases both profit opportunities and risk.

5. Matched Orders

Matched orders are transactions arranged to create a false impression that a particular security is actively traded. A speculator instructs one broker to place a buy order for 5,000 shares at ₹150 each and another broker to place a sell order for the same quantity at the same price. Although there is no genuine buying interest, other investors see the transaction and believe that the stock is highly active. This may attract additional buyers and influence the share price. Matched orders are misleading because they create artificial trading activity.

6. Buying In and Selling Out

Buying in and selling out are remedies available when a party fails to fulfil a contract.

Buying In

Suppose Meera purchases shares at ₹500 each, but the seller fails to deliver them on the settlement date. The stock exchange buys the shares from the market on her behalf. If the current market price has risen to ₹550, the additional ₹50 per share loss must be borne by the defaulting seller.

Selling Out

Suppose Arjun agrees to purchase shares at ₹500 each but fails to make payment. The stock exchange sells the shares in the market on behalf of the seller. If the market price falls to ₹450, the ₹50 per share loss must be borne by the defaulting buyer.

7. Bucket Shops

Bucket shops are establishments where securities are bought and sold outside recognised stock exchanges. For example, two traders may privately agree to speculate

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on the future price of a share without executing the transaction through a recognised stock exchange. Since such dealings take place outside the regulatory framework, they are considered illegal. Bucket shop transactions are prohibited because they lack transparency and investor protection.

8. Option Dealing

An option is a contract that gives the holder the right, but not the obligation, to buy or sell securities at a specified price within a specified period.

(a) Call Option (Teji Souda)

A call option gives the holder the right to buy securities. For example, Aswani purchases a call option allowing her to buy shares at ₹500 per share within three months. If the market price rises to ₹600, she can still buy the shares at ₹500 and earn a profit of ₹100 per share. Call options are generally used by bull speculators who expect prices to rise.

(b) Put Option (Mandi Souda)

A put option gives the holder the right to sell securities. If Kiran purchases a put option allowing him to sell shares at ₹500 per share. If the market price falls to ₹400, he can still sell them at ₹500, thereby protecting himself from loss. Put options are generally used by bear speculators who expect prices to fall.

(c) Double Option (Teji Mandi)

A double option combines both call and put options. A speculator expects large price movements but is uncertain about the direction. By obtaining a double option, he gains the right either to buy or to sell securities depending on market conditions. This provides flexibility in uncertain markets.

9. Hedging

Hedging is a method of protecting against possible losses arising from adverse price movements. A bull speculator purchases shares at ₹1,000 each, expecting the price to rise. But to protect himself against a possible fall in price, he also purchases a put option. If the market price falls to ₹900, the loss on the shares can be reduced through gains from the put option. Thus, hedging acts like insurance against market risk.

10. Carry Over or Badla Transactions

Carry over, also known as Badla, refers to postponing the settlement of a forward contract to the next settlement period with the consent of both parties. A speculator purchases shares at ₹400 expecting the price to rise to ₹450 before settlement. But the price falls to ₹350. Rather than settling immediately and suffering a loss, the parties agree to postpone settlement until the next month. The speculator hopes that prices will recover before the new settlement date. This postponement of settlement is known as a carryover or Badla transaction.

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11. Wash Sales

Wash sales are transactions in which the same person acts as both the buyer and the seller, either directly or through associated accounts, without any real change in ownership. A speculator sells 10,000 shares from one account and simultaneously purchases the same 10,000 shares through another account under his control. Although ownership remains unchanged, the market records a large volume of trading. Other investors may wrongly assume that the security is highly active and begin purchasing it. Wash sales are unethical because they create a false impression of market activity.

12. Arbitrage

Arbitrage is the practice of earning profits from differences in the prices of the same security in different markets. For example, the shares of a company are trading at ₹500 on one stock exchange and ₹510 on another stock exchange at the same time. An arbitrageur purchases the shares at ₹500 and immediately sells them at ₹510. The ₹10 difference per share becomes profit without waiting for future price movements. Arbitrage helps in reducing price differences between markets and contributes to efficient price discovery.

While speculative transactions involve taking risks in the stock market with the expectation of earning profits from future price movements, they are generally based on publicly available information and market forecasts. But when a person buys or sells securities using confidential and unpublished price-sensitive information that is not available to other investors, the activity moves beyond normal speculation and becomes insider trading. Unlike legitimate speculation, insider trading provides an unfair advantage to certain individuals and is prohibited by law to ensure fairness, transparency, and investor confidence in the securities market.

2.2.4 Insider trading

Insider trading is the buying or selling of shares by a person who has access to unpublished price-sensitive information (UPSI) about a company before that information becomes available to the public. It is considered an unfair and illegal trading practice because insiders can make profits or avoid losses by using confidential information that ordinary investors do not possess. According to SEBI, an insider is a person who relates to a company and has access to unpublished price-sensitive information. Insiders may include directors, managers, officers, employees, auditors, consultants, or any other person associated with the company. Suppose a company director learns that the company has earned exceptionally high profits and will soon declare a large dividend. Before this information is officially announced, the director purchases 1,000 shares at ₹500 each. After the announcement, the share price rises to ₹650 per share. The director sells the shares and earns a profit of ₹1,50,000 [(₹650 − ₹500) × 1,000] by using confidential information. This is an example of insider trading.

2.2.4.1 Unpublished Price-Sensitive Information (UPSI)

The following types of information are considered price-sensitive because they can significantly affect the market price of a company's shares:

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1. Financial Results – Half-yearly, quarterly, or annual profits and losses of the company.
2. Declaration of Dividends – Proposed interim or final dividends to shareholders.
3. Issue of Securities – Public issues, rights issues, bonus issues, or preferential allotments.
4. Expansion Plans and New Projects – Major business expansion, diversification, or commencement of new projects.
5. Mergers, Amalgamations, and Takeovers – Plans relating to business combinations or acquisitions.
6. Sale of Undertakings – Disposal of the whole or a substantial part of the company's business.
7. Information Affecting Earnings – Any event likely to increase or decrease company profits significantly.
8. Changes in Policies or Operations – Important changes in business strategy, management policies, or operational activities.

2.2.4.2 Provisions in SEBI regulations 2015

1. SEBI (Prohibition of Insider Trading) Regulations, 2015 is the primary regulation governing insider trading in India. Key provisions include:
2. Prohibition on trading by insiders when in possession of UPSI.
3. Prohibition on communication of UPSI except for legitimate purposes.
4. Mandatory maintenance of a Structured Digital Database (SDD) by companies to record persons with whom UPSI is shared.
5. Trading Window Closure – companies must close the trading window for designated persons during periods when UPSI is likely to exist (e.g., before results announcements).
6. Code of Conduct – listed companies and market intermediaries must frame and enforce an internal code of conduct for prevention of insider trading.
7. Disclosure requirements for trading by promoters, directors, KMPs, and designated persons beyond specified thresholds.

2.2.4.3 Penalties for Insider Trading

Under the SEBI Act, 1992, penalties for insider trading may include:

1. Monetary penalty (which can extend to crores of rupees or three times the profit made, whichever is higher).
2. Disgorgement of profits made through insider trading.
3. Debarment from accessing the securities market.
4. Criminal prosecution, including imprisonment and/or fine under the SEBI Act.

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Recap

- ◊ Speculation involves buying or selling securities to earn profits from future price changes.
- ◊ Investment focuses on long-term wealth creation, whereas speculation aims at quick profits.
- ◊ Bull speculators expect prices to rise and buy securities in anticipation of future gains.
- ◊ Bear speculators expect prices to fall and sell securities to profit from declining prices.
- ◊ Stag speculators mainly apply for new share issues, expecting listing gains.
- ◊ Lame Duck is a bear speculator who cannot fulfil delivery obligations on the settlement date.
- ◊ Cornering and rigging are illegal practices used to manipulate market prices artificially.
- ◊ Margin trading allows investors to trade with borrowed funds, increasing both profit potential and risk.
- ◊ Arbitrage involves earning profits from price differences of the same security in different markets.
- ◊ Insider trading is the illegal buying or selling of securities using unpublished price-sensitive information (UPSI).

Objective Questions

1. Who is a speculator who expects security prices to rise?
2. Who is a speculator who expects security prices to fall?
3. Which type of speculator mainly deals in new issues of shares?
4. What is a bear speculator who fails to deliver securities called?
5. What is the process of acquiring control over most of the available shares called?
6. What is the practice of creating artificial demand to raise share prices called?
7. What type of trading involves the use of borrowed funds?

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8. What option gives the holder the right to buy securities?
9. What is the practice of earning profit from price differences in different markets called?
10. What is trading based on unpublished price-sensitive information called?

Answers

1. Bull
2. Bear
3. Stag
4. Lame Duck
5. Cornering
6. Rigging
7. Margin Trading
8. Call Option
9. Arbitrage
10. Insider Trading

Self-Assessment Questions

1. Explain the meaning of speculation and distinguish between speculation and investment.
2. Discuss the different types of speculators in the stock market with suitable examples.
3. Explain the various speculative transactions carried out in the securities market.
4. Describe the concept of option dealing and explain call option, put option and double option.
5. What is insider trading?

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Assignments

1. Select any two listed companies and compare whether purchasing their shares would be an investment decision or a speculative decision. Give reasons for your answer.
2. Track the share price of a company for ten trading days and identify whether the market behaviour reflects the actions of a bull or a bear speculator. Prepare a brief report.
3. Study a recent IPO in India and analyse how a stag speculator could earn profit from the issue. Support your answer with relevant market data.
4. Collect information on any reported insider trading case in India and explain the nature of the unpublished price-sensitive information involved, and the action taken by SEBI.
5. Using hypothetical data, illustrate how profits or losses can arise from margin trading, arbitrage, and option dealing. Present the calculations and conclusions.

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Suggested Reading

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BLOCK 3

Financial Services

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Unit 1
Introduction to Financial Services

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ gain insight into the meaning of financial services.
- ◊ explain the characteristics of financial services.
- ◊ analyse the significance and scope of financial services
- ◊ explain the objectives of financial services.
- ◊ understand the functions of financial services

Prerequisite

Anu is a small business owner who runs a home-based bakery. As her business grows, she needs a business loan to purchase new equipment. She approaches a bank for financial assistance. At the same time, her friend Riya wants to invest her savings in shares but does not know how to buy and sell securities. She approaches a stockbroker for assistance. Another entrepreneur, Manu, wants to raise funds by issuing shares and seeks the help of a merchant banker to complete the process.

In these situations, Anu, Riya, and Manu need different kinds of assistance related to money, investment, and business finance. Banks provide loans, stockbrokers facilitate the buying and selling of securities, and merchant bankers provide specialised financial assistance. These activities are examples of financial services.

Financial services are not limited to providing loans or helping with investments. They include a wide range of services that help individuals, businesses, and other organisations mobilise funds, invest money, raise finance, manage financial

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risks, and carry out financial transactions efficiently.

The growing importance of such services can be seen in everyday activities such as banking, insurance, investment, leasing, hire purchase, merchant banking, mutual funds, stockbroking, credit rating, and digital financial services. These services support individuals in managing their finances and help businesses obtain and utilise financial resources effectively.

Thus, the experiences of Anu, Riya, and Manu show how financial services form an essential part of modern economic and business activities.

This unit discusses the meaning, characteristics, significance, and scope of financial services.

Keywords

Financial Services, Liquidity, Risk Management

Discussion

3.1.1 Meaning and Definition of Financial Services

Meaning

Financial services are all activities that are financial in nature. Financial services are the economic services provided by financial institutions and financial intermediaries that facilitate the smooth flow of funds in the economy by offering a variety of financial products and services, thereby helping individuals and businesses save, borrow, invest, insure, transfer funds, and manage financial risks effectively. Financial services constitute an essential component of the financial system. They facilitate the mobilization of savings and the allocation of funds through a variety of financial products, credit instruments, and investment avenues. These services assist customers in meeting their financial requirements by providing borrowing, lending, investment, insurance, payment, and fund transfer facilities. Financial institutions such as commercial banks, non-banking financial companies (NBFCs), insurance companies, credit card companies, consumer finance companies, stock brokers, investment companies, and mutual funds offer a wide range of financial services.

Definition

Financial service is defined as, "the products and services offered by institutions like banks of various kinds for the facilitation of various financial transactions and other related activities in the world of finance like loans, insurance, credit cards, money management as well as providing information on stock markets."

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3.1.2 Characteristics of Financial Services

1. Intangibility

Financial services are intangible in nature, as they cannot be seen, touched, or physically possessed. They exist in the form of financial advice, expertise, contractual arrangements, or financial assistance rather than physical products. For example, the advisory services provided by a tax consultant cannot be physically examined before they are received. Consequently, customers evaluate financial services based on the competence, reputation, reliability, and quality of the service provider. Customer satisfaction and feedback also play an important role in assessing the effectiveness of financial services.

2. Inseparability

Financial services are inseparable from the service provider because their production and consumption occur simultaneously. Unlike manufactured goods, financial services are delivered and consumed at the same time. For instance, loan processing by a bank, investment advice by a financial consultant, or credit rating by a credit rating agency can only be provided through the respective institution or professional. Therefore, the quality of financial services largely depends on the knowledge, efficiency, and professionalism of the service provider.

3. Customer-Specific (Customer-Oriented)

Financial services are customer-specific, as they are designed to meet the unique financial needs of individual customers and business organizations. Financial institutions assess factors such as customers' financial objectives, income, investment preferences, liquidity requirements, and risk-bearing capacity before recommending suitable financial products. For example, a stockbroker recommends investments based on the client's investment goals and risk tolerance, while banks offer different loan schemes for students, entrepreneurs, and housing purposes. Thus, financial services emphasize customization rather than standardization.

4. Dynamic Nature

Financial services are dynamic because they continuously evolve in response to technological advancements, economic developments, government regulations, market competition, and changing customer expectations. Financial institutions regularly introduce innovative products and delivery channels such as internet banking, mobile banking, digital wallets, Unified Payments Interface (UPI) and fintech solutions. Continuous innovation enables financial institutions to improve customer convenience, operational efficiency, and competitiveness.

5. Direct Sale

Financial services are generally delivered through direct interaction between the financial institution and the customer. Banks, insurance companies, mutual funds, stockbrokers, and other financial institutions provide services directly through their branches, websites, mobile applications, call centres, and authorized representatives.

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6. Credibility of the Service Provider

The success of financial services largely depends on the credibility, reputation, and trustworthiness of the service provider. Since customers entrust financial institutions with their savings, investments, and confidential financial information, they prefer institutions that are financially sound, transparent, ethically managed, and well regulated. Factors such as goodwill, financial stability, quality of customer service, regulatory compliance, and corporate governance significantly influence customer confidence. Therefore, credibility is one of the most valuable assets of a financial service provider.

7. Information-Based

Financial services are information-intensive, as they rely heavily on the collection, processing, analysis, and dissemination of financial information. Decisions relating to lending, investment, insurance, taxation, and risk management depend on accurate, timely, and reliable information. Efficient information management improves decision-making, enhances service quality, and reduces financial risks.

8. Dependence on Technology

Modern financial services are increasingly technology-driven. The widespread use of digital technologies such as online banking, mobile banking, electronic payment systems, cloud computing, artificial intelligence, blockchain, and data analytics has transformed the financial services sector. Technology enhances speed, accuracy, accessibility, security, and customer convenience while reducing operational costs.

3.1.3 Significance of Financial Services

Financial services play a vital role in the growth and development of an economy. Their importance can be explained through the following points:

The scope of financial services refers to the wide range of functions and activities performed by financial institutions to meet the financial needs of individuals, businesses, and governments. Financial services facilitate the mobilization of savings, efficient allocation of financial resources, risk management, and economic development. The major areas covered under the scope of financial services are discussed below.

1. Promotion of Savings

One of the primary functions of financial services is to promote savings by providing individuals and institutions with a variety of safe and attractive investment opportunities. Financial institutions mobilize surplus funds through instruments such as bank deposits, insurance policies, mutual funds, pension schemes, and other savings products. These services encourage a saving habit among the public and ensure that idle funds are channelled into productive investments.

2. Capital Formation

Financial services play a significant role in capital formation, which refers to the creation and expansion of capital assets such as machinery, equipment, factories,

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infrastructure, and other productive resources. By mobilizing savings from surplus units and directing them to businesses and industries requiring funds, financial services facilitate investment in productive activities. This process increases the productive capacity of the economy and contributes to long-term economic development.

3. Risk Management

Financial services provide various mechanisms for managing and minimizing financial risks faced by individuals and business organizations. Insurance services offer protection against unforeseen losses arising from events such as accidents, illness, fire, or natural disasters. Similarly, credit rating services assess the creditworthiness of companies and financial instruments, enabling investors to make informed investment decisions. Portfolio management, financial advisory, and risk assessment services further assist investors in diversifying investments and reducing financial risk.

4. Provision of Liquidity

Financial services enhance the liquidity of financial assets by enabling investors to convert their investments into cash with ease and minimum loss of value. Financial institutions offer a wide range of investment avenues and facilitate the buying, selling, and transfer of financial assets. This flexibility allows investors to reallocate their funds according to changing financial needs and market conditions, thereby improving the efficient utilization of financial resources.

5. Creation of Employment Opportunities

The financial services sector contributes significantly to employment generation. Financial institutions such as banks, insurance companies, mutual funds, stock exchanges, non-banking financial companies (NBFCs), and fintech firms create direct employment opportunities for professionals in banking, finance, accounting, marketing, information technology, and customer service. Moreover, by providing financial assistance to businesses and entrepreneurs, financial services promote industrial and commercial growth, thereby generating indirect employment opportunities throughout the economy.

6. Improvement in the Standard of Living

Financial services contribute to an improved standard of living by increasing access to savings, credit, insurance, and investment facilities. They enable individuals to finance education, housing, healthcare, business activities, and other essential needs. Greater financial inclusion, improved access to financial resources, and increased investment opportunities enhance income generation, financial security, and the overall quality of life.

7. Promotion of Economic Growth

A well-developed financial services sector is a key driver of economic growth and development. By mobilizing savings, facilitating capital formation, promoting investment, managing risks, and supporting entrepreneurship, financial services improve the efficiency of resource allocation within the economy. These activities

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increase production, generate employment, raise national income, and contribute to sustainable and inclusive economic development.

3.1.4 Scope of Financial Services

The scope of financial services is broad and continuously expanding with the growth of the financial sector and advancements in technology. Financial institutions offer a wide range of services that cater to the financial requirements of individuals, businesses, and governments. These services facilitate savings, investment, borrowing, risk management, financial planning, and the efficient allocation of financial resources. The increasing complexity of financial markets and the growing demand for specialised financial solutions have further widened the scope of financial services. The major areas covered under the scope of financial services include the following:

1. Asset/Fund-Based Financial Services

Asset-based or fund-based financial services involve the direct deployment of funds by financial institutions to provide financial assistance to customers. These services are primarily intended to meet the financial requirements of individuals and business organisations for investment, expansion, and working capital. Major asset-based financial services include lease financing, housing finance, hire purchase, factoring, forfaiting, insurance, venture capital, bills discounting, and mutual funds.

2. Fee-Based Financial Services

Fee-based financial services involve the provision of specialised financial expertise, consultancy, and intermediary services without deploying the financial institution's own funds. Financial institutions earn income mainly through fees, commissions, brokerage, and other service charges. Important fee-based financial services include merchant banking, credit rating, stock broking, corporate advisory services, and custodial services.

3.1.5 Objectives of Financial Services

Financial services are designed to facilitate the efficient allocation and utilization of financial resources in an economy. They cater to the financial needs of individuals, businesses, and governments while promoting economic stability and growth. The major objectives of financial services are as follows:

1. Mobilization of Funds

One of the primary objectives of financial services is to mobilize savings from individuals and institutions possessing surplus funds. Financial institutions collect these savings through various financial instruments and services such as bank deposits, insurance policies, mutual funds, and pension schemes. The mobilization of funds helps convert idle savings into productive capital, thereby contributing to capital formation and economic development.

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2. Productive Employment of Funds

Financial services ensure that mobilized funds are efficiently allocated to productive sectors of the economy. Through services such as loans, advances, bill discounting, leasing, hire purchase, securitization, and project financing, financial institutions provide the required capital to individuals and business enterprises. This enables investment, expansion of business activities, employment generation, and overall economic progress.

3. Provision of Financial Advisory Services

An important objective of financial services is to provide expert financial guidance to individuals and organizations. Professional advisory services assist clients in making informed financial decisions regarding investments, taxation, financial planning, risk management, project appraisal, mergers and acquisitions, and wealth management. Such advisory services enhance financial literacy and promote efficient financial decision-making.

4. Provision of Need-Based Financial Services

Financial services aim to meet the diverse financial requirements of customers by offering specialized products and services tailored to their specific needs. With the expansion of the financial sector, customers can access a wide range of services such as venture capital financing, housing finance, consumer finance, infrastructure finance, credit rating services, merchant banking, and asset management. These customized financial solutions improve customer satisfaction and support different stages of personal and business development.

5. Promotion of Economic Growth and Development

A well-developed financial services sector plays a crucial role in promoting economic growth by ensuring the efficient mobilization, allocation, and utilization of financial resources. Financial services encourage savings, facilitate investments, support entrepreneurship, improve industrial productivity, and strengthen the financial system. Continuous innovation in financial products and services further enhances economic efficiency, resulting in sustainable and inclusive economic development.

3.1.6 Functions of Financial Services

i. **Facilitating Transactions:**Financial services facilitate economic transactions by enabling the exchange of goods and services. They act as a lubricant for the monetary and financial system, ensuring the smooth functioning of economic activities.

ii. **Mobilisation of Savings:**Financial services play a significant role in mobilising savings from individuals and institutions and channelising them into productive investments for the growth of commerce and industry. Thus, they contribute to capital formation and the overall economic development of a country.

iii. **Effective Deployment of Funds:**The financial services sector provides an efficient market mechanism for the proper allocation and utilisation of funds for

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productive investments. It helps redirect financial resources from unproductive uses to more productive and profitable avenues.

iv. **Provision and Monitoring of Services:**Financial services also perform the important function of providing need-based financial services and monitoring the utilisation of funds to ensure that they are used for the intended purposes.

v. **Risk Management:**Financial service institutions, such as insurance companies and insurance brokers, help minimise risk by pooling and spreading the risks of a large number of individuals. They also enable individuals and businesses to transfer their risks to those who are willing to bear them.

vi. **Economic Growth and Development:**The institutions operating in the financial services sector provide both quantitative and qualitative direction to the flow of funds. They ensure the rational allocation of financial resources, thereby promoting the economic growth and development of the country.

Recap

- ◊ Financial services are economic services provided by financial institutions and intermediaries to facilitate financial transactions, mobilise savings, provide credit, manage investments, and manage financial risks.
- ◊ Financial services possess distinctive characteristics, including intangibility, inseparability, customer orientation, dynamic nature, direct delivery, credibility, information-based operations, and dependence on technology.
- ◊ Financial services are significant because they promote savings, facilitate capital formation, improve liquidity, manage financial risks, generate employment opportunities, enhance the standard of living, and contribute to economic growth and development.
- ◊ The major objectives of financial services are to mobilise and productively utilise funds, provide financial advisory services, offer need-based financial solutions, and promote economic growth and development.
- ◊ The functions of financial services include facilitating financial transactions, mobilising savings, ensuring the effective deployment of funds, providing need-based financial services, monitoring the utilisation of funds, and managing financial risks.

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Objective Questions

1. Which characteristic of financial services refers to the fact that they cannot be seen or physically possessed?
2. Which characteristic of financial services indicates that their production and consumption occur simultaneously?
3. Which characteristic of financial services means that they are designed to meet the specific needs of customers?
4. Which characteristic of financial services reflects their continuous evolution in response to technological and economic changes?
5. Which characteristic of financial services involves providing services directly to customers without intermediaries?
6. Which characteristic of financial services emphasizes the importance of the reputation and trustworthiness of the service provider?
7. Which objective of financial services focuses on collecting savings from individuals and institutions?
8. Which objective of financial services ensures that mobilized funds are allocated to productive sectors of the economy?
9. Which objective of financial services provides expert guidance on investments, taxation, and financial planning?
10. Which objective of financial services aims to provide specialized financial products tailored to customer requirements?
11. Which objective of financial services ultimately contributes to the overall development of the economy?
12. Which scope of financial services enables investors to convert their investments into cash easily?
13. Which scope of financial services helps protect individuals and businesses against financial risks?
14. Which scope of financial services contributes to increasing the stock of productive capital in the economy?
15. Which scope of financial services promotes employment by supporting business and industrial growth?

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Answers

1. Intangibility
2. Inseparability
3. Customer-Specific (Customer-Oriented)
4. Dynamic Nature
5. Direct Sale
6. Credibility of the Service Provider
7. Mobilization of Funds
8. Productive Employment of Funds
9. Provision of Financial Advisory Services
10. Provision of Need-Based Financial Services
11. Promotion of Economic Growth and Development
12. Provision of Liquidity
13. Risk Management
14. Capital Formation
15. Creation of Employment Opportunities

Self-Assessment Questions

1. Define financial services. Explain the major characteristics of financial services.
2. Discuss the objectives of financial services.
3. Explain the scope of financial services.
4. Describe the major functions of financial services.
5. Explain the significance of financial services in the economic development of a country.

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Assignments

1. "Financial services promote savings and capital formation." Examine this statement in the light of the objectives and scope of financial services.
2. Analyse how the characteristics of financial services distinguish them from tangible goods.
3. Examine the role of financial services in promoting economic growth through efficient mobilization and productive employment of funds.
4. Analyse how financial services contribute to risk management, liquidity, and improvement in the standard of living.
5. Evaluate the contribution of financial services to the development of businesses and the economy with reference to their functions and significance.

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Unit 2
Types of Financial Services

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ gain insight into the various fund-based financial services
- ◊ understand the different fee-based financial services.

Prerequisite

Sanjay is an entrepreneur who has been successfully running a small manufacturing business. As his business expanded, he needed different kinds of financial support. He approached a bank to obtain a term loan for purchasing new machinery, invested some surplus funds in mutual funds, and sought the assistance of a merchant banker for raising additional capital. He also consulted a financial advisor to plan his investments and used the services of a stockbroker to purchase and sell securities.

Through these experiences, Sanjay realised that financial services are not limited to providing finance alone. Some services involve the direct provision or deployment of funds, while others provide professional advice, assistance, and intermediary services for which fees or commissions are charged. Thus, financial services can broadly be understood through these two categories.

As Sanjay's business continued to grow, he required different financial services for raising funds, investing surplus money, managing financial risks, and carrying out financial transactions. The availability of these services helped him meet his financial requirements and make informed decisions at different stages of his business.

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Today, businesses and individuals require a wide range of financial services to manage their financial activities effectively. While some services provide or deploy funds for various purposes, others offer specialised expertise, advisory support, and intermediary services. Understanding these different types of financial services helps businesses select suitable services according to their financial needs.

This unit discusses the different types of financial services, with particular focus on Fund-Based Financial Services and Fee-Based Financial Services.

Keywords

Financial Services, Fund-Based Financial Services, Fee-Based Financial Services, Leasing, Factoring

Discussion

Financial services constitute an integral part of the financial system and encompass a wide range of products and services offered by financial institutions to meet the financial requirements of individuals, businesses, and governments. These services facilitate the mobilisation of savings, provide access to finance, promote investment, support risk management, and ensure the efficient allocation and utilisation of financial resources. By contributing to capital formation, entrepreneurship, employment generation, and economic development, financial services play a crucial role in the growth and stability of the economy. To effectively fulfil these objectives and address diverse customer needs, financial institutions offer different types of financial services.

3.2.1 Types of Financial Services

Financial services can be broadly classified into two categories, namely Asset/Fund-Based Services and Fee-Based Services.

3.2.1.1 . Asset / Fund Based Financial Services

Asset/Fund-based financial services involve the lending or investment of funds by financial institutions to meet the financial requirements of individuals and business organisations. These services generate income primarily through interest, lease rentals, dividends, or investment returns.

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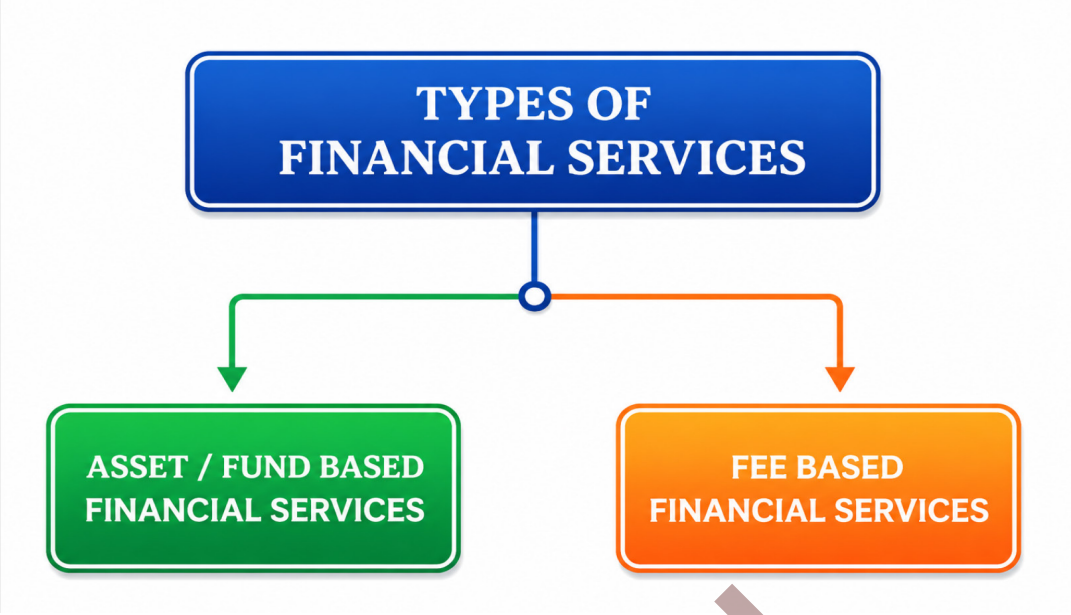


Figure 3.2.1 Types of Financial Services

a. Lease Financing

Lease financing is an important asset-based financial service under which the owner of an asset, known as the lessor, grants another party, known as the lessee, the right to use the asset for a specified period in return for periodic payments called lease rentals. Ownership of the asset remains with the lessor, while the lessee enjoys the right to use the asset in accordance with the terms of the lease agreement. The leasing industry in India began with the establishment of the First Leasing Company of India Ltd. in 1973. It later expanded with the entry of financial institutions, commercial banks, and Non-Banking Financial Companies (NBFCs), making leasing an important source of medium- and long-term finance.

Lease financing enables businesses to use costly assets such as machinery, equipment, vehicles, and industrial plants without making a large initial investment. For example, if a business requires an expensive machine but lacks sufficient funds to purchase it, it can enter into a lease agreement with the owner of the asset and use the machine by paying periodic lease rentals. Lease financing is broadly classified into operating lease and financial lease. An operating lease is generally a short-term lease in which the lease period is shorter than the economic life of the asset, and the lessor is normally responsible for repairs and maintenance. At the end of the lease period, the lessee may renew the agreement or return the asset. A finance lease, on the other hand, is a long-term lease covering a major part of the asset's economic life. In this case, the lessee identifies the asset and its supplier, while the lessor purchases the asset and leases it to the lessee. The lessee generally bears the cost of maintenance, repairs, and insurance, and the lease rentals substantially recover the cost of the asset. Depending on the terms of the agreement, ownership of the asset may be transferred to the lessee at the end of the lease period. In India, lease financing services are provided by institutions such as Infrastructure Leasing & Financial Services Ltd. (IL&FS), ICICI, IFCI, LIC, HDFC,

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commercial banks, NBFCs, and other financial institutions, making lease financing an important source of business finance for acquiring productive assets.

b.Housing Finance

Housing finance is a specialised form of financial service that provides long-term financial assistance for acquiring, constructing, repairing, renovating, or extending residential properties. It is offered by banks, housing finance companies, and other financial institutions. Housing is one of the basic necessities of human life and plays a significant role in the socio-economic development of a country. However, the high cost of land and construction makes it difficult for individuals to meet housing expenses solely from their personal savings, thereby creating a growing demand for external housing finance. Housing finance institutions, commercial banks, and Non-Banking Financial Companies (NBFCs) provide home loans and other housing finance products to meet this demand. To attract customers, these institutions offer competitive interest rates, flexible repayment options, longer loan tenures, lower margin requirements, and both fixed-rate and floating-rate housing loans, often allowing borrowers to switch from one interest rate option to another under specified conditions. In addition, they provide faster loan processing, quick disbursement, professional financial advisory services, and concessions in processing charges and other upfront fees. Institutions such as the National Housing Bank (NHB), Housing Development Finance Corporation (HDFC), commercial banks, housing finance companies, and other financial institutions play a significant role in providing housing finance, thereby promoting home ownership and contributing to the overall economic and social development of the country.

c. Hire Purchase

Hire purchase is an important asset-based financial service that enables individuals and businesses to acquire an asset by paying its cost in equal periodic instalments over an agreed period. According to the International Finance Corporation (IFC), hire purchase is a hybrid financial instrument that provides an alternative to bank finance for purchasing assets. Under a hire purchase agreement, the purchaser, known as the hirer, obtains immediate possession and the right to use the asset. At the same time, the ownership remains with the owner (vendor) until the payment of the final instalment. Each instalment consists of both principal and interest, commonly referred to as the hire purchase charge. After the last instalment is paid, the ownership of the asset is transferred to the hirer. However, if the hirer defaults in making the agreed payments, the owner has the legal right to repossess the asset. Hire purchase is widely used for financing consumer durables such as televisions, refrigerators, washing machines, and furniture, and has become particularly popular in automobile financing. Along with leasing, hire purchase has emerged as an important supplementary source of medium- and long-term finance, enabling customers to acquire assets without making a large initial investment. In India, hire purchase services are mainly provided by Non-Banking Financial Companies (NBFCs), commercial banks, financial institutions, and other financing organizations.

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d. Factoring

Factoring is a financial service in which a business (known as the client) sells its trade receivables or book debts to a specialised financial institution called a factor. The factor undertakes the responsibility of collecting the receivables from customers and provides finance to the business either immediately or on a predetermined payment date. In addition to financing, factoring also transfers the responsibility for managing receivables and maintaining related records from the client to the factor. As a result, businesses can improve cash flow, reduce administrative work, and focus on their core operations.

The factor generally performs five major functions. First, it maintains the client's sales ledger by keeping records of receivables. Second, it collects outstanding debts from customers. Third, it provides short-term finance by advancing a substantial portion of the invoice value before the receivables are collected. Fourth, depending on the agreement, it may assume or manage the credit risk associated with customer default. Finally, the factor offers advisory services relating to credit management and receivables administration. For these services, the factor charges two types of fees: a commission for sales ledger maintenance and debt collection, and an interest or discount charge on the amount advanced until the receivables are realised.

Factoring arrangements are designed to meet the diverse financing needs of businesses. They are commonly classified based on risk assumption, payment method, disclosure of the factor's identity, extent of services provided, and the geographical location of the parties involved. The major types include recourse and non-recourse factoring, advance and maturity factoring, full factoring, disclosed and undisclosed factoring, and domestic and international (export) factoring.

i. **Recourse Factoring:** Here, the client bears the credit risk, and the factor has the right to recover the amount from the client if the customer fails to pay.
ii. **Non-Recourse Factoring:** Here, the factor assumes the credit risk, and the client is not liable if the customer defaults.
iii. **Advance Factoring:** In advance factoring, the factor pays a major portion of the invoice value to the client in advance, with the balance paid after collection of the receivables.
iv. **Maturity Factoring:** In maturity factoring, the factor does not make any advance payment and pays the client only on the agreed payment date or after collecting the receivables.
v. **Full Factoring:** Full factoring is a comprehensive arrangement that provides financing, sales ledger administration, debt collection, and credit protection.
vi. **Disclosed Factoring:** In disclosed factoring, the customer is informed that the receivables have been assigned to the factor and payment is made directly to the factor.
vii. **Undisclosed Factoring:** In undisclosed factoring, the customer is not informed about the involvement of the factor, although the factor manages the receivables and may provide finance.

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viii. **Domestic Factoring:** Domestic factoring involves the client, customer, and factor all being located within the same country.

ix. **International (Export/Cross-Border) Factoring:** International or export factoring is a factoring arrangement in which the parties are located in different countries, facilitating the financing and collection of receivables arising from international trade transactions.

e. Forfaiting

Forfaiting is a financial service used in international trade to provide immediate finance to exporters by purchasing their export receivables. Under this arrangement, a bank or financial institution, known as the forfaiter, purchases the exporter's trade bills or promissory notes at a discount without recourse. This means that once the receivables are sold, the exporter is relieved of the risk of non-payment, as the forfaiter assumes full responsibility for collecting the amount from the importer. Thus, forfaiting enables exporters to convert future receivables into immediate cash while transferring the risks associated with credit, collection, and default to the forfaiter.

In a typical forfaiting transaction, an exporter and an importer enter into a commercial agreement under which the importer purchases goods on a deferred payment basis. To settle the payment, the importer issues a series of promissory notes or accepts bills of exchange drawn by the exporter. These instruments are generally guaranteed by a bank guarantee assuring payment if the importer fails to meet the obligation. The exporter then sells these bank-guaranteed bills or promissory notes to a forfaiter at a discounted value without recourse. The forfaiting agreement specifies various terms such as the discount rate, commitment charges, risk premium, grace period, repayment schedule, and interest rate. The discount charged by the forfaiter depends on factors such as the maturity period of the instrument, the currency involved, the creditworthiness of the guaranteeing bank, and the country risk of the importer. After deducting the agreed discount and charges, the forfaiter pays the exporter the balance amount immediately. The forfaiter may retain the bills until maturity and collect the payment from the guaranteeing bank or sell them in the secondary market as negotiable financial instruments.

f. Insurance Services

Insurance is a financial service based on a legal contract between two parties, namely the insurer (insurance company) and the insured (individual or organisation seeking insurance coverage). Under this contract, the insurer agrees to compensate the insured for financial losses arising from specified unforeseen events in return for the payment of a premium. Insurance operates on the principle of risk pooling, where the losses of a few policyholders are shared by a larger group through the collection of premiums. This mechanism helps restore the insured, as far as possible, to the financial position they were in before the loss occurred, thereby providing financial security and reducing the financial impact of unexpected events.

Besides offering financial protection, insurance also supports long-term financial planning. Many insurance products combine risk coverage with savings or investment features, helping individuals and businesses achieve financial goals while ensuring protection against potential risks. Certain insurance policies may also provide tax

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benefits in accordance with prevailing tax laws. Therefore, insurance serves as an important tool for risk management, financial security, and wealth planning.

In India, the insurance sector is regulated by the Insurance Regulatory and Development Authority of India (IRDAI), which oversees the functioning of insurance companies, promotes the orderly development of the industry, and safeguards the interests of policyholders. Today, both public and private insurance companies operate in the market, offering a wide range of life and non-life insurance products to meet the diverse needs of individuals and businesses.

g. Venture capital

It is a form of long-term financing provided to new, innovative, and high-growth businesses that have strong commercial potential but involve a high degree of risk. It is generally invested in start-ups or early-stage enterprises that are developing new products, services, or technologies but may not have access to traditional sources of finance due to their limited operating history or uncertain future earnings. Venture capital investors provide funds with the expectation of earning substantial returns through the future growth and success of the business.

Typically, venture capital is invested in businesses that are commercially viable but are based on untested ideas, innovative business models, or advanced technologies. Such ventures require significant financial support during the early stages of development, including product development, market expansion, and commercialisation. In addition to financial assistance, venture capital firms often provide strategic guidance, managerial expertise, technical support, and business networks to help the enterprise grow successfully. Venture capital investment may be made at different stages of a business, from the start-up phase to the expansion stage, depending on the funding requirements and growth prospects of the enterprise.

Venture capital plays a vital role in promoting entrepreneurship, technological innovation, employment generation, and economic development. By supporting innovative enterprises that may otherwise find it difficult to obtain conventional finance, venture capital contributes to the development of new industries and enhances the competitiveness of the economy

h. Bill discounting

It is a short-term trade financing service through which businesses obtain immediate funds by selling their trade bills to banks or financial institutions before their maturity date. It is commonly used to finance working capital and day-to-day business transactions rather than long-term capital expenditure. Under this arrangement, the financial institution purchases the trade bill at a discount and pays the bill holder the amount after deducting the discount charges. On the due date, the financial institution collects the full amount from the party responsible for payment. Trade bills are negotiable money market instruments that facilitate credit transactions in business. By converting trade receivables into immediate cash, bill discounting improves the liquidity and cash flow of businesses while ensuring the smooth conduct of commercial activities. Financial institutions and specialised discount houses play an important role in bill discounting

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by providing liquidity to the financial system and supporting the efficient functioning of the money market.

i. Mutual Fund

A mutual fund is a financial service that pools money from a large number of investors and invests it in a diversified portfolio of financial securities such as shares, bonds, government securities, money market instruments, and other eligible assets.

A mutual fund is organised as a trust consisting of four important constituents: (i) Sponsor, (ii) Trustees, (iii) Asset Management Company (AMC), and (iv) Custodian. The sponsor acts as the promoter and establishes the trust. The trustees hold the assets of the trust on behalf of the unitholders and exercise overall supervision over the functioning of the AMC. They are responsible for monitoring the AMC's performance and ensuring compliance with SEBI regulations. The AMC manages the investment portfolio and day-to-day operations of the mutual fund, while the custodian is responsible for holding and safeguarding the securities of the fund.

As a financial intermediary, a mutual fund offers several benefits to investors. It provides convenience in investing, reduces investment risk through diversification, ensures professional fund management by experienced experts, and lowers investment costs by taking advantage of economies of scale.

The regulatory framework for mutual funds in India is governed by SEBI Regulations. The major elements of this regulatory mechanism include (i) registration of mutual funds, (ii) constitution and management of mutual funds, (iii) constitution and management of Asset Management Companies (AMCs) and custodians, (iv) mutual fund schemes, (v) investment objectives and valuation policies, (vi) real estate mutual fund schemes, (vii) inspection and audit, (viii) general obligations, and (ix) action in cases of default.

j. Term Lending / Project Finance

Long-term funds extended by financial institutions to finance fixed capital requirements of new projects or expansion of existing ones.

3.2.1.2 . Fee-based financial services

Fee-based financial services refer to specialised financial services provided by financial institutions, where income is earned primarily through fees, commissions, brokerage, discounts, and other service charges instead of interest from lending activities. These services generally involve advisory, intermediary, and support functions for individuals, businesses, and institutions.

a. Credit Rating

Credit rating is the process of assessing the creditworthiness of an individual, company, financial institution, or debt instrument. It indicates the ability and willingness of the borrower or issuer to meet financial obligations, such as the repayment of principal and interest, on time. Since evaluating the repayment capacity of borrowers requires specialised financial analysis and continuous monitoring, this function is

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performed by independent credit rating agencies. These agencies analyse factors such as financial strength, profitability, cash flow, debt-servicing capacity, business prospects, management quality, and industry risk before assigning a rating expressed through standard symbols (such as AAA, AA, A, BBB, etc.). Credit ratings help investors assess investment risk, assist issuers in raising funds, and promote transparency and confidence in the financial market. In India, major credit rating agencies include CRISIL Limited, ICRA Limited, CARE Ratings Limited, India Ratings & Research Pvt. Ltd., and Acuité Ratings & Research Limited.

b. Merchant Banking

Merchant banking refers to specialised financial services provided mainly to corporate clients for raising capital and obtaining professional financial advice. Unlike commercial banks, merchant banks primarily earn income through fees and commissions rather than accepting public deposits or providing conventional banking services. Merchant bankers offer a wide range of services, including issue management, underwriting of securities, project counselling, loan syndication, corporate restructuring, mergers and acquisitions, portfolio management, investment advisory, and corporate counselling. They also assist companies in complying with regulatory requirements, preparing offer documents, pricing securities, coordinating with various intermediaries, and ensuring the successful completion of capital market transactions. Owing to the importance of issue management, merchant banking is often closely associated with managing public issues of securities.

c. Stock Broking

Stock broking is a financial service through which stockbrokers act as intermediaries between investors and recognised stock exchanges for the purchase and sale of securities. Stockbrokers execute transactions in shares, bonds, derivatives, exchange-traded funds (ETFs), and other securities on behalf of investors. In India, stockbrokers must be registered with the Securities and Exchange Board of India (SEBI) and comply with the regulations of recognised stock exchanges. In addition to executing trades, they provide investment advice, research reports, online trading platforms, portfolio-related services, and market information. Although investors can now place orders directly through electronic trading platforms, all transactions are executed through SEBI-registered stockbrokers, who earn brokerage or commissions for the services rendered.

d. Corporate Advisory Services

Corporate advisory services are specialised consultancy services provided to business organisations on financial, strategic, and managerial matters. Companies often require expert guidance in areas such as project financing, capital structure, business expansion, diversification, mergers and acquisitions, corporate restructuring, valuation, financial planning, and regulatory compliance. These services are generally offered by merchant bankers, investment banks, and financial consultants to help businesses make informed decisions and utilise their financial resources efficiently. Corporate advisory services also assist companies in adapting to changes in government policies, economic conditions, and the business environment, thereby improving operational efficiency, reducing financial risks, and supporting long-term growth.

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e. Custodial Services

Custodial services refer to the safekeeping and administration of financial assets on behalf of investors. A custodian is a financial institution that holds securities such as shares, bonds, mutual fund units, government securities, and other financial instruments in electronic or physical form to protect them from loss, theft, damage, or unauthorised use. Besides ensuring the safe custody of securities, custodians provide a range of related services, including settlement of securities transactions, collection of dividends and interest, maintenance of investment records, processing of corporate actions such as bonus issues, rights issues and stock splits, tax-related services, and periodic reporting of investment holdings. In certain cases, custodians may also act on behalf of clients in accordance with the custodial agreement. These services are provided in return for a custodial fee, which varies according to the nature and extent of the services offered.

Table 3.2.1 Comparison of fund-based and fee-based financial services

Basis	Fund-Based Services	Fee-Based Services
Nature	Involves actual deployment/ lending of funds	Involves only advice/ expertise, no deployment of own funds
Income Source	Interest, rentals, discount margin	Fees, commission, brokerage
Risk	Institution bears credit/ financial risk	Institution bears mainly professional/reputational risk
Examples	Leasing, hire purchase, factoring, venture capital	Merchant banking, credit rating, portfolio management
Balance Sheet Impact	Appears as assets/liabilities on the provider's balance sheet	Generally off-balance-sheet activity

Recap

- ◊ Fund-based services involve financial services where the institution uses its own funds to provide loans, advances, leasing, or other forms of finance to customers.
- ◊ Fee-based services involve services where the institution earns fees, commissions, or service charges without directly deploying its own funds.
- ◊ Fund-based services generate income mainly through interest or other returns on the funds provided, while fee-based services generate income through charges for services rendered.

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◊ The main difference between fund-based and fee-based services is that fund-based services involve the deployment of funds, whereas fee-based services mainly involve providing services for a fee.

Objective Questions

1. Which type of financial service involves the deployment of a financial institution's own funds to provide finance to customers?
2. Which asset-based financial service enables a business to use an asset without acquiring its ownership by paying periodic lease rentals?
3. Which financial service provides long-term financial assistance for the purchase, construction, repair, or renovation of residential properties?
4. Under which asset-based financial service does the ownership of the asset remain with the seller until the payment of the final instalment?
5. Which financial service involves the sale of trade receivables by a business to a specialised financial institution called a factor?
6. Which financial service enables exporters to obtain immediate finance by selling export receivables to a forfaiter without recourse?
7. Which financial service provides financial protection against specified risks in return for the payment of a premium?
8. Which type of financing is provided to innovative start-ups and high-growth business ventures with strong commercial potential?
9. Which fee-based financial service assesses the creditworthiness of a company or a debt instrument?
10. Which fee-based financial service acts as an intermediary between investors and recognised stock exchanges for the purchase and sale of securities?

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Answers

1. Asset-based (Fund-based) Financial Service
2. Lease Financing
3. Housing Finance

4. Hire Purchase
5. Factoring
6. Forfaiting
7. Insurance
8. Venture Capital
9. Credit Rating
10. Stock Broking

Self-Assessment Questions

1. Explain the meaning of asset-based (fund-based) financial services. Describe the various types of asset-based financial services.
2. What are fee-based financial services? Discuss the major types of fee-based financial services provided by financial institutions.
3. Describe the concept, features, and advantages of lease financing as an asset-based financial service.
4. Explain the concept and working of factoring and forfaiting. How do these services help businesses manage their receivables?
5. Discuss the role and importance of venture capital, housing finance, and insurance in promoting business development and economic growth.

Assignments

1. Differentiate between asset-based (fund-based) financial services and fee-based financial services with suitable examples.
2. Compare lease financing and hire purchase. Under what circumstances would a business prefer lease financing over hire purchase?
3. A manufacturing company is planning to expand its operations and improve its cash flow while reducing financial risk. Analyse how lease financing, factoring, insurance, and venture capital can support its growth.
4. An exporter wishes to receive immediate payment for export receivables while avoiding the risk of non-payment by overseas buyers. Analyse why forfaiting is more suitable than factoring in this situation.

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5. A company intends to raise capital from the public. Analyse the role of merchant banking, credit rating, stock broking, corporate advisory services, and custodial services in ensuring a successful capital issue.

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Unit 3.2
Merchant Banking

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ explain the concept and development of merchant banking services in India.
- ◊ discuss the role and functions of merchant bankers.
- ◊ understand the merchant banking regulations in India.

Prerequisite

Imagine that Priya, an entrepreneur, has successfully established a company manufacturing organic food products. As the demand for her products increases, she plans to expand the business by setting up a new production facility and entering new markets. However, she needs substantial funds and professional assistance to plan the expansion and raise the required capital.

Priya approaches a merchant banker for guidance. The merchant banker examines her business plans, helps her identify suitable sources of finance, assists in raising capital, and provides advice on the issue of securities. The merchant banker also helps coordinate with investors, financial institutions, and regulatory authorities involved in the fund-raising process. As Priya's business grows, she may further require assistance in areas such as underwriting, loan syndication, mergers and acquisitions, corporate restructuring, and other financial activities.

Through these services, Priya realises that a merchant banker does much more than simply arrange finance. A merchant banker provides specialised financial advice and support to companies at different stages of their business

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activities and acts as an important link between companies, investors, financial institutions, and regulatory authorities.

The experience of Priya shows how merchant banking services support businesses in raising finance, managing financial activities, and making important corporate decisions. Merchant bankers play an important role in the development of the capital market by assisting companies in mobilising funds and facilitating various corporate financial transactions.

This unit discusses about the merchant banking services in India and the role and functions of merchant bankers in the financial system.

Keywords

Merchant Banking, Merchant Banker, Issue Management, Underwriting, Corporate Advisory Services, Corporate Restructuring.

Discussion

3.3.1 Introduction to Merchant Banking Services in India

3.3.1.1 Meaning and Definition of Merchant Banking

Meaning

Merchant banking refers to a specialised financial service that provides a wide range of financial, investment, and advisory services to businesses, particularly corporate enterprises. Unlike commercial banking, merchant banking primarily focuses on providing professional financial expertise rather than accepting public deposits or extending conventional loans. Merchant banks earn income mainly through fees and commissions for the specialised services they provide.

In modern financial markets, merchant banks assist businesses in raising capital and making strategic financial decisions. They offer services such as issue management, underwriting of securities, portfolio management, project counselling, corporate advisory services, financial restructuring, mergers and acquisitions, venture capital assistance, and investment advisory. Merchant banks also help companies prepare offer documents, comply with regulatory requirements, and manage capital market transactions. In addition to providing advisory services, some merchant banks make direct equity investments in promising businesses, particularly start-ups and small or medium-sized enterprises with strong growth potential.

Merchant banking services are offered by specialised merchant banking firms, investment banks, financial institutions, mutual fund companies, venture capital firms,

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and other authorised financial intermediaries. Unlike commercial banks, whose primary activities include accepting deposits and granting loans, merchant banks mainly provide financial and advisory services for a fee, enabling businesses to raise capital, manage investments, and achieve their financial objectives more effectively.

Definition of Merchant Banking

SEBI (Merchant Bankers') Regulation Act, 1992 defines a 'merchant banker' as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

3.3.1.2 History of Merchant Banking Services in India

The concept of merchant banking was introduced in India during the late nineteenth century by merchants from European countries, particularly Britain and France. These foreign merchants established agency houses that offered financial and advisory services to Indian traders and business enterprises. However, the services were available only at relatively high charges. Some of the prominent agency houses operating during this period included Cropper Benson & Rathbone (1820), Ogilvy Gillanders & Co. (1824), and Arbuthnot & Co. (1833).

During the nineteenth century, several merchant banking firms became financially weak and eventually ceased operations because they were unable to withstand increasing competition from new entrants. Subsequently, the managing agency system emerged as a dominant feature of Indian business and gained widespread popularity during the later decades. This system gradually reduced the importance of merchant banking activities. Among the leading British managing agencies were Andrew Yule, Gillanders, Hendersons, and Duncan Brothers, while prominent Indian managing houses included the Tata, Birla, Dalmia, and Singhania groups. Over time, the managing agency system attracted considerable criticism for its shortcomings, leading to its abolition by the Government of India in 1970.

A major milestone in the development of merchant banking in India was achieved in 1967, when National Grindlays Bank introduced organised merchant banking services. Its merchant banking division undertook activities such as management of new capital issues, project evaluation, project promotion, project appraisal, and other financial advisory services. The success of this initiative encouraged Citibank to establish its merchant banking operations in 1970. These institutions played an important role in assisting entrepreneurs, evaluating investment projects, and helping companies mobilise funds through borrowings and equity issues.

The Banking Commission (1972) strongly emphasised the importance of merchant banking in a developing economy like India. In its report, the Commission recommended the establishment of specialised merchant banking institutions, independent of commercial banks and other financial institutions, to provide professional financial advisory services. The recommendations received a favourable response from the banking sector.

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Following these developments, the State Bank of India (SBI) became the first Indian commercial bank to establish a dedicated Merchant Banking Division in 1972. The division's successful performance led SBI to establish a wholly owned subsidiary, SBI Capital Markets Ltd. (SBICAP), in 1986, with an authorised share capital of ₹50 crore and a paid-up capital of ₹20 crore. Inspired by SBI's initiative, several other commercial banks, including Central Bank of India, Syndicate Bank, Bank of Baroda, and Standard Chartered Bank, also established merchant banking divisions or subsidiaries.

Development financial institutions also entered the field of merchant banking. Industrial Credit and Investment Corporation of India (ICICI) established its merchant banking division in 1973. Later, the Industrial Finance Corporation of India (IFCI) and the Industrial Development Bank of India (IDBI) started their merchant banking divisions in 1986 and 1991, respectively. In addition, leading financial and brokerage firms such as ITC Classic Finance, Kotak Mahindra Finance, and Prudential Capital expanded their operations by offering merchant banking services, thereby contributing to the growth and development of merchant banking in India.

3.3.1.3 Merchant Banking Regulations in India

Merchant banking is an important component of the Indian financial system and plays a significant role in facilitating capital formation and corporate finance. Since merchant bankers deal with activities such as issue management, underwriting, corporate advisory services, and other capital market transactions, their operations require effective regulation to ensure transparency, fairness, and investor protection. In India, merchant banking activities are regulated by the Securities and Exchange Board of India (SEBI) under the SEBI (Merchant Bankers) Regulations, 1992, as amended from time to time.

The primary objective of these regulations is to ensure that only qualified and financially sound institutions are permitted to undertake merchant banking activities. The regulations prescribe the eligibility conditions, registration requirements, capital adequacy norms, code of conduct, and responsibilities of merchant bankers. They also empower SEBI to supervise the functioning of merchant bankers and take appropriate action in cases of non-compliance or professional misconduct. By establishing a comprehensive regulatory framework, SEBI promotes transparency, accountability, and efficiency in the securities market while safeguarding the interests of investors.

Merchant bankers are required to comply with all applicable provisions of the SEBI regulations while carrying out their professional responsibilities. They are expected to maintain high standards of integrity, exercise due diligence in all transactions, provide accurate and timely disclosures, and avoid practices that may adversely affect investors or the securities market. Through continuous monitoring and regulation, SEBI ensures that merchant banking services are provided in a fair, ethical, and professional manner, thereby strengthening public confidence in the capital market.

Classification of Merchant Bankers

The Securities and Exchange Board of India (SEBI) originally classified merchant bankers into four categories based on the nature and scope of activities they were

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authorised to undertake. This classification was introduced under the SEBI (Merchant Bankers) Regulations, 1992. Subsequently, SEBI revised the regulatory framework through the SEBI (Merchant Bankers) (Amendment) Regulations, 2025, replacing the four-category system with a two-category classification to strengthen regulation and improve the efficiency of merchant banking services.

A. Historical Classification (Earlier SEBI Framework)

1. Category I Merchant Bankers

Category I merchant bankers were authorised to undertake the widest range of merchant banking activities. They could act as issue managers, advisers, consultants, managers, co-managers, underwriters, and portfolio managers. They were also permitted to manage public issues and perform all major merchant banking functions.

2. Category II Merchant Bankers

Category II merchant bankers were permitted to function as advisers, consultants, co-managers, underwriters, and portfolio managers. However, they were not allowed to act as lead managers for public issues independently.

3. Category III Merchant Bankers

Category III merchant bankers were authorised to act only as underwriters, advisers, and consultants. They were not permitted to undertake issue management, act as co-managers, or provide portfolio management services

4. Category IV Merchant Bankers

Category IV merchant bankers were restricted to advisory and consultancy services. They were not authorised to undertake underwriting, issue management, or portfolio management activities.

B. Present Classification (SEBI Amendment Regulations, 2025)

To strengthen the merchant banking framework and align regulatory requirements with the complexity of activities performed, SEBI introduced a two-category system, effective from 3 January 2026.

1**. Category I Merchant Bankers**

Category I merchant bankers are authorised to undertake all permitted merchant banking activities, including:

- ◊ Management of Main Board public issues.
- ◊ Management of Small and Medium Enterprises public issues.
- ◊ Rights issues, preferential issues, qualified institutions placements (QIPs), and private placements.
- ◊ Open offers, buy-backs, delistings, and other capital market transactions permitted by SEBI.

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◊ Corporate advisory and issue management services.

These merchant bankers are required to maintain higher capital adequacy because they undertake activities involving greater financial and regulatory responsibility.

2. Category II Merchant Bankers

Category II merchant bankers are permitted to undertake all authorised merchant banking activities except the management of Main Board public issues of equity shares. Their activities generally include:

◊ Management of Small and Medium Enterprises public issues.

◊ Rights issues and private placements.

◊ Open offers, buy-backs, and delistings.

◊ Corporate advisory and financial consultancy services.

◊ Other activities permitted by SEBI, excluding Main Board equity public issues.

Since their scope of activities is comparatively limited, the prescribed capital adequacy requirements are lower than those applicable to Category I merchant bankers.

Registration of Merchant Bankers

Registration with the Securities and Exchange Board of India (SEBI) is mandatory for carrying on merchant banking activities in India. The registration process ensures that only qualified and financially sound institutions are permitted to provide merchant banking services.

The important provisions relating to registration are as follows:

a. **Mandatory Registration:** No person or organisation can undertake merchant banking activities without obtaining a Certificate of Registration from SEBI.

b. **Body Corporate:** The applicant must be incorporated as a body corporate before applying for registration.

c. **Application to SEBI:** An application for registration should be submitted to SEBI in the prescribed form along with the prescribed application fee and supporting documents.

d. **Verification by SEBI:** SEBI examines the application to ensure that the applicant satisfies the prescribed eligibility conditions, including infrastructure, professional competence, financial strength, and integrity.

e. **Grant of Registration:** If the applicant fulfils all the requirements specified under the regulations, SEBI grants a Certificate of Registration, authorising the applicant to carry on merchant banking activities.

f. **Compliance with Regulations:** A registered merchant banker is required to comply with the provisions of the SEBI (Merchant Bankers) Regulations, 1992, and other applicable guidelines and circulars issued by SEBI from time to time.

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g. **Continuous Supervision:** SEBI continuously monitors the activities of registered merchant bankers and may take appropriate action in cases of non-compliance or violation of the regulations.

Eligibility for Registration of Merchant Bankers

To obtain registration as a merchant banker, an applicant must satisfy the eligibility conditions prescribed by SEBI. The major requirements are as follows:

i. **Body Corporate:** The applicant should be incorporated as a body corporate under the applicable laws.

ii. **Adequate Infrastructure:** The organisation should have sufficient office space, equipment, communication facilities, and qualified workforce to conduct merchant banking activities efficiently.

iii. **Experienced Personnel:** It should employ at least two experienced professionals with adequate knowledge of merchant banking or related financial services.

iv. **Capital Adequacy:** The applicant must satisfy the minimum net worth or capital **adequacy requirements** prescribed by SEBI.

v. **Professional Competence:** The principal officers should possess appropriate qualifications and experience in areas such as finance, law, business management, accountancy, or related fields.

vi. **Good Reputation and Integrity:** The applicant, its directors, partners, and principal officers should have a good professional reputation and should not have been convicted of offences involving fraud, moral turpitude, or economic misconduct.

vii. **Fit and Proper Person:** The applicant must fulfil the 'fit and proper person' criteria specified by SEBI, demonstrating honesty, financial soundness, competence, and ethical conduct.

viii. **Regulatory Compliance:** The applicant should comply with all the conditions and requirements specified under the SEBI (Merchant Bankers) Regulations, 1992, as amended from time to time.

Procedure for Registration of a Merchant Banker

The registration process prescribed by SEBI ensures that only eligible and professionally competent institutions are permitted to undertake merchant banking activities. The procedure is as follows:

a. Submission of Application

The applicant should submit an application to SEBI in the prescribed form along with the prescribed application fee and the required supporting documents.

b. Submission of Additional Information

SEBI may require the applicant to furnish additional information, documents, or clarifications regarding its financial position, infrastructure, management, or proposed activities. If necessary, the principal officers of the applicant may also be required to appear before SEBI.

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c. Examination of the Application

SEBI scrutinises the application to verify whether the applicant satisfies all the prescribed eligibility conditions relating to infrastructure, professional competence, financial soundness, integrity, and regulatory compliance.

d. Grant of Registration

If SEBI is satisfied that the applicant fulfils all the requirements under the regulations, it grants a Certificate of Registration, authorising the applicant to carry on merchant banking activities.

e. Compliance after Registration

After obtaining registration, the merchant banker must comply with the provisions of the SEBI regulations, maintain the prescribed capital requirements, follow the Code of Conduct, and submit periodic reports and disclosures as required by SEBI.

Capital Adequacy Requirements

Capital adequacy refers to the minimum level of financial resources that a merchant banker is required to maintain to carry out merchant banking activities effectively. It reflects the financial strength and stability of the merchant banker and ensures that sufficient funds are available to discharge professional obligations, absorb business risks, and protect the interests of investors. Under the revised SEBI framework, merchant bankers are also required to maintain a prescribed level of liquid net worth, enabling them to meet financial commitments promptly and support underwriting and issue management activities.

Net Worth Requirements

The SEBI (Merchant Bankers) (Amendment) Regulations, 2025 introduced a revised capital adequacy framework with phased implementation. The minimum net worth and liquid net worth requirements are as follows:

Category of Merchant Banker	By 2 January 2027	By 2 January 2028
Category I	Net Worth – ₹25 crore Liquid Net Worth – ₹6.25 crore	Net Worth – ₹50 crore Liquid Net Worth – ₹12.50 crore
Category II	Net Worth – ₹7.5 crore Liquid Net Worth – ₹1.875 crore	Net Worth – ₹10 crore Liquid Net Worth – ₹2.50 crore

SEBI has also prescribed that every merchant banker must maintain liquid net worth equal to at least 25% of the prescribed minimum net worth. Liquid net worth consists of cash and other highly liquid assets that can be readily converted into cash to meet immediate financial obligations. Merchant bankers who fail to comply with these capital adequacy requirements may face regulatory action by SEBI.

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Note: Earlier SEBI regulations prescribed a uniform minimum net worth of ₹5 crore for merchant bankers. The 2025 amendments replaced this with a category-wise, phased capital adequacy framework.

3.3.2 Role of Merchant Banking

i. Mobilises Savings into Productive Investments

Merchant bankers help channel the savings of individuals and institutions into productive business ventures by facilitating the issue of securities. This promotes capital formation and contributes to economic development.

ii. Facilitates Capital Formation

Merchant bankers assist companies in raising long-term finance through equity shares, preference shares, debentures, bonds, and other financial instruments. The availability of adequate capital enables businesses to undertake expansion, diversification, and modernisation programmes.

iii. Promotes Industrial Growth

By arranging project finance, credit syndication, and investment advisory services, merchant bankers support the establishment of new industries and the expansion of existing enterprises. This contributes to increased industrial production and national income.

iv. Supports Entrepreneurship Development

Merchant bankers encourage entrepreneurship by providing financial advisory services, venture capital assistance, and guidance in project formulation and implementation. These services help new entrepreneurs establish viable business enterprises.

v. Encourages Corporate Growth and Restructuring

Merchant bankers provide professional advice on mergers, acquisitions, amalgamations, takeovers, and corporate restructuring. These services improve operational efficiency, strengthen competitive advantage, and facilitate sustainable business growth.

vi. Promotes Foreign Investment

Merchant bankers act as intermediaries between foreign investors and domestic companies. They assist in investment planning, regulatory compliance, and project evaluation, thereby attracting foreign capital and technology into the country.

vii. Strengthens the Capital Market

Merchant bankers enhance the efficiency of the capital market by managing public issues, underwriting securities, ensuring regulatory compliance, and improving investor confidence. Their services contribute to the orderly development of the securities market.

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viii. Facilitates Efficient Allocation of Financial Resources

Merchant bankers identify financially viable projects and guide investors towards profitable investment opportunities. This ensures the effective utilisation of scarce financial resources and promotes balanced economic development.

ix. Generates Employment Opportunities

The establishment and expansion of business enterprises financed through merchant banking services create both direct and indirect employment opportunities, thereby improving income levels and living standards.

x. Supports the Growth of Emerging Sectors

Merchant bankers facilitate investment in emerging industries such as information technology, renewable energy, biotechnology, healthcare, and infrastructure. By supporting innovation and technological advancement, they contribute to sustainable economic development.

xi. Provides Professional Financial Expertise

Merchant bankers offer specialised knowledge in financial planning, project appraisal, business valuation, risk assessment, and investment management. Their expertise helps businesses make informed financial decisions and improves corporate governance.

xii. Contributes to Overall Economic Development

Through capital mobilisation, industrial financing, entrepreneurship promotion, capital market development, and investment facilitation, merchant bankers play a significant role in accelerating economic growth and improving the overall financial system.

3.3.3 Functions of Merchant Banking

1. Issue Management

Issue management is one of the most significant and traditional functions performed by merchant bankers. It involves planning, managing, and coordinating the process of raising capital by issuing securities such as equity shares, preference shares, debentures, and bonds in the primary market. Merchant bankers assist both new and existing companies in mobilising funds through public issues, rights issues, preferential allotments, and other methods of capital issuance.

The issue management process begins with advising the company on the most suitable method of raising capital and determining the size, timing, pricing, and structure of the issue. Merchant bankers prepare the necessary documents, including the offer document or prospectus, ensuring compliance with the regulations prescribed by the Securities and Exchange Board of India (SEBI) and other statutory authorities. They also obtain the required approvals from regulatory bodies before the issue is launched.

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A successful public issue requires the coordinated efforts of several intermediaries such as underwriters, bankers to the issue, brokers, registrars, legal advisers, auditors, advertising agencies, and printers. The merchant banker acts as the lead manager, coordinating the activities of these agencies and ensuring that every stage of the issue is completed efficiently. By planning, supervising, and controlling the entire issue process, merchant bankers play a crucial role in the successful marketing of corporate securities and help companies raise capital smoothly from the investing public.

2. Credit Syndication

Credit syndication, also known as loan syndication, refers to the service of arranging loans from multiple financial institutions, banks, and other lending agencies to meet the financial requirements of a company. Merchant bankers assist clients in obtaining both rupee-denominated loans and foreign currency loans from institutions within India as well as overseas.

The need for syndicated credit generally arises when the amount required is too large for a single lender or when the borrower wishes to diversify its borrowing sources. Merchant bankers identify appropriate lending institutions based on the nature of the project, the borrower's financial position, and the loan requirements. They prepare project reports, financial statements, loan applications, and other supporting documents required by lenders.

In addition to arranging long-term loans, merchant bankers also facilitate bridge finance to meet temporary funding needs until long-term finance becomes available. They may also arrange additional financial resources to meet cost escalations and project cost overruns during project implementation. Merchant bankers coordinate with lending institutions throughout the appraisal, sanction, documentation, disbursement, and follow-up stages, thereby simplifying the borrowing process for their clients.

3. Portfolio Management

Portfolio management is an important investment-related function performed by merchant bankers. It involves managing clients' investment portfolios by selecting an appropriate combination of securities to maximise returns while maintaining an acceptable level of risk.

Under a contractual arrangement, merchant bankers analyse the financial goals, investment horizon, and risk tolerance of investors before recommending suitable investment avenues. Based on these factors, they invest in marketable securities such as equity shares, preference shares, debentures, bonds, government securities, and other financial instruments.

Merchant bankers continuously monitor market conditions and review the performance of the investment portfolio. They make necessary adjustments by purchasing or selling securities whenever required to improve portfolio performance or reduce investment risk. Besides portfolio management, merchant bankers may also provide advisory services relating to investment decisions, purchase and sale of securities, and management of fixed deposits and other financial assets. Through

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professional investment management, they help investors achieve an optimal balance between risk and return.

4. Corporate Restructuring

Corporate restructuring refers to the process of reorganising the financial, operational, or ownership structure of a business to improve its performance, competitiveness, or long-term growth prospects. Merchant bankers provide specialised advisory services to companies undergoing restructuring through mergers, acquisitions, amalgamations, takeovers, demergers, or business reorganisations.

Their role begins with evaluating the financial and strategic feasibility of the proposed restructuring. Merchant bankers conduct company valuations, perform due diligence, assess financial risks, and advise clients on the most suitable restructuring strategy. They also assist in negotiating the terms and conditions of mergers or acquisitions, structuring the transaction, and preparing the required legal and financial documentation.

In addition, merchant bankers help clients obtain statutory and regulatory approvals, resolve taxation issues, and ensure compliance with applicable corporate laws and SEBI regulations. Their professional expertise helps protect the interests of clients throughout the restructuring process. Merchant bankers also provide strategic guidance for future expansion, diversification, joint ventures, and international collaborations, thereby contributing to the long-term growth of corporate enterprises.

5. Underwriting

Underwriting is an important merchant banking function that assures companies issuing securities in the capital market. Under this arrangement, the merchant banker enters into a contractual agreement with the issuing company to subscribe to the securities that remain unsubscribed by the public.

The primary objective of underwriting is to ensure the successful completion of a public issue by reducing the risk of under-subscription. If investors fail to subscribe to the entire issue, the underwriter is legally bound to purchase the unsubscribed portion up to the extent of the commitment made under the underwriting agreement. This provides confidence to the issuing company regarding the availability of the required capital.

Before accepting underwriting commitments, merchant bankers carefully evaluate the financial position, management quality, business prospects, and marketability of the securities issued by the company. Effective underwriting enhances investor confidence, improves the credibility of public issues, and contributes to the orderly functioning of the capital market. Since underwriting involves financial risk, merchant bankers charge an underwriting commission for providing this service.

6. Bill Discounting

Bill discounting is another financial service that may be provided by merchant bankers, particularly in well-developed money markets. It enables businesses to obtain immediate funds by converting trade bills or bills of exchange into cash before their maturity date. Instead of waiting until the due date for payment, the holder of the bill receives funds after deducting a discount or commission.

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Merchant bankers arrange finance against eligible bills by discounting them or by facilitating their discounting through financial institutions. In markets where the bill market is not well developed, this function is generally performed by commercial banks. Depending on their financial strength and credibility, merchant bankers may also undertake bill acceptance, thereby enhancing the acceptability of the bill in the market.

Merchant bankers may discount both domestic and foreign bills, subject to their internal policies and regulatory requirements. They assess the creditworthiness of the parties involved before accepting or discounting bills to minimise the risk of default. For providing this service, merchant bankers charge a commission or discounting fee. Bill discounting improves liquidity for businesses and helps maintain a smooth flow of working capital.

7. Venture Capital Financing

Venture capital financing is a specialised function of merchant banking that involves providing financial assistance to innovative business ventures with high growth potential but relatively high levels of risk. These investments are generally made in start-ups, technology-oriented enterprises, and businesses introducing new products, services, or production methods.

Merchant bankers evaluate the technical, commercial, financial, and managerial feasibility of such projects before making investment decisions. Since venture capital investments are made primarily through equity or equity-related instruments, the investors share both the risks and the potential rewards of the business. This form of financing is often referred to as risk capital or seed capital, especially during the early stages of a business.

Besides providing financial support, merchant bankers often offer managerial guidance, strategic advice, and professional expertise to help the enterprise achieve sustainable growth. Once the business becomes financially stable or reaches a suitable stage of development, the venture capitalist exits the investment through methods such as an Initial Public Offering (IPO), strategic sale, or sale of shares to other investors. This enables the funds to be reinvested in new entrepreneurial ventures, thereby supporting innovation and economic development.

8. Bought-out Deals

A bought-out deal is a method of raising capital in which a merchant banker or a financial institution purchases a substantial portion of a company's securities before they are offered to the public. This arrangement is particularly useful for companies that may find it difficult to raise funds directly through a public issue due to uncertain market conditions or limited investor response.

Under this system, the merchant banker purchases the securities from the promoter or the issuing company at a mutually agreed price and holds them for a specified period. At an appropriate time, when market conditions become favourable, these securities are offered for sale to the investing public or other institutional investors. The merchant banker earns a return from the difference between the purchase price and the eventual selling price.

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Bought-out deals provide immediate funds to the issuing company and reduce the uncertainty associated with public issues. At the same time, the merchant banker assumes the market risk associated with holding and subsequently selling the securities. This method is widely used in the capital market as an alternative means of financing corporate growth.

9. Lease Financing and Hire Purchase

Merchant bankers may also provide advisory and financing services relating to lease financing and hire purchase arrangements, depending on the availability of financial resources and the requirements of their clients.

In lease financing, the merchant banker or leasing company (lessor) purchases an asset. It grants the client (lessee) the right to use it for an agreed period in return for periodic lease rentals. Ownership of the asset generally remains with the lessor throughout the lease period unless otherwise specified in the agreement. Leasing enables businesses to use expensive assets without making large initial investments, thereby improving liquidity and financial flexibility.

Under a hire purchase arrangement, the customer acquires possession of the asset immediately after agreeing and pays the purchase price in periodic instalments. Although the asset remains legally owned by the financier until all instalments are paid, the hirer is generally given the option to become the owner of the asset upon payment of the final instalment and fulfilment of the contractual terms.

Merchant bankers advise clients on selecting the most suitable financing alternative by considering factors such as cost, tax implications, cash flow, ownership requirements, and the nature of the asset. They may also arrange lease or hire purchase finance through specialised financial institutions whenever required.

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Recap

- ◊ Merchant banking refers to a specialised financial service that provides a wide range of financial, investment, and advisory services to businesses, particularly corporate enterprises.
- ◊ Unlike commercial banking, merchant banking primarily focuses on providing professional financial expertise rather than accepting public deposits or extending conventional loans.
- ◊ Merchant banks earn income mainly through fees and commissions for the specialised services they provide.
- ◊ In India, merchant banking activities are regulated by the Securities and Exchange Board of India (SEBI).

- ◊ Merchant bankers are classified into Category I and Category II under the present SEBI framework.
- ◊ Registration of merchant bankers is mandatory with SEBI to carry on merchant banking activities.
- ◊ The major functions of merchant bankers include issue management, credit syndication, portfolio management, underwriting, corporate restructuring, and venture capital financing.
- ◊ Merchant banking contributes to economic development by facilitating capital formation, industrial growth, entrepreneurship, investment, and efficient allocation of financial resources.

Objective Questions

1. Which financial institution provides specialised financial, investment, and advisory services to corporate enterprises?
2. Which type of banking primarily focuses on providing professional financial expertise rather than accepting public deposits?
3. Which regulatory authority governs merchant banking activities in India?
4. Which regulation prescribes the registration requirements, capital adequacy norms, and code of conduct for merchant bankers?
5. Which regulatory framework replaced the four-category classification of merchant bankers with a two-category classification?
6. Which requirement makes it compulsory for every merchant banker to obtain a Certificate of Registration before commencing business?
7. Which category of merchant bankers, under the present SEBI framework, is authorised to undertake all permitted merchant banking activities?
8. Which category of merchant bankers is not permitted to manage Main Board public issues of equity shares under the revised SEBI framework?
9. Which function of merchant banking involves planning, managing, and coordinating the issue of securities in the primary market?
10. Which function of merchant banking refers to arranging loans from multiple financial institutions to meet the financial requirements of a company?

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11. Which function of merchant banking involves managing clients' investments to maximise returns while maintaining an acceptable level of risk?
12. Which function of merchant banking provides professional advice on mergers, acquisitions, amalgamations, takeovers, and business reorganisations?
13. Which function of merchant banking assures the issuing company against the risk of under-subscription of securities?
14. Which function of merchant banking provides financial assistance to innovative business ventures with high growth potential and relatively high risk?
15. Which function of merchant banking enables a business to use an asset for a specified period by paying periodic lease rentals?

Answers

1. Merchant Bank
2. Merchant Banking
3. Securities and Exchange Board of India (SEBI)
4. SEBI (Merchant Bankers) Regulations, 1992
5. SEBI (Merchant Bankers) (Amendment) Regulations, 2025
6. Mandatory registration with SEBI
7. Category I Merchant Banker
8. Category II Merchant Banker
9. Issue Management
10. Credit Syndication (Loan Syndication)
11. Portfolio Management
12. Corporate Restructuring
13. Underwriting
14. Venture Capital Financing
15. Lease Financing

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Self-Assessment Questions

1. Explain the concept of merchant banking and distinguish it from commercial banking.
2. Discuss the major roles played by merchant bankers in promoting business growth and economic development.
3. Explain any five functions of merchant bankers with suitable examples.
4. Describe the regulatory framework governing merchant banking in India, highlighting the role of SEBI.
5. Explain the procedure for registration of merchant bankers and discuss the Code of Conduct prescribed by SEBI.

Assignments

1. Trace the evolution of merchant banking in India and explain its significance in the development of the Indian financial system.
2. "Merchant bankers play a vital role in the capital market." Discuss this statement with reference to their role and functions.
3. Explain the classification of merchant bankers under the earlier and the revised SEBI regulatory framework. Compare the features of Category I and Category II merchant bankers.
4. Discuss the eligibility conditions, capital adequacy requirements, and registration procedure prescribed by SEBI for merchant bankers.
5. Analyse the importance of the Code of Conduct for merchant bankers in ensuring investor protection, market integrity, and ethical business practices.

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BLOCK 4

Leasing and Factoring

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Unit 1
Leasing

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ gain insight into the meaning of Leasing
- ◊ get an idea on the different types of leasing
- ◊ explain the advantages and limitations of leasing
- ◊ differentiate between Leasing and Hire Purchase

Prerequisite

A small bakery owner wanted a modern oven to increase production, but buying it outright required a large amount of money. Instead of purchasing it, the owner entered into a lease agreement with a finance company. The bakery could use the oven immediately by paying a fixed monthly lease rental, while the ownership remained with the finance company. This allowed the business to operate without making a heavy initial investment.

Another bakery owner chose a hire purchase arrangement, where the oven was also used by paying instalments, but ownership could eventually be transferred after all the payments were completed. These two situations show that leasing and hire purchase are different methods of acquiring assets. Understanding this distinction provides a foundation for learning the meaning, essentials, types, advantages, limitations, and comparison of leasing with hire purchase.

In this unit, you will study more about the concept and essential elements of leasing, the different types of leasing, and the characteristics of operating and financial leases. The unit also explains special forms of leasing such as sale and lease back and other important classifications of leases. Further, it examines the advantages and limitations of leasing from the

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perspectives of both the lessor and the lessee. Finally, the unit presents a comparison between leasing and hire purchase to help learners understand their differences and identify the most suitable financing option in different business situations.

Keywords

Lease, Financial lease, Operating lease, Hire purchase, Sale and lease back

Discussion

Businesses often require expensive assets such as machinery, vehicles, computers, and equipment for their operations and expansion. However, purchasing these assets by making the entire payment at once may create a financial burden, particularly for small and growing businesses. Leasing is one such financing arrangement that enables businesses to obtain the use of assets while managing their financial resources through periodic payments. Other arrangements, such as hire purchase, also provide ways of acquiring assets with payment spread over a period. Understanding these arrangements helps businesses choose a suitable method according to their financial and operational requirements.

4.1.1 Meaning and Definition of Leasing

Meaning

Leasing is an arrangement that enables a business to obtain the right to use and control an asset without purchasing or acquiring ownership of it. In essence, it is a method of hiring or renting an asset for a specified period. A lease is a contractual agreement between the lessor, who is the legal owner of the asset, and the lessee, who is granted the right to use the asset. Under this agreement, the lessor allows the lessee to use the asset for an agreed period in exchange for a payment known as lease rental.

The lease agreement is governed by the terms and conditions mutually accepted by both parties. The lessee is required to pay lease rentals to the lessor at regular intervals as fixed periodic payments. These payments may be scheduled at the beginning or the end of a month, quarter, half-year, or year. The amount and timing of lease rentals may also be structured according to the lessee's profitability and cash flow requirements, subject to the agreement between the parties.

Definition

A lease may be defined as a contractual arrangement/transaction in which a party owning an asset/equipment (lessor) provides the asset for use to another/transfer the right to use the equipment to the user (lessee) over a certain/for an agreed period of time for consideration in form of/in return for periodic payment (rentals) with or without a

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further payment (premium).

According to Miller, M.H. and C.W. Upton. "Leasing separates ownership and use as two economic activities, and facilitates asset use without ownership".

4.1.2 Essential Elements of Leasing

The effectiveness of a lease agreement depends on certain essential elements that define the rights, responsibilities, and obligations of the parties involved. The key elements are discussed below:

1. Parties to the Lease Agreement

Every lease agreement involves two principal parties:

- ◊ **Lessor:** The owner of the asset who purchases and leases the asset to another party while retaining legal ownership throughout the lease period.
- ◊ **Lessee:** The user of the asset who acquires the right to use it in return for periodic lease payments.

The lessor and lessee may be individuals, partnership firms, companies, corporations, or financial institutions. In large-value transactions, there may be multiple lessors or lessees. Lease transactions may also involve lease brokers, who facilitate lease arrangements for a commission, and lease financiers, who provide financial assistance to the lessor through loans, equity participation, or refinancing schemes.

2. Lease Asset

The asset is the subject matter of the lease agreement and forms the basis of the leasing transaction. It may include movable or immovable property such as machinery, equipment, vehicles, aircraft, buildings, factories, land, or even an ongoing business. The asset selected for leasing should suit the operational requirements of the lessee.

3. Separation of Ownership and Right to Use

A distinctive feature of leasing is the separation between ownership and possession. The legal ownership of the asset always remains with the lessor during the lease period, whereas the lessee enjoys the right to use the asset for business or commercial purposes. Unless otherwise agreed, the asset normally returns to the lessor after the expiry of the lease.

4. Lease Period (Lease Term)

The lease term refers to the duration for which the lease agreement remains valid. Every lease must specify a definite period; otherwise, it may not be legally enforceable. The duration may:

- ◊ Extend over the entire economic life of the asset in the case of a financial lease.
- ◊ Cover only a portion of the asset's useful life in the case of an operating lease.
- ◊ Include an option for renewal upon expiry, if mutually agreed by both parties.

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5. Lease Rentals

Lease rental is the consideration paid by the lessee to the lessor for the right to use the leased asset. These periodic payments are structured to enable the lessor to recover:

- ◊ The cost of the asset through depreciation,
- ◊ Interest on the investment made,
- ◊ Expenses relating to repairs and maintenance (where applicable), and
- ◊ Other administrative or servicing charges incurred during the lease period.

6. Termination of the Lease

A lease agreement comes to an end upon the expiry of the agreed lease term. Depending on the terms of the contract, one of the following alternatives may take place:

- ◊ Renewal of the lease for a further fixed period or continuingly.
- ◊ Return of the asset to the lessor at the end of the lease.
- ◊ Return of the asset followed by its sale by the lessor to a third party.
- ◊ Sale of the asset to the lessee, if such an option is provided in the agreement.

The method of termination is generally decided by mutual agreement at the time the lease contract is executed.

7. Risk

The risks associated with ownership include the possibility of losses arising from idle capacity, technological obsolescence, and changes in returns due to varying economic conditions.

8. Rewards

The rewards of ownership include the expected profits from using the asset during its economic life, as well as gains arising from an increase in the asset's value or the realisation of its residual value.

4.1.3 Types of Leasing

1. Finance Lease

According to International Accounting Standard (IAS) 17, a finance lease is a long-term leasing arrangement in which the lessor transfers substantially all the risks and rewards associated with the ownership of an asset to the lessee. The lease may or may not result in the transfer of legal title at the end of the lease term. In a finance lease, the lessor primarily acts as a financier, whereas the lessee assumes most of the responsibilities and economic benefits arising from the use of the asset.

The lease is generally non-cancellable during the primary lease period, and the lease rentals are structured to enable the lessor to recover the entire investment made in acquiring the asset along with a reasonable return. For this reason, finance leases are

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also known as full payout leases, as the lessor recovers both the cost of the asset and the expected profit through lease payments.

Finance leases are commonly used for high-value assets such as aircraft, ships, railway wagons, land, buildings, heavy machinery, industrial equipment, and diesel generating sets. Normally, the lease term extends over most or all the economic life of the asset, and the total lease payments are generally higher than the lessor's original investment in the asset.

Key Characteristics of a Finance Lease

- ◊ It is generally a long-term and non-cancellable lease arrangement.
- ◊ The lessee assumes substantially all risks and rewards associated with ownership.
- ◊ The lessor retains legal ownership, but primarily functions as a financier.
- ◊ Lease rentals are designed to recover the full cost of the asset and provide a return on investment.
- ◊ The lease term usually covers most or all of the asset's economic life.
- ◊ The lessee may have the option to purchase the asset at the end of the lease period.
- ◊ Finance leases are widely used for expensive capital assets such as industrial machinery, commercial buildings, ships, and aircraft.

Types of Financial Lease

Financial Lease may be classified into the following types

(i) Sale and Lease Back and Direct Lease

Sale and Lease Back

A Sale and Lease Back is an indirect form of leasing. Under this arrangement, the owner of an asset sells it to a leasing company and immediately takes it back on lease. Thus, the seller becomes the lessee, while the leasing company becomes the lessor. This arrangement enables the owner to receive immediate funds while continuing to use the asset.

A common example is the sale and lease back of safe deposit lockers by banks. The bank sells the lockers to a leasing company at a market price, and the leasing company leases them back to the bank on a long-term basis. The bank then provides these lockers to its customers. A sale and lease back arrangement may take the form of either a finance lease or an operating lease.

Direct Lease

A Direct Lease is a lease arrangement in which the owner of the asset and the lessee are different persons. The lessor purchases the asset from the supplier and leases it directly to the lessee.

A direct lease may be of two types:

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(a) Bipartite Lease

(b) Tripartite Lease

(a) Bipartite Lease

A Bipartite Lease involves two parties:

- ◊ Equipment supplier-cum-lessor
- ◊ Lessee

In this arrangement, the equipment supplier also acts as the lessor and leases the asset directly to the lessee. Such leases are generally operating leases and may provide additional facilities such as upgrading the equipment, adding new features, or replacing the equipment when required (swap lease). The lessor is also responsible for maintaining the asset.

(b) Tripartite Lease

A Tripartite Lease involves three parties, namely the Equipment supplier, the Lessor and the Lessee

A common form of tripartite lease is the sales-aid lease, in which the equipment supplier helps the leasing company arrange lease finance. The supplier may:

- ◊ Recommend customers to the leasing company.
- ◊ Negotiate the lease terms and complete the required formalities on behalf of the leasing company.
- ◊ Execute the lease in its own name and later assign or discount the lease receivables to the leasing company.

In this arrangement, the leasing company becomes the owner of the asset and receives the lease rentals from the lessee.

If the lessee fails to make the lease payments, the supplier may support the leasing company by repurchasing the equipment or providing a guarantee on behalf of the lessee.

(ii) Single Investor Lease and Leveraged Lease

Single Investor Lease

A Single Investor Lease is a lease arrangement involving two parties—the lessor and the lessee. In this type of lease, the lessor finances the entire cost of the leased asset by using a suitable combination of equity and borrowed funds. Although the lessor may borrow money from lenders to purchase the asset, such borrowings are without recourse to the lessee. This means that if the lessor fails to repay the loan, the lender cannot recover the amount from the lessee. The lessee's responsibility is limited to paying the agreed lease rentals to the lessor.

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Leveraged Lease

A Leveraged Lease is a lease arrangement involving three parties:

- ◊ Lessor (equity investor)
- ◊ Lender (loan participant)
- ◊ Lessee

In this type of lease, the lessor contributes only a part of the total cost of the asset as equity, while the remaining amount is financed through borrowings from the lender. The lender obtains the right to receive the lease rentals from the lessee and holds the first charge or mortgage on the leased asset as security.

Generally, the transaction is managed through a trustee, who safeguards the interests of both the lessor and the lender. The trustee collects the lease rentals from the lessee, pays the amount required for servicing the loan to the lender, and transfers the remaining balance to the lessor.

Thus, in a leveraged lease, the lessor provides only a small portion of the investment, whereas the major share of the asset's cost is financed by the lender.

(iii) Straight Lease and Modified Lease

Straight Lease

A Straight Lease is a lease arrangement in which the lessee pays the agreed lease rentals throughout the expected service life or lease term of the asset. The terms and conditions of the lease remain unchanged during the entire lease period, and no provision is made for modifying the original lease agreement.

Modified Lease

A Modified Lease is a lease arrangement that offers flexibility to the lessee during the lease period. Unlike a straight lease, it allows certain changes to the original lease agreement. For example, the lessee may be given the option to terminate the lease before its expiry by either purchasing the leased asset or returning it to the lessor, depending on the terms of the agreement.

(iv) Primary and Secondary Lease (Front-ended and Back-ended Lease)

A Primary and Secondary Lease is a lease arrangement in which the lease rentals are structured differently for two stages of the lease period. During the primary lease period, the lease rentals are comparatively high so that the lessor can recover the cost of the asset along with a reasonable profit. After the lessor has substantially recovered the investment, the lease may continue for a secondary lease period at nominal or significantly lower rentals.

In simple terms, the rentals payable during the primary lease period are much higher than those charged during the secondary lease period. Since the lease rentals are higher in the beginning and lower in the later stage, this arrangement is also known as a Front-ended and Back-ended Lease.

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(v) Domestic Lease and International Lease

Domestic Lease

A lease transaction is called a Domestic Lease when all the parties involved in the lease agreement, namely the equipment supplier, lessor, and lessee, are domiciled in the same country. Since the entire transaction takes place within one country, it is governed by the domestic laws, regulations, and taxation policies of that country.

International Lease

A lease transaction is known as an International Lease when the parties involved in the lease agreement are in different countries. International leases are broadly classified into:

1. Import Lease
2. Cross-Border Lease

Import Lease

An Import Lease is an international lease in which the lessor and the lessee are domiciled in the same country, while the equipment supplier is located in another country. In such cases, the lessor imports the asset from the foreign supplier and leases it to the lessee.

Cross-Border Lease

A Cross-Border Lease is an international lease in which the lessor and the lessee are domiciled in different countries. In this type of lease, the location of the equipment supplier is not important for determining the nature of the lease.

From an operational point of view, domestic and international leases mainly differ in terms of risk. International leases involve two additional risks, namely country risk and currency risk.

- ◊ **Country Risk:** This risk arises because the lease transaction is influenced by the political, economic, legal, tax, and regulatory environment of the countries involved.
- ◊ **Currency Risk:** This risk arises when payments to the equipment supplier or lease rentals are made in different currencies. Any fluctuation in exchange rates may affect the cost of the lease transaction.

2. Operating Lease

According to International Accounting Standard (IAS) 17, an operating lease is a lease that is not classified as a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards associated with the ownership of the asset to the lessee. Also, the cost of the asset is not fully recovered during the primary lease period.

Apart from providing the asset, the lessor also offers services such as maintenance, repairs, insurance, and technical support. Therefore, an operating lease is also known as a service lease. The lease rentals include charges for both the use of the asset and the

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services provided by the lessor. Since the lessor expects to lease the asset to more than one user, the recovery of the investment does not depend on a single lessee.

Operating leases are commonly used for computers, office equipment, automobiles, trucks, telecommunication equipment, and similar assets.

Examples of operating leases include

- ◊ Hiring a mobile crane along with an operator.
- ◊ Chartering an aircraft or ship together with crew, fuel, and support services.
- ◊ Leasing computers with operators or technical support.
- ◊ Hiring a taxi, where the rental includes the driver's service, fuel, maintenance, and repairs.

Features of an Operating Lease

The main features of an operating lease are:

i. **Short Lease Period:** The lease period is generally much shorter than the useful life of the asset. Depending on the nature of the asset, the lease may be on an hourly, daily, weekly, monthly, or yearly basis. Normally, either the lessor or the lessee can cancel the lease according to the terms of the agreement.

ii. **Incomplete Recovery of Cost:** Since the lease period is short, the lease rentals collected during this period are not sufficient to recover the full cost of the asset.

iii. **Residual Value Remains with the Lessor:** The lessor does not depend on a single lessee to recover the investment. Instead, the lessor expects to recover the remaining cost by leasing the asset to other users or by selling it after the lease period. Therefore, the lessor bears the risk of obsolescence.

iv. **Maintenance by the Lessor:** The lessor usually undertakes the maintenance of the asset and may also provide services such as insurance, technical assistance, operators, fuel, and repairs.

Table 4.1.1 Comparison between Financial lease and Operating lease

Item	Financial lease	Operating lease
1. Duration	Long-term	Short-term
2. Cancelability	Non-cancellable	Cancellable at lessee's option
3. Maintenance & Insurance	Borne entirely by the Lessee	Borne by the Lessor
4. Payout Type	Full-payout (covers asset cost + interest)	Non-payout (depends on re-leasing/residual value)
5. Risk of Obsolescence	Borne by the Lessee	Borne by the Lessor
6. Purchase Option	Frequently offered at nominal value	Rarely offered; asset returns to lessor

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4.1.4 Advantages and Limitations of Leasing

4.1.4.1 Advantages of Leasing to the Lessor

1. Higher Profits

A lessor can earn attractive profits by leasing assets when the leasing business is managed efficiently. The lease rentals generally cover the cost of capital invested as well as the risks associated with the leasing transaction.

2. Tax Benefits

Since the lessor is the legal owner of the leased asset, various tax benefits such as depreciation and investment allowance can be claimed. Leasing has therefore been widely used as an effective means of reducing the lessor's tax liability.

3. Quick Returns

Compared to many long-term investment projects, leasing provides quicker returns. The lessor receives regular lease rentals, enabling a faster recovery of the investment.

4. Increase in Sales

Lease financing provided through leasing companies helps manufacturers increase the sale of their products. At the same time, the lessor may also be able to negotiate favourable terms or concessions from the manufacturers while purchasing the assets.

4.1.4.2 Disadvantages of Leasing to the Lessor

1. Risk of Obsolescence

The lessor bears the risk that the leased asset may become technologically outdated before recovering the full investment. This risk is particularly high in industries where technology changes rapidly.

2. Intense Competition

The growth of leasing companies has increased competition in the leasing market. As a result, the lessor may find it difficult to charge lease rentals that are sufficient to recover the cost of the asset, earn the expected profit, and compensate for the risks involved.

3. Effect of Price-Level Changes

Although the market price of assets may increase due to inflation, the lessor generally receives fixed lease rentals that are based on the original cost of the asset. This may reduce the real return on investment.

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4. Difficulty in Managing Cash Flows

Efficient cash flow management is essential for the success of a leasing business. However, fluctuations in market conditions and unexpected changes in cash inflows and outflows can make cash flow management difficult.

5. Higher Cost Due to Loss of User Benefits

The lessor cannot enjoy certain benefits available to the actual users of the asset, such as concessions in sales tax, customs duty, or other taxes. This increases the overall cost of acquiring the asset and may require the lessor to charge higher lease rentals.

6. Long Recovery Period

Recovering the investment made in leased assets generally takes a considerable period through lease rentals. Therefore, the lease rentals received may not always represent actual realised profits, as they are subject to various business risks. If dividends are distributed from current earnings without considering these risks, it may eventually result in payment out of capital.

4.1.4.3 Advantages of Leasing to the Lessee

1. Avoids Large Initial Investment

Leasing enables a business to use an asset without making a substantial initial capital investment. In many cases, lease financing provides up to 100% finance, eliminating the need for margin money, although some leasing companies may require the first lease rental to be paid in advance.

2. Easy and Quick Source of Finance

Leasing is a convenient source of medium- and long-term finance. Lease proposals are generally processed faster than term loans, enabling the lessee to acquire and use the asset without unnecessary delay. Since ownership remains with the lessor, the lessee is not required to provide additional security or mortgage assets.

3. Preserves Borrowing Capacity

Lease financing allows a business to acquire the use of assets without significantly affecting its borrowing capacity. This enables the firm to retain its ability to obtain additional finance for future business needs.

4. Improves Liquidity

A sale and lease back arrangement helps a business convert fixed assets into cash while continuing to use them. This improves liquidity and assists in meeting working capital requirements.

5. Tax Benefits and Tax Planning

Lease rentals are treated as revenue expenditure and are deductible while computing taxable income. This reduces the lessee's tax liability. In addition, tax benefits available

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to the lessor may be reflected in the form of lower lease rentals, making leasing an effective tax planning tool.

6. Higher Return on Capital Employed

Since the lessee acquires only the right to use the asset and not its ownership, the leased asset generally does not appear as an owned asset in the balance sheet. This results in a comparatively higher return on capital employed.

7. Transfer of Obsolescence Risk

By leasing instead of purchasing an asset, the lessee can transfer a major part of the risk of technological obsolescence to the lessor, particularly in industries where technology changes rapidly.

8. Convenience and Flexibility

Operating or service leases are generally cancellable, allowing the lessee to discontinue the lease when the asset is no longer required. This makes leasing a flexible method of financing.

9. Certainty of Finance

A lease is generally a medium-term financing arrangement that cannot be withdrawn merely because of changes in economic conditions. Unless the lessee defaults, the lessor cannot demand accelerated payment of lease rentals during the primary lease period.

10. No Flotation Costs

Leasing eliminates the need to raise funds through the issue of shares or debentures. Consequently, the expenses associated with issuing securities, known as flotation costs, are avoided.

11. No Disposal Responsibility

At the end of the lease period, the lessee is not responsible for disposing of the asset. The responsibility for taking back or disposing of the asset rests with the lessor.

12. Lower Administrative and Maintenance Costs

Under a gross lease or an operating lease, the lessor may undertake the maintenance and servicing of the leased asset. Although these costs are included in the lease rentals, the lessee benefits from professional maintenance services and reduced administrative responsibility.

4.1.4.4 Disadvantages of Leasing to the Lessee

1. Higher Cost of Finance

Lease financing is generally more expensive than other sources of finance because the lease rentals include the lessor's profit margin as well as compensation for the risk of obsolescence.

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2. No Moratorium Period

Unlike term loans, lease agreements generally do not provide a moratorium period. Lease rentals become payable according to the agreement even before the asset starts generating sufficient income.

3. No Ownership Benefits

Since the lessee does not become the owner of the asset, ownership-related benefits such as depreciation, investment allowance, and other tax incentives cannot be claimed.

4. Restrictions on Alteration of the Asset

The lessee cannot make major modifications or structural changes to the leased asset without the lessor's consent. In contrast, an owner has complete freedom to alter the asset according to business requirements.

5. Loss of Salvage Value

The lessee cannot realise the asset's salvage value at the end of its useful life because ownership remains with the lessor. The asset must be returned after the lease period.

6. Penalty for Early Termination

If the lessee terminates the lease agreement before the expiry of the agreed lease period, penalties or compensation may have to be paid as specified in the lease contract.

7. Risk of Losing the Asset

The lessee may lose the right to use the leased asset if the lessor experiences financial difficulties or if the leasing company is wound up.

4.1.5 Leasing Vs Hire Purchase

Hire Purchase and Leasing are two widely used methods of acquiring the use of business assets without making a substantial upfront investment. Both arrangements enable businesses to obtain machinery, equipment, vehicles, and other assets by making periodic payments rather than paying the entire purchase price at once. However, they differ significantly in terms of legal ownership, payment structure, transfer of risks and rewards, maintenance responsibilities, and the user's rights over the asset. In a hire purchase agreement, the hirer acquires ownership of the asset after paying all the agreed instalments. In contrast, under a lease agreement, the lessor retains ownership of the asset while granting the lessee the right to use it for a specified period in return for periodic lease rentals. Understanding these differences helps businesses select the most

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appropriate financing option based on their operational and financial requirements.

Differences between Hire Purchase and Leasing

Table 4.1.2 Differences between Hire Purchase and Leasing

Basis	Hire Purchase	Leasing
1. Meaning	Hire purchase is a method of acquiring an asset by paying the purchase price in instalments over an agreed period.	Leasing is an arrangement in which an asset is rented from its owner (lessor) for a specified period against regular lease payments.
2. Duration	Hire purchase agreements generally extend over a relatively longer period, ranging from several months to years.	Lease agreements are usually for a shorter duration and can be tailored to the needs of the parties.
3. Ownership Transfer	Ownership of the asset passes to the hirer after all the agreed instalments have been paid.	Ownership remains with the lessor throughout the lease period.
4.Payment Structure	The hirer pays periodic instalments until the ownership of the asset is transferred.	The lessee makes regular lease payments only for the right to use the asset during the agreed period.
5.Maintenance and Insurance	The hirer is generally responsible for the maintenance and insurance of the asset.	The lessor generally takes responsibility for maintenance and upkeep, depending on the lease agreement.
6.Flexibility	Hire purchase agreements usually have fixed terms and offer limited flexibility after execution.	Leasing provides greater flexibility, allowing changes in terms or asset upgrades in many cases.
7. Tax Treatment	The interest component of hire purchase instalments may qualify as a deductible business expense for tax purposes.	Lease rentals are generally treated as operating expenses and may be deducted while computing taxable income.
8. End of Term Options	At the end of the agreement, ownership is transferred to the hirer, and no further payments are required.	At the end of the lease period, the lessee may have the option to purchase, renew, or return the asset, depending on the agreement.
9. Risk Exposure	The hirer bears the risk associated with depreciation or damage to the asset.	Since ownership remains with the lessor, the lessor generally bears the ownership-related risks.
10. Contract Termination	A hire purchase agreement may be terminated before ownership is transferred, subject to the terms and applicable charges.	Early termination of a lease may result in legal or financial consequences as specified in the lease contract.

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Recap

- ◊ Leasing is a contractual arrangement in which the owner of an asset (lessor) grants another party (lessee) the right to use the asset for a specified period in return for lease rentals.
- ◊ The essential elements of leasing include the lessor, lessee, lease asset, lease period, lease rentals, separation of ownership and use, and termination of the lease.
- ◊ Based on the transfer of risks and rewards, leasing is broadly classified into Finance Lease and Operating Lease.
- ◊ A Finance Lease transfers all the risks and rewards of ownership substantially to the lessee, whereas an Operating Lease retains most of the risks and rewards with the lessor.
- ◊ Finance leases include Sale and Lease Back, Direct Lease, Single Investor Lease, Leveraged Lease, Straight Lease, Modified Lease, Primary and Secondary Lease, and Domestic and International Lease.
- ◊ Operating leases are generally short-term, cancellable, and include maintenance and other support services provided by the lessor.
- ◊ Leasing offers several advantages to the lessor, such as higher profits, tax benefits, quick recovery of investment, and increased sales opportunities.
- ◊ Leasing also benefits the lessee by avoiding heavy initial investment, improving liquidity, preserving borrowing capacity, providing tax benefits, and reducing the risk of obsolescence.

Objective Questions

1. Which party to a lease agreement is the legal owner of the leased asset?
2. What is the consideration paid by the lessee to the lessor known as?
3. Which type of lease transfers substantially all the risks and rewards of ownership to the lessee?
4. Which type of lease is also known as a full payout lease?
5. Which type of lease is commonly referred to as a service lease?
6. In which type of lease does the lessor generally provide maintenance and technical services?
7. Which lease arrangement involves the owner selling an asset and immediately leasing it back?

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8. Which type of direct lease involves only the lessor and the lessee?
9. Which type of lease involves the equipment supplier, lessor, and lessee?
10. In which type of lease does the lessor finance the entire cost of the asset?
11. Which type of lease involves three parties—the lessor, lender, and lessee?
12. Which lease provides flexibility by allowing modification of the lease terms?
13. Which lease consists of a primary period followed by a secondary period with nominal rentals?
14. A lease in which all the parties are located in the same country is called _____.
15. Which type of international lease involves a foreign equipment supplier but a domestic lessor and lessee?
16. Which type of lease exists when the lessor and lessee are located in different countries?
17. Which risk arises due to fluctuations in foreign exchange rates in an international lease?
18. Which benefit allows the lessor to claim depreciation on the leased asset?
19. Which advantage of leasing enables the lessee to use an asset without making a large initial investment?
20. Which disadvantage of leasing prevents the lessee from claiming depreciation and investment allowance?

Answers

1. Lessor
2. Lease rental
3. Finance lease
4. Finance lease
5. Operating lease
6. Operating lease
7. Sale and lease back
8. Bipartite lease
9. Tripartite lease
10. Single investor lease
11. Leveraged lease

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12. Modified lease
13. Primary and secondary lease (Front-ended and Back-ended lease)
14. Domestic lease
15. Import lease
16. Cross-border lease
17. Currency risk
18. Tax benefits
19. Avoidance of initial capital outlay
20. Loss of ownership benefits

Self-Assessment Questions

1. Explain the essential elements of a lease agreement.
2. Differentiate between a finance lease and an operating lease.
3. Describe the different types of finance leases with suitable examples.
4. Discuss the advantages and disadvantages of leasing from the perspective of the lessee.
5. Explain the advantages and disadvantages of leasing from the perspective of the lessor.
6. Differentiate between Hire Purchase and Leasing.

Assignments

1. Compare finance lease and operating lease and explain the situations in which each type of lease is most appropriate.
2. Analyse the various forms of finance lease, such as sale and lease back, direct lease, leveraged lease, and single investor lease, with suitable examples.
3. Critically examine the advantages and limitations of leasing for both the lessor and the lessee.
4. "Leasing is an effective alternative to purchasing business assets." Discuss this statement by analysing its benefits and drawbacks.
5. Explain the different classifications of leasing and discuss how the choice of lease depends on the financing and operational requirements of a business.

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Unit 2 Factoring

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ explain the concept of Factoring
- ◊ comprehend the process of factoring
- ◊ explain the functions of a factor
- ◊ describe the various types of factoring
- ◊ differentiate between factoring and bill discounting

Prerequisite

A manufacturing company regularly supplies its products to retailers and distributors on credit. Although its sales are increasing, the company faces a recurring cash-flow problem because customers take 60 to 90 days to make payments. During this waiting period, the company still has to pay its suppliers, employees, transport charges, and other day-to-day expenses. As the business grows, the amount of money locked up in customer dues also increases, making it difficult to meet immediate financial requirements.

The management therefore considers obtaining external financial assistance against the amounts due from its customers. It also wants support in maintaining records of receivables, following up with customers, collecting payments, and managing credit-related activities. At the same time, the company comes across another financing option where short-term funds can be obtained against bills before their maturity.

This situation leads us to the discussion of factoring and bill discounting. The topic helps us examine the parties involved, the process, functions and different types of factoring, and the key differences between factoring and bill discounting.

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Keywords

Factor, Factoring, Bill discounting, Equipment supplier, Recourse and non-recourse factoring

Discussion

A business can have strong sales and still experience a shortage of cash. This often happens when customers purchase goods on credit and the business has to wait for the agreed payment period. Meanwhile, expenses such as wages, purchases, transportation, and other operating costs have to be met regularly. Managing this gap between sales and actual cash receipts becomes an important financial concern for the business.

As the volume of credit sales increases, businesses may look for ways to obtain funds against amounts expected from customers and to reduce the burden of collecting and managing those amounts. Different financial arrangements are available for this purpose, each involving its own procedures, participants, and services. Among these, factoring and bill discounting are important arrangements that businesses may consider for managing short-term financial requirements.

4.2.1 Meaning and Definition of Factoring

Meaning

Factoring is a financial arrangement created through an agreement between a business organisation selling goods or providing services (known as the client) and a financial institution (known as the factor). Under this arrangement, the factor purchases the client's accounts receivable arising from credit sales and undertakes the responsibility of managing and collecting those receivables.

Factoring is a continuous business relationship between a factor and a client, in which the client sells goods or renders services to customers on open account terms. The factor purchases the client's book debts, either with or without recourse, administers the sales ledger, controls the credit extended to customers, and collects the outstanding receivables on behalf of the client.

Definition

The International Institute for the Unification of Private Law (UNIDROIT), Rome (1988) defined factoring as an arrangement between a factor and a client under which the factor provides at least two of the following services:

- ◊ Finance
- ◊ Maintenance of accounts

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- ◊ Collection of debts
- ◊ Protection against credit risk

4.2.2 Features of Factoring

The important features of factoring are as follows:

1. Factoring is a financial service that converts credit sales into immediate cash by purchasing accounts receivable and other credit dues.
2. The factor assumes the credit risk associated with the receivables purchased and collects the debts from customers when they become due.
3. A factor normally performs at least two or more of the following functions:
   - ◊ Provides finance through loans or advance payments.
   - ◊ Maintains accounts and sales ledgers relating to receivables.
   - ◊ Collects receivables from customers.
   - ◊ Protects the client against the risk of bad debts or default by debtors.
4. A factor is a specialised financial institution that provides both financing and management of receivables arising from credit sales. It acts as a financial intermediary between the buyer and the seller.
5. Unlike commercial banks, a factor specialises in managing and collecting receivables. Since the invoices are assigned to the factor, payments are received directly from the customers.
6. The factor is responsible for sales accounting, debt collection, credit control, protection against bad debts, and advisory services relating to receivables.

4.2.3 Parties to Factoring

A factoring transaction generally involves three parties:

1. Buyer

The buyer purchases goods on credit from the seller and agrees to make payment to the factor on the due date. If payment is delayed or default occurs, the factor takes the necessary steps for recovery.

2. Seller

The seller enters into a credit sale agreement with the buyer, supplies the goods, and assigns the receivables to the factor. The seller receives an advance, generally 80% or more of the receivables, and receives the balance amount after deduction of the factor's service charges.

3. Factor

The factor is a financial institution that agrees with the seller to provide factoring services. The factor purchases the receivables, makes advance payment to the seller,

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collects the outstanding amount from the buyer on the due date, and remits the balance to the seller after deducting the agreed charges.

4.2.4 Process of Factoring

Factoring arises from credit sales made in the normal course of business. The primary responsibility of the factor is to realise the sale proceeds by collecting the receivables from customers. Thus, the factor acts as an intermediary between the seller and the buyer and, in some cases, also works in coordination with the seller's bank.

The mechanism of factoring involves the following steps:

1. The seller and the factor enter into a factoring agreement specifying the terms and conditions under which factoring services will be provided.
2. The seller supplies goods or services to the buyer on credit. The sales documents and invoice contain instructions directing the buyer to make payment directly to the factor.
3. If required under the agreement, the factor provides advance finance to the seller against the receivables.
4. On the due date, the buyer makes payment directly to the factor.
5. After receiving the payment, the factor credits the seller's account after deducting the agreed fees, interest, and other charges, and remits the balance amount to the seller.

4.2.5 Functions of a Factor

1. Administration of Sales Ledger

One of the primary services offered by a factor is the administration of the client's sales ledger. The factor maintains a separate sales ledger for each client. Whenever a sales transaction takes place, the client prepares the invoice in duplicate. One copy is issued to the customer, while the other is forwarded to the factor. The factor records the transaction using the open-item method, whereby every payment received is matched with the corresponding invoice. Consequently, the customer's account reflects all outstanding invoices on any given date. The factor also provides the client with periodic reports showing the status of receivables and collections. The frequency of these reports depends on the volume of transactions. Thus, the entire responsibility for maintaining the sales ledger is transferred from the client to the factor.

The factor performs the following functions in relation to sales ledger administration:

i. Verifies that invoices represent genuine trade transactions arising from the sale of goods or the provision of services.
ii. Maintains and updates the sales ledger by recording new invoices issued and payments received.
iii. Ensures that monthly statements are sent to debtors and follows up for timely

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recovery through reminders, telephone calls, personal contacts, and other appropriate methods.

iv. Remits the retained balance to the client after collection of receivables. In the case of Fixed Maturity Period (FMP) factoring, the retained amount is released to the client on the expiry of the agreed maturity period.

v. Maintains close coordination with both the client and the customers to resolve disputes relating to quantity, quality, unauthorised discounts, or other issues affecting payment.

vi. Periodically reviews the financial position and creditworthiness of debtors to assess the likelihood of successful debt recovery.

vii. Provides the client with regular reports containing details of overdue invoices, unpaid accounts, disputes, legal proceedings, and other relevant information.

2. Collection of Receivables

Collection of receivables is one of the most important functions of a factor. The factor undertakes the responsibility of collecting outstanding dues from customers on behalf of the client, thereby relieving the client from the difficulties and administrative burden associated with debt collection. This enables the client to focus on core business operations while reducing the time, effort, and cost involved in maintaining a collection department. With trained personnel, advanced technology, and an efficient collection system, the factor ensures prompt follow-up and timely realisation of receivables.

3. Provision of Finance

A major advantage of factoring is the availability of immediate finance to the client. Since working capital is essential for the smooth functioning of any business, the factor purchases the client's book debts, which are legally assigned to the factor. Generally, the factor provides an advance of 75–80% of the value of the assigned receivables, enabling the client to maintain adequate liquidity.

a. **Without Recourse Factoring:** When receivables are purchased on a without recourse basis, the factor assumes the credit risk. The factor is obligated to pay the client on the due date of the invoice irrespective of whether the customer makes payment.

b. **With Recourse Factoring:** In with recourse factoring, the factor provides finance against receivables, but the client remains ultimately responsible for payment. If the customer fails to settle the invoice on the due date, the client must reimburse the amount advanced by the factor.

4. Protection Against Risk

Protection against credit risk is available in without recourse factoring. Under this arrangement, the factor fixes credit limits for approved customers, specifying the maximum value of credit sales that the client can make to each customer. Within these approved limits, the factor purchases the trade debts and bears the risk of non-payment by the customers.

Apart from assuming credit risk, the factor also assists the client by evaluating

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the creditworthiness of existing and prospective customers. This enables the client to implement an effective credit control policy. The assessment is based on various sources such as credit rating reports, bank references, trade references, financial statements, and analysis of key liquidity and profitability ratios.

5. Advisory Services

Factoring also includes a range of advisory services arising from the close business relationship between the factor and the client. Owing to their financial expertise and extensive knowledge of customers' credit profiles, factors provide valuable guidance on several business matters.

The advisory services generally include:

i. Providing information regarding customers' preferences and changing demand for the client's products.

ii. Advising the client on changes in competitors' marketing policies and strategies.

iii. Recommending improvements in invoicing procedures, delivery systems, and the handling of sales returns.

iv. Assisting the client in obtaining finance from banks and other financial institutions.

In addition, the factor regularly furnishes the client with statements indicating the sanctioned credit limit, credit utilised, and the balance available.

The periodic reports generally contain the following information:

a. Details of book debts purchased by the factor.

b. Book debts realised during the period.

c. Age-wise classification of outstanding receivables.

d. Debts collected and debts that are due for collection.

e. Details of receivables purchased under with recourse and without recourse arrangements.

4.2.6 Types of Factoring

1. Recourse and Non-Recourse Factoring

(a) Recourse Factoring

Under **recourse factoring**, the factor has the right to recover the amount from the client if the customer fails to pay the receivable. Therefore, the risk of bad debts remains with the client, and the factor does not assume the credit risk of the buyer.

In this arrangement:

◊ The factor mainly acts as an agent for collecting receivables.

◊ If the customer defaults, the factor can recover the amount from the client.

◊ The client is responsible for assessing the buyer's creditworthiness.

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- ◊ The factor charges a fee for sales ledger maintenance and debt collection, along with interest on any advance provided.

(b) Non-Recourse Factoring

In non-recourse factoring, the factor bears the risk of non-payment by the customer. If the customer fails to pay due to financial inability, the factor cannot recover the amount from the client.

The main features are:

- ◊ The factor assumes the credit risk of approved customers.
- ◊ The client is protected against bad debts.
- ◊ Since the factor bears the risk, the service charges are higher than in recourse factoring.
- ◊ The additional fee charged for taking this risk is known as del credere commission.

2. Advance and Maturity Factoring

(a) Advance Factoring

In advance factoring, the factor provides an advance of 75% to 90% of the approved receivables to the client. The remaining balance is paid on the agreed payment date after deducting the applicable charges.

The important features are:

- ◊ Immediate finance is provided against receivables.
- ◊ The advance is released once the receivables are approved by the factor.
- ◊ Interest or discount is charged from the date of advance until the amount is collected from the customer.
- ◊ The rate depends on the client's creditworthiness, sales volume, and prevailing short-term interest rates.

(b) Maturity Factoring

In maturity factoring, the factor purchases the receivables but does not provide any advance payment at the time of purchase. Instead, the client receives payment on the agreed maturity date. During this period, the factor manages the receivables and collects payment from the customers.

3. Conventional or Full Factoring

Conventional factoring, also called Full Factoring or Old Line Factoring, is the most comprehensive form of factoring. Under this arrangement, the factor provides almost all services related to receivables management.

These services include:

- ◊ Collection of receivables.

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- ◊ Maintenance of the sales ledger.
- ◊ Credit control and credit administration.
- ◊ Credit insurance or protection against bad debts.
- ◊ Fixing credit limits based on outstanding receivables.
- ◊ Providing finance against receivables.
- ◊ Managing invoice collections according to their maturity.

This type of factoring is widely used in developed countries. In India, institutions such as SBI Factors mainly provide full factoring services on a recourse basis to financially sound companies.

4. Domestic and Export Factoring

The main difference between domestic and export factoring is the number of parties involved.

(a) Domestic Factoring

Domestic factoring involves three parties:

- ◊ Customer (Buyer)
- ◊ Client (Seller)
- ◊ Factor

All the parties are located in the same country.

(b) Export Factoring

Export factoring, also known as International Factoring or Cross-border Factoring, involves four parties:

- ◊ Exporter (Seller)
- ◊ Importer (Buyer)
- ◊ Export Factor
- ◊ Import Factor

Since two factors participate in the transaction, it is also known as the Two-Factor System.

This arrangement consists of two related agreements:

- ◊ Between the exporter and the export factor.
- ◊ Between the export factor and the import factor.

The import factor helps assess the buyer's creditworthiness, collect receivables, handle legal and language issues, and transfer the payment to the export factor in the invoice currency. Export factoring is generally provided on a non-recourse basis, giving the exporter protection against bad debts.

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5. Limited Factoring

In limited factoring, the factor purchases or discounts only selected invoices instead of all the receivables of the client. This enables the client to obtain finance only against specific receivables.

6. Selected Seller-Based Factoring

In selected seller-based factoring, the factor approves the seller before entering into a factoring agreement. After making sales, the seller assigns receivables along with supporting documents such as invoices, delivery challans, and contracts to the factor.

The factor performs functions such as:

- ◊ Maintaining receivable accounts.
- ◊ Collecting outstanding debts.
- ◊ Sending reminders to customers.
- ◊ Performing all related activities connected with receivables management.

7. Selected Buyer-Based Factoring

Under selected buyer-based factoring, the factor first identifies and approves buyers based on their reputation and creditworthiness.

The approved buyers purchase goods from the seller, and the factor discounts the receivables arising from these transactions. The seller receives payment without recourse, and the factor bears the credit risk of the approved buyers.

8. Disclosed and Undisclosed Factoring

(a) Disclosed Factoring

In disclosed factoring, the buyer is informed that the receivables have been assigned to a factor. The supplier mentions the factor's name on the invoice and instructs the buyer to make payment directly to the factor.

The important features are:

- ◊ The buyer knows about the factoring arrangement.
- ◊ Payment is made directly to the factor.
- ◊ The factor assumes credit risk only under non-recourse agreements and within the approved credit limit.
- ◊ Any amount beyond the approved limit is usually covered on a recourse basis, with the seller bearing the risk.

(b) Undisclosed Factoring

In undisclosed factoring, the buyer is not informed about the involvement of the factor. The factor manages the receivables in the background, while the seller continues to deal with the customer in its own name.

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In this arrangement:

- ◊ The factor's identity remains confidential.
- ◊ The factor maintains the sales ledger.
- ◊ Short-term finance is provided against receivables.
- ◊ The entire transaction is carried out in the name of the supplier, and the customer remains unaware of the factoring arrangement.

4.2.7 Factoring vs Bill Discounting

Banks and financial institutions provide both factoring and bill discounting as short-term financing facilities to businesses. Although both services help firms improve liquidity by converting receivables into immediate cash, they differ in their features, scope, and responsibilities.

Similarities between Factoring and Bills Discounting

The following are the major similarities between factoring and bill discounting:

1. Both provide short-term finance to businesses to meet their working capital requirements.
2. Both involve the financing of accounts receivable, enabling the client to receive funds before the expiry of the credit period instead of waiting for payment from the buyer.

Differences Between Factoring and Bills Discounting

Table 4.2.1 Differences Between Factoring and Bills Discounting

Basis	Factoring	Bill Discounting
Meaning	Factoring is a financial service in which receivables are sold to a factor, who provides finance along with receivables management services.	Bill discounting is a financing arrangement in which a bank or financial institution provides funds by discounting bills of exchange before their maturity.
Nature of Service	Provides finance as well as services such as sales ledger maintenance, debt collection, and credit administration.	Primarily provides finance by discounting bills; no additional management services are offered.
Ownership of Receivables	Receivables are assigned or transferred to the factor.	Ownership of the bill generally remains with the client until payment is realised.

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Collection of Receivables	The factor is responsible for collecting payments from customers.	The client generally remains responsible for collection unless otherwise agreed.
Sales Ledger Maintenance	The factor maintains the client's sales ledger.	No sales ledger maintenance is undertaken by the bank or financial institution.
Credit Risk	In non-recourse factoring, the factor bears the credit risk. In recourse factoring, the client bears the risk.	The client normally bears the risk of non-payment by the buyer.
Credit Investigation	The factor evaluates the creditworthiness of customers before accepting receivables.	Usually, no detailed investigation of the buyer's creditworthiness is undertaken.
Finance Provided	Advance is generally 75–90% of the value of receivables.	Finance is provided by discounting the bill after deducting the discount charges.
Additional Services	Includes advisory services, credit control, receivables management, and customer follow-up.	No advisory or receivables management services are provided.
Suitable For	Suitable for businesses seeking both finance and efficient receivables management.	Suitable for businesses that require only short-term finance against bills.

Recap

- ◊ Factoring is a financial arrangement in which a factor purchases a client's receivables arising from credit sales and undertakes their financing, administration, and collection.
- ◊ A factoring transaction generally involves three parties: the seller (client), buyer (customer/debtor), and factor.
- ◊ Factoring converts credit sales into immediate cash, thereby improving the liquidity and working capital position of the client.
- ◊ A factor generally provides services such as finance, maintenance of sales ledgers, collection of receivables, and protection against credit risk.
- ◊ The mechanism of factoring begins with a factoring agreement, followed by credit sales, assignment of receivables to the factor, advance payment

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to the client, collection of debts from customers, and settlement of the balance amount after deducting charges.

◊ Factoring helps businesses improve cash flow, credit management, and debt collection efficiency, while allowing them to concentrate on their core business activities.

Objective Questions

1. Which type of factoring allows the factor to recover the amount from the client if the customer fails to pay?
2. In which type of factoring does the factor bear the risk of bad debts?
3. What is the additional commission charged by the factor for assuming the risk of bad debts called?
4. Which type of factoring provides an advance of 75% to 90% of the approved receivables?
5. Which type of factoring does not provide any advance payment at the time of purchasing receivables?
6. Which type of factoring is also known as Old Line Factoring?
7. Which type of factoring involves four parties, namely the exporter, importer, export factor, and import factor?
8. Which type of factoring is also known as the Two-Factor System?
9. Which type of factoring finances only selected invoices instead of all receivables?
10. In which type of factoring does the factor first approve the seller before entering into the factoring agreement?
11. In which type of factoring does the factor first approve the buyers based on their creditworthiness?
12. Which type of factoring informs the buyer that payment should be made directly to the factor?
13. In which type of factoring is the buyer not informed about the involvement of the factor?
14. Which financing method provides services such as sales ledger maintenance, debt collection, and advisory services in addition to finance?
15. Which financing facility provides finance by discounting bills of exchange before their maturity?
16. In which financing method are receivables assigned to the factor?

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17. Which financing method is generally with recourse, making the client liable if the buyer defaults?
18. Which financing method usually follows the principle of whole-turnover financing?
19. Which financing method is generally considered off-balance sheet financing in full factoring arrangements?
20. Which financing method is primarily transaction-oriented, with each bill assessed separately?

Answers

1. Recourse factoring
2. Non-recourse factoring
3. Del credere commission
4. Advance factoring
5. Maturity factoring
6. Conventional (Full) Factoring
7. Export factoring (International factoring)
8. Export factoring
9. Limited factoring
10. Selected seller-based factoring
11. Selected buyer-based factoring
12. Disclosed factoring
13. Undisclosed factoring
14. Factoring
15. Bill discounting
16. Factoring
17. Bill discounting
18. Factoring
19. Factoring
20. Bill discounting

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Self-Assessment Questions

1. Explain the various types of factoring with suitable examples.
2. Distinguish between recourse factoring and non-recourse factoring.
3. Discuss the features of advance factoring and maturity factoring.
4. Explain the concept of domestic factoring and export factoring. How does export factoring differ from domestic factoring?
5. Differentiate between factoring and bill discounting.

Assignments

1. A manufacturing company frequently experiences delays in collecting payments from customers. Which type of factoring arrangement would be most suitable for the company? Justify your answer.
2. "Non-recourse factoring provides greater protection to the client than recourse factoring." Critically examine this statement.
3. Compare factoring and bill discounting from the perspective of risk, ownership of receivables, and services provided. Which method would you recommend for a growing business? Give reasons.
4. An exporter intends to expand sales to overseas customers but is concerned about bad debt risk and legal complexities. Explain how export factoring can address these concerns.
5. A company requires only short-term finance against a few selected invoices and does not need receivables management services. Analyse whether bill discounting or limited factoring would be a more appropriate financing option. Give reasons.

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Unit 3
Forfaiting

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ explain the meaning and concept of forfaiting
- ◊ identify the parties involved in a forfaiting transaction
- ◊ explain the mechanism and documentation involved in forfaiting.
- ◊ differentiate between factoring and forfaiting based on their features and applications.

Prerequisite

Consider an Indian company that exports machinery to a buyer in another country. Since the machinery is expensive, the foreign buyer requests a credit period of three years and agrees to make payment in instalments. The exporter accepts the arrangement because it wants to maintain a good business relationship and secure the order. However, the exporter now has to wait for a long period to receive the money, while it needs funds immediately to purchase raw materials, pay workers, and undertake new export orders.

The exporter is therefore faced with two concerns: how to receive the money before the agreed credit period and how to reduce the risk associated with waiting for payment from a foreign buyer. It may approach a specialised financial institution that can provide funds against these future export receivables. This type of arrangement is particularly relevant in international trade, where credit periods can be long and payment risks may be higher.

This situation provides a foundation for studying forfaiting, including its mechanism and the way it differs from factoring.

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Keywords

Forfaiting, Factoring, Exporter's bank, Importer's bank

Discussion

International trade often involves credit sales, where exporters may have to wait for a long period before receiving payment from foreign buyers. During this period, exporters may face cash-flow difficulties as well as concerns about the timely payment of export receivables. Financial arrangements that help exporters receive funds earlier can therefore play an important role in supporting international business.

In this context, forfaiting is an important trade-finance arrangement. It provides a mechanism for managing export receivables and payment-related risks. It is also useful to distinguish forfeiting from factoring, as both are associated with receivables financing but differ in their nature and operation.

4.3.1 Meaning of Forfaiting

Forfaiting is a mechanism of financing exports by discounting export receivables evidenced by bills of exchange or promissory notes, without recourse to the exporter, for medium- to long-term maturities, at a fixed discount rate, and generally up to 100% of the contract value.

In other words, forfaiting is a trade finance arrangement in which a forfaiter purchases an exporter's receivables arising from deferred payment export transactions at an agreed discount rate. It is commonly used for the export of capital goods, commodities, and services, especially when overseas buyers require credit for a longer period. Although forfaiting is mainly used for medium- and long-term export credit, it may also be used for receivables with a maturity of less than one year where such financing is permitted.

4.3.2 Parties to Forfaiting

A forfaiting transaction generally involves five parties:

1. Exporter
2. Importer
3. Exporter's Bank
4. Importer's Bank
5. Forfaiter

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4.3.3 Mechanism of Forfaiting

The forfaiting process generally involves the following steps:

1. The exporter and the importer negotiate the export contract, including the credit terms. The exporter then approaches a forfaiter to obtain the terms and conditions of forfaiting.
2. The forfaiter gathers information relating to the importer, the nature of the export transaction, credit terms, and the required documentation.
3. The forfaiter evaluates the country risk and credit risk associated with the transaction.
4. Based on the assessment, the forfaiter quotes an appropriate discount rate.
5. The exporter includes the discount charges, commitment fee, and other related costs in the export contract price quoted to the overseas buyer.
6. After both parties agree to the terms, the exporter and the forfaiter enter into a forfaiting agreement.
7. The exporter ships the goods, and the export documents are supported or guaranteed by the importer's bank.
8. The exporter discounts the bills or promissory notes with the forfaiter. The forfaiter then collects payment from the importer on the due date or may sell the receivables in the secondary market before maturity.

4.3.4 Documentation for Forfaiting

The following documents are commonly used in a forfaiting transaction:

1. The transaction is generally supported by bills of exchange or promissory notes.
2. The payment obligation is normally guaranteed by a bank, usually the importer's bank.
3. Bills of exchange may carry an 'Aval' by the importer's bank. An Aval is a bank guarantee given by endorsing the words "Per Aval" on the bill of exchange or promissory note with proper authorisation. This endorsement guarantees payment if the importer defaults.

4.3.5 Factoring Vs. Forfaiting

Similarities Between Factoring and Forfaiting

Forfaiting is similar to export (international or cross-border) factoring to the extent that both have the following common features:

1. **Non-recourse financing:** In both methods, the financial institution assumes the credit risk, and the seller is generally not liable if the buyer fails to make payment.

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2. **Advance payment:** In both factoring and forfaiting, the seller receives advance payment against the receivables, thereby improving liquidity.

Dissimilarities

Although factoring and forfaiting have the above similarities, they differ from each other in several respects. The major points of difference are presented in the following table.

Table 4.3.1 Differences between Factoring and Forfaiting

Factoring	Forfaiting
1. Factoring mainly involves the purchase and discounting of domestic trade receivables.	1. Forfaiting involves discounting foreign trade receivables arising from international transactions.
2. It is generally used for open account sales, and a letter of credit or bill of exchange is not mandatory.	2. A letter of credit or bank guarantee is normally required, even for a single transaction.
3. The factor generally finances about 75–85% of the receivables and retains the balance until payment is received on maturity.	3. The forfaiter discounts the full value of the receivable, providing 100% financing to the exporter.
4. Factoring may be either with recourse or without recourse. It may also include services such as collection and sales ledger management, even without financing.	4. Forfaiting is purely a financing arrangement and is always without recourse.
5. It is mainly used for short-term credit, usually up to 180 days.	5. It mainly finances medium- to long-term credit ranging from 180 days to about 7 years, although short-term facilities may also be available.
6. Factoring is a continuous arrangement in which the client's receivables are regularly assigned to the factor.	6. Forfaiting is arranged on a transaction-by-transaction basis.
7. The factor undertakes the responsibility for collecting payments from debtors, helping the client reduce collection-related administrative costs.	7. The forfaiter is responsible only for collecting the forfaited debt.
8. Charges may include financing fees, collection charges, sales ledger administration, credit protection, and information services.	8. A single discount charge is usually applied, based on factors such as the guaranteeing bank, country risk, credit period, debt value, and any additional delivery-period charges.
9. Factoring can be used for both domestic and export receivables.	9. Forfaiting is generally available only for export receivables denominated in freely convertible currencies.

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10. The factor assists clients in completing import formalities and may also provide advisory or consultancy services.	10. The forfaiter accepts only properly documented transactions that comply with the regulations of the importer's country.

Recap

- ◊ Forfaiting is a method of export financing in which a forfaiter purchases an exporter's receivables arising from deferred payment export transactions without recourse to the exporter.
- ◊ It is mainly used for medium- and long-term export credit, although it may also be used for certain short-term receivables.
- ◊ A forfaiting transaction generally involves five parties: the exporter, importer, exporter's bank, importer's bank, and the forfaiter.
- ◊ The forfaiting process includes negotiating the export contract, evaluating the creditworthiness of the importer, agreeing on a discount rate, executing the forfaiting agreement, shipping the goods, discounting the receivables, and collecting payment on maturity.
- ◊ The principal documents used in forfaiting are bills of exchange or promissory notes, usually supported by a bank guarantee or an Aval provided by the importer's bank.
- ◊ Factoring and forfaiting are both receivable financing techniques that provide advance finance and generally involve non-recourse financing.
- ◊ Factoring is mainly used for short-term domestic and export receivables and often includes additional services such as debt collection, sales ledger administration, and credit management.
- ◊ Forfaiting is primarily used for international trade receivables, provides 100% financing, and is arranged on a transaction-by-transaction basis.
- ◊ While factoring may be with recourse or without recourse, forfaiting is always without recourse.
- ◊ Both factoring and forfaiting improve the liquidity of businesses by converting credit sales into immediate cash, thereby facilitating efficient working capital management and promoting trade.

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Objective Questions

1. Which method of export finance involves the purchase of export receivables without recourse to the exporter?
2. Who purchases the export receivables in a forfaiting transaction?
3. Which financial instrument is commonly used as evidence of receivables in forfaiting?
4. How many parties are generally involved in a forfaiting transaction?
5. Which bank usually guarantees the payment obligation in a forfaiting transaction?
6. What is the bank guarantee endorsed on a bill of exchange or promissory note called?
7. Forfaiting is mainly used to finance which type of trade?
8. Which method of receivable financing generally provides up to 100% financing of the receivables?
9. Which method is generally arranged on a transaction-by-transaction basis?
10. Which method of receivable financing is mainly used for medium- to long-term export credit?

Answers

1. Forfaiting
2. Forfaiter
3. Bill of exchange or promissory note
4. Five
5. Importer's bank
6. Aval
7. Export trade
8. Forfaiting
9. Forfaiting
10. Forfaiting

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Self-Assessment Questions

1. Define forfaiting and explain its features.
2. Describe the parties involved in a forfaiting transaction.
3. Explain the mechanism of forfaiting with suitable steps.
4. Discuss the documentation required in a forfaiting transaction.
5. Explain the similarities and differences between factoring and forfaiting.

Assignments

1. Analyse the role of forfaiting as an effective method of financing international trade and exports.
2. Compare and contrast factoring and forfaiting with reference to their scope, financing pattern, risk assumption, and services provided.
3. Evaluate the importance of bank guarantees and documentation in ensuring the success of a forfaiting transaction.
4. "Forfaiting enables exporters to improve liquidity while eliminating credit risk." Discuss this statement with suitable reasons.
5. Explain how forfaiting differs from factoring in terms of financing, risk, period of credit, and operational procedures, and examine the situations in which forfaiting is more suitable than factoring.

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BLOCK 5

Venture Capital and Securitisation

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Unit 1
Introduction to Venture Capital

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ comprehend the concept of venture capital and its features
- ◊ classify the different types of venture capital based on the nature and purpose of investment.
- ◊ explain the various stages of venture capital financing and their significance in the growth of a startup
- ◊ differentiate the stages of venture capital financing according to the funding requirements and business life cycle of an enterprise
- ◊ examine the role and contribution of venture capital firms in promoting entrepreneurship and startup development in India

Prerequisite

Consider a young entrepreneur who develops an idea for a mobile application that connects local farmers directly with consumers. She believes the idea has good potential, but turning it into a successful business requires money for developing the application, hiring a small team, marketing, and expanding the service. Initially, she may use her own savings or receive financial support from family and friends. However, as the business grows, the amount of money required becomes much larger. At the same time, the business is still new, so obtaining a traditional bank loan may be difficult because it has limited assets and an uncertain income.

At this stage, an investor or investment firm may be willing to provide funds by taking a financial interest in the new business. The investor expects that if the business grows success-

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fully, the value of the investment will increase. The funding may also be provided at different points in the business journey, beginning with developing the idea and continuing through expansion.

This situation introduces an important form of business financing that supports new and promising businesses with high growth potential. To understand how such financing works, it is necessary to examine its features, different types, stages of financing, and the role of specialised firms that provide such funds.

Keywords

Venture capital, bridge financing, seed financing

Discussion

The case shows that promising business ideas often require substantial funds before they can generate stable profits. Unlike conventional sources of finance, some investors are willing to support businesses that involve greater risk because they expect significant growth in the future. Such financing is particularly important for start-ups and innovative businesses, where financial requirements change as the business moves from one stage of development to another.

This leads to the study of venture capital, its features and types, the various stages at which venture capital financing is provided, and the role of venture capital firms in India.

5.1.1 Meaning of Venture Capital

Venture capital emerged as an innovative method of business financing during the twentieth century. It refers to capital provided by professionally managed investment firms that invest alongside entrepreneurs and management teams in young, rapidly growing, or transforming companies with strong growth potential. Venture capital is a form of equity financing specifically intended for projects that involve high risk but also offer the possibility of high returns.

A common misconception is that venture capital is limited to financing high-technology businesses. In reality, venture capital is a long-term investment made in:

1. Ventures promoted by technically or professionally qualified but relatively inexperienced entrepreneurs.
2. Ventures aiming to commercialize innovative or unproven technologies.
3. High-risk business ventures with significant growth potential.

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The term venture capital refers to financial investment in projects that involve substantial risk, with the expectation of earning high returns, mainly through capital appreciation. Although the concept of venture capital has existed for many years, the economic liberalization policies introduced by the Government of India significantly accelerated the growth of venture capital financing in the country. Today, venture capital has become an important component of the Indian capital market, particularly due to the increasing number of technology-oriented entrepreneurs who possess innovative ideas but lack sufficient financial resources.

Venture capital firms (VCFs) provide the risk capital required by such entrepreneurs, often helping them meet the promoters' contribution required by financial institutions. Beyond financial support, these firms actively participate in mentoring, advising, and guiding the businesses in which they invest, thereby increasing the likelihood of their success.

Typically, venture capital is sought by young, high-growth companies in the early stages of development that are not yet prepared to raise funds through a public issue of securities. Venture capital funds generally provide long-term equity financing with the expectation of generating substantial returns, primarily in the form of capital gains. In this relationship, the venture capitalist functions not merely as an investor but also as a strategic partner of the entrepreneur.

Venture capitalists may provide seed capital for innovative ideas, new products, technology-based enterprises, and start-up firms. They may also invest in businesses that are unable to obtain financing through conventional sources such as banks or other financial institutions, thereby enabling promising ventures to grow and succeed.

5.1.2 Features of venture capital

Venture capital combines the characteristics of a banker, a stock market investor, and an entrepreneur. It provides financial support to high-potential businesses while actively contributing to their growth and development. The major features of venture capital are as follows:

1. High Degree of Risk

Venture capital involves investing in businesses with significant uncertainty and risk, such as start-ups and innovative ventures. Since many of these businesses are untested, the possibility of failure is high. However, venture capitalists accept this risk with the expectation of earning substantial returns if the venture succeeds.

2. Equity Participation

Venture capital financing is primarily provided in the form of equity or quasi-equity. Instead of earning fixed interest like traditional lenders, venture capitalists acquire an ownership stake in the business. Their return is mainly realised through capital gains when they sell their shares after the company achieves profitability or growth.

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3. Long-Term Investment

Venture capital is a long-term source of finance. Investments are generally held for several years, allowing the business sufficient time to develop, expand, and generate value before the venture capitalist exits the investment.

4. Active Participation in Management

Venture capitalists do more than provide financial assistance. They actively participate in the strategic direction and management of the enterprise by offering guidance, technical expertise, industry knowledge, and professional networks. Unlike traditional bankers or ordinary stock market investors, venture capitalists work closely with entrepreneurs to enhance the firm's chances of success. Hence, venture capital is often described as combining the roles of a banker, an investor, and an entrepreneur.

5. Contribution to Economic and Social Development

Although venture capital investments are driven primarily by the objective of earning profits, they also contribute to broader economic and social development. Successful venture-backed enterprises create employment opportunities, encourage innovation, promote entrepreneurship, and support balanced regional development by establishing new businesses in different parts of the country.

6. Exit through Liquidity Events

Venture capital investments are not repaid through periodic instalments or fixed repayment schedules, unlike bank loans. Instead, venture capitalists realize their returns through an exit, such as the sale of their equity stake to another investor, acquisition of the company, or listing of the company's shares on a stock exchange through an Initial Public Offering (IPO). This makes venture capital an equity-based investment rather than a debt obligation.

5.1.3 Types of venture capital

Venture capital financing is provided at different stages of a business depending on its financial requirements and growth potential. As a business progresses from an idea to a well-established enterprise, its funding needs change. Venture capitalists offer financial assistance at each stage to support the development, expansion, and long-term success of the business. Venture capital (VC) can be categorized by the stage of investment or by the type of investor.

A. Venture capital by stage of investment

1. Seed Capital

Seed capital is the earliest form of venture capital financing. It is provided to entrepreneurs who have an innovative business idea but lack the financial resources to convert that idea into a viable business. At this stage, the business may exist only as a concept, and no commercial production or sales have begun.

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The funds are mainly used for market research, product design, prototype development, technical feasibility studies, and preparing a business plan. Since there is considerable uncertainty regarding the success of the project, seed capital involves the highest degree of risk. However, if the venture succeeds, it offers substantial returns to the investor.

Example: A software engineer develops an idea for an artificial intelligence-based healthcare application. Venture capital is provided to develop a prototype and conduct market research before launching the product.

2. Start-up Financing

Start-up financing is provided to newly established businesses that have completed product development and are ready to begin commercial operations. At this stage, the enterprise requires funds to introduce its products or services into the market.

The financing is generally used for setting up production facilities, recruiting employees, purchasing equipment, marketing the product, and meeting initial working capital requirements. The objective is to help the business establish itself in the market and achieve commercial success.

Example: A company that has developed an eco-friendly packaging product receives venture capital to establish its manufacturing unit and launch the product in the market.

3. Early-Stage Financing (First-Stage Financing)

Early-stage financing is provided to businesses that have started production and sales but require additional funds to strengthen their operations. Although the business has entered the market, it may not yet have achieved stable profitability.

The funds are used to increase production capacity, improve product quality, strengthen distribution channels, expand marketing activities, and meet additional working capital requirements. This financing helps the company achieve sustainable growth during its initial years of operation.

Example: A food processing company experiencing increasing customer demand receives venture capital to expand production and strengthen its distribution network.

4. Expansion Financing (Second-Stage Financing)

Expansion financing is provided to businesses that have established themselves successfully in the market and are planning to grow further. At this stage, the company has demonstrated its commercial viability and seeks additional funds to expand its operations.

The financing may be used to increase production capacity, introduce new products, enter new geographical markets, modernise technology, establish additional production facilities, or acquire other businesses. Since the company has already demonstrated growth potential, the investment risk is relatively lower than in the earlier stages.

Example: A successful pharmaceutical company obtains venture capital to establish a new manufacturing plant and expand its export operations.

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5. Bridge Financing (Mezzanine Financing)

Bridge financing is a short-term form of venture capital provided to companies that are approaching a major financial event, such as an Initial Public Offering (IPO), merger, acquisition, or strategic investment. It serves as a temporary source of finance until long-term funds become available.

The purpose of bridge financing is to ensure that the company has sufficient funds to continue its operations and complete its expansion plans before raising capital from the public or institutional investors.

Example: A technology company preparing to issue shares to the public receives bridge financing to meet its operational expenses until the IPO is completed.

6. Development Capital

Development capital is provided to established companies that require funds for modernization, technological upgradation, diversification, or capacity expansion. Unlike early-stage financing, this type of investment is made in businesses that have already achieved financial stability.

The objective is to improve efficiency, increase competitiveness, and support long-term growth.

Example: A textile manufacturing company receives development capital to install modern automated machinery that improves productivity and reduces production costs.

7. Replacement Capital

Replacement capital involves the purchase of shares held by existing shareholders rather than providing new funds directly to the company. This enables the existing investors to exit their investment while introducing new investors into the business.

Replacement capital does not increase the company's financial resources but helps facilitate changes in ownership without affecting the company's operations.

Example: A venture capital firm purchases the shares of an early investor who wishes to exit a successful start-up.

8**. Management Buyout (MBO) Financing**

Management Buyout financing is provided when the existing management team wishes to acquire ownership of the company from its current owners. Venture capitalists provide financial assistance to enable the management to purchase the business.

This type of financing is common when business owners retire, restructure the company, or decide to transfer ownership to the management team.

Example: The senior managers of a manufacturing company obtain venture capital to purchase the company from its retiring promoters.

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9. Turnaround Financing

Turnaround financing is provided to companies experiencing financial difficulties but possessing the potential to recover and become profitable. Venture capitalists invest in such businesses after carefully assessing their prospects and restructuring plans. The funds are generally used to improve operations, repay urgent liabilities, modernize production facilities, strengthen management, and restore profitability. Since these businesses face financial challenges, turnaround financing involves relatively high risk. However, successful revival can generate significant returns for investors.

Example: A consumer electronics company facing temporary financial losses receives venture capital to restructure its operations and regain market competitiveness.

The different types of venture capital provide financial support throughout the life cycle of a business. From financing an innovative idea through seed capital to supporting expansion, restructuring, or public listing, venture capital plays a vital role in promoting entrepreneurship, technological innovation, and economic development. By providing both financial resources and managerial guidance, venture capitalists help businesses overcome challenges and achieve sustainable growth.

B. Venture Capital Based on Type of Investors

The major types of venture capital based on the type or source of investors are discussed below.

1. Institutional Venture Capital

Institutional venture capital refers to funds invested by specialised financial institutions such as venture capital firms, private equity firms, insurance companies, pension funds, and other investment institutions. These investors generally invest substantial amounts in businesses with high growth potential and expect returns through appreciation in the value of their investment.

2. Corporate Venture Capital (CVC)

Corporate venture capital refers to investments made by large, established companies in start-ups and emerging businesses. Such investments are made not only to earn financial returns but also to gain access to new technologies, innovative products, new markets, and business opportunities. CVC enables established companies to benefit from the innovation and growth potential of start-ups.

3.Government-Backed Venture Capital

Government-backed venture capital refers to funding provided directly or indirectly by governments or government-supported institutions to promote entrepreneurship, innovation, employment, and economic development. Such funding is particularly important for innovative and high-risk businesses that may face difficulties in obtaining finance from private investors.

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4.Private Venture Capital

Private venture capital refers to investment provided by privately owned venture capital firms, private investment groups, and high-net-worth individuals. These investors generally focus on businesses with significant growth potential and provide funds in exchange for an ownership interest or other financial rights. They may also provide managerial and strategic support to the investee business.

5.Foreign Venture Capital

Foreign venture capital refers to investments made by overseas venture capital firms, international investment funds, or foreign investors in businesses located in another country. Foreign venture capital can provide not only financial resources but also access to international markets, technology, managerial expertise, and global business networks.

6.Angel Investors

Angel investors are wealthy individuals who invest their personal funds in promising start-ups and early-stage businesses. They generally invest when the business is at a relatively early stage and may accept higher risks in expectation of high returns. In addition to finance, angel investors may provide valuable business experience, mentoring, and professional contacts.

5.1.4 Various Stages of Venture Capital Financing

Venture capital financing follows a systematic process that helps identify promising business ideas and provide financial support at different stages of their growth. The major steps are explained below.

1. Selection of Investment

The first step in venture capital financing is the evaluation of the business proposal submitted by the entrepreneur. The venture capital institution carefully examines the feasibility of the project before making an investment decision. Along with the feasibility reports prepared by development finance institutions for term loans or other financial assistance, the following aspects are also assessed:

- ◊ History and background of the project
- ◊ Track record and capabilities of the entrepreneur
- ◊ Market potential of the proposed business
- ◊ Projected future sales and turnover
- ◊ Expected profitability of the venture

2. Stages of Financing

Once the investment is selected, the venture capitalist determines the different stages at which financial assistance will be provided. Venture capital financing is broadly divided into early-stage financing and later or last-stage financing.

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A. Early-stage financing

Early-stage financing supports a business during its initial phases of development. It includes the following:

(a) Seed Capital Financing

Seed capital refers to the funds provided to an entrepreneur for conducting research and development before commercial production begins. It helps to transform an innovative idea into a viable business proposal. At this stage, the entrepreneur may develop a prototype, which may or may not eventually lead to a commercial product.

The venture capitalist evaluates whether the entrepreneur's technological capabilities are aligned with market opportunities. Since the product has not yet entered the market, the major risks relate to its successful commercialization. Factors such as market demand, competition, and the appropriate timing of product launch are carefully assessed. This stage involves the highest level of risk.

(b) Start-up Financing

Start-up financing is provided after the business has been established and is ready to begin commercial operations. At this stage, the enterprise starts manufacturing products or delivering services. Venture capitalists provide the required funds to support the commencement of business activities.

(c) Second-Round Financing

Second-round financing is provided after the product has been introduced into the market. Although the business has started operations, it is usually not yet profitable enough to issue shares to the public. Until this stage, the entrepreneur has primarily relied on personal funds.

The venture capitalist provides additional financial support for expansion and diversification, enabling the business to achieve economies of scale and strengthen its market position. The amount of funding at this stage is generally higher than that provided during the earlier phases.

B. Later stage financing/ last stage financing

Later-stage financing is provided to well-established businesses that require additional financial support but are unable to raise funds through a public issue. Such enterprises approach venture capital funds to obtain finance for business development, expansion, buyouts, replacement capital, or turnaround strategies.

1. Development Capital

Development capital refers to financial assistance provided to enterprises that have successfully moved beyond the highly risky start-up stage and have begun generating profits but are not yet in a position to raise funds from the public. These businesses require additional capital to support their growth and development.

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The funds are generally used for purchasing new machinery or equipment, expanding production facilities, strengthening marketing and distribution networks, introducing products into new markets, and undertaking similar growth-oriented activities. The investment period usually ranges from one to three years, and the associated level of risk is considered moderate.

2. Expansion Finance

Expansion finance is provided to businesses that require funds to increase the scale of their operations. Venture capitalists generally consider this type of financing to involve relatively low risk, as the business has already established its market presence.

The funds may be used to expand manufacturing capacity, construct larger factories or warehouses, establish new production units, introduce new products, enter new markets, or acquire existing businesses. The investment period generally ranges from one to three years and usually represents the final round of financing before the venture capitalist exits the investment.

3. Buyouts

Buyouts involve the transfer of ownership and management control of an existing business from its current owners to another group through venture capital financing.

Buyouts are classified into two types:

(i) Management Buyouts (MBOs)

In a Management Buyout (MBO), venture capital institutions provide financial assistance to the existing management team or current investors to acquire ownership of an existing business or product line. MBOs constitute an important area of venture capital activity, as the existing management is already familiar with the company's operations and business environment.

(ii) Management Buy-ins (MBIs)

A Management Buy-in (MBI) occurs when venture capital funds are provided to an external management team to acquire an existing company. This arrangement involves three parties: the new management team, the target company, and the venture capital institution.

MBIs are generally considered riskier than MBOs because the new management may find it difficult to accurately assess the true potential and operational challenges of the target company. Consequently, MBIs are less common and are usually undertaken in weaker or underperforming companies.

4. Replacement Capital

Replacement capital refers to venture capital financing provided for the purchase of shares held by existing shareholders. The objective is not to inject new funds into the business but to facilitate a change in ownership.

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Shareholders may decide to sell their holdings for various reasons, such as personal financial requirements, family disputes, or the desire to associate the company with a well-known investor. The investment period for replacement capital generally ranges from one to three years and is regarded as involving low risk.

5. Turnaround Financing

Turnaround financing is provided to financially distressed or sick companies that have the potential to recover and become profitable. This type of venture capital investment involves medium to high risk, with an investment period generally ranging from three to five years.

Turnaround financing often requires specialised managerial expertise and may involve restructuring the company's borrowings, changing the management team, or even transferring ownership. During the initial stages of the recovery process, venture capitalists usually adopt a hands-on approach by appointing their own chairman or nominating directors to the company's board to closely supervise and guide the restructuring process.

In conclusion, venture capital firms invest in both early-stage and later-stage ventures to maintain an appropriate balance between risk and return. While making early-stage investments, venture capitalists carefully evaluate the technology, market potential, and the entrepreneur's ability to implement the project. In later-stage investments, greater emphasis is placed on the company's business performance, growth prospects, track record, and opportunities for expansion into new markets.

5.1.5 Venture Capital Firms in India

Venture capital financing was almost non-existent in India until 1975, when the Industrial Finance Corporation of India (IFCI) established the Risk Capital Foundation (RCF). This marked the beginning of venture capital financing in the country.

In 1976, the Government of India, with financial assistance from the World Bank, created the Technical Development Fund (TDF) under the Ministry of Industry. The primary objective of this fund was to ensure the availability of adequate rupee resources for financing modernization programmes.

In 1986, the Government introduced the Venture Capital Fund (VCF) to encourage enterprises based on indigenous technology and to support the modernization of existing technologies. During the same period, Grindlays Bank of Australia established the Indian Technology Fund Ltd. (ITFL) to provide venture capital assistance to young and growing companies requiring funds during their early stages of development.

Public sector banks also entered the venture capital sector. State Bank of India (SBI) and Canara Bank started venture capital activities. SBI Capital Markets Ltd. (SBI Caps), the merchant banking subsidiary of SBI, launched a venture capital fund under its Bought-Out Deals Scheme, through which it invested in the equity shares of newly established companies.

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Similarly, the Industrial Credit and Investment Corporation of India (ICICI) established a venture capital fund to support small and medium entrepreneurs by providing initial equity capital. The fund primarily focused on the development and commercialization of indigenous technologies.

India also made a significant advancement by introducing venture capital financing in the biotechnology sector. Bangalore Genie Pvt. Ltd., based in Bengaluru, became India's first venture capital-supported biotechnology company engaged in manufacturing enzymes used in genetic engineering research and technology.

An important but often overlooked feature of venture capital financing in India is the support extended by commercial banks to small-scale industries. These industries face risks similar to venture capital projects, including managerial failures and high business uncertainty.

The major providers of venture capital in India, apart from commercial banks, can be classified into the following categories**:**

1. Specialised financial institutions and their financing schemes.
2. Funds promoted by state-level institutions.
3. Funds promoted by public sector banks.
4. Private agencies.
5. Overseas venture capital funds.

I. Specialised Financial Institutions and their Financing Schemes

In India, the three major financial institutions involved in financing high-technology ventures are the Industrial Finance Corporation of India (IFCI), the Industrial Development Bank of India (IDBI), and the Industrial Credit and Investment Corporation of India (ICICI). Although their schemes differ in objectives and operational features, all of them aim to promote entrepreneurship and technological innovation.

A. Risk Capital Scheme of IFCI

The Industrial Finance Corporation of India (IFCI) initiated equity financing through its Risk Capital Foundation (RCF) by providing risk capital assistance on favourable terms to first-generation entrepreneurs. The scheme was designed to support technologists and professionals who possessed innovative ideas but lacked sufficient financial resources to contribute equity towards industrial projects. Its objective was to broaden the entrepreneurial base and promote wider ownership and control of industries in the national interest.

To strengthen these efforts, IFCI established the Risk Capital and Technology Finance Corporation Ltd. (RCTFC) in 1988 as its wholly owned subsidiary. The corporation was created to provide financial assistance for projects involving innovative technology, energy conservation, and environmental protection.

Projects financed under this scheme include the development of artificial intelligence software, three-dimensional computer animation, educational robots, and hybrid seeds.

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Apart from implementing its own schemes, RCTFC also manages the Venture Capital Unit Scheme (VECAUS-III), which was launched in mid-1991 with a resource base of ₹30 crore contributed equally by the Unit Trust of India (UTI), IFCI, and the World Bank.

B. Technology Development and Information Company of India Ltd. (TDICI) of ICICI

Encouraged by the positive response to its technology financing initiatives, ICICI, in collaboration with the Unit Trust of India (UTI), established the Technology Development and Information Company of India Ltd. (TDICI) in 1988. Besides providing venture capital finance, TDICI offers technology consultancy and technology support services, including assistance in marketing, business management, export promotion, and project guidance for venture capital enterprises.

TDICI invests in projects that involve high risk but have the potential to generate substantial returns in the future. It gives preference to companies that are unable to raise funds through public issues and are unlikely to receive financial support from other institutions.

Apart from providing equity participation of up to 49%, which is common in venture capital financing, TDICI also offers conditional loans. Under this arrangement, the entrepreneur is not required to pay interest or repay the principal amount during the initial period. If the venture becomes successful, TDICI recovers its investment by receiving a royalty on sales, generally ranging between 2% and 8%. However, if the venture fails to become commercially viable even after five years, TDICI may decide to write off the loan.

TDICI generally appoints a nominee director to the boards of the companies in which it invests. It also assists these companies in arranging working capital finance, recruiting senior executives, and obtaining expert advice for important business decisions.

Some of the successful projects financed by TDICI include:

Mastek, a Mumbai-based software company, received an equity investment of ₹42 lakh from TDICI in 1989. The company went public in 1992 and achieved an annual turnover growth of 70–80%.

Temptation Foods, an exporter of frozen fruits and vegetables, received an equity investment of ₹50 lakh from TDICI before becoming a public company in November 1992.

C. Seed Capital Scheme (Venture Capital Fund) of IDBI

The Industrial Development Bank of India (IDBI) introduced the Seed Capital Scheme to encourage the emergence of a new generation of entrepreneurs who possess entrepreneurial abilities but lack adequate financial resources to establish industrial ventures. The scheme aims to meet the risk capital requirements of such entrepreneurs.

Through this venture capital fund, IDBI has successfully financed projects that promote indigenous technology in India. Financial assistance is provided to projects

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involving chemicals, software, electronics, biotechnology, food products, and medical equipment, particularly where the technology is new and untested.

The project cost eligible under this scheme ranges from ₹5 lakh to ₹250 lakh. Assistance is provided for financing fixed assets as well as meeting operating expenses through unsecured loans carrying a concessional interest rate of 6% per annum during the initial stages of development.

II. Funds Promoted by State-Level Institutions

Several state-level financial institutions have established venture capital funds to encourage technological innovation and industrial development.

a. APIDC Venture Capital Ltd. (AVCL)

APIDC Venture Capital Ltd. (AVCL) is a wholly owned subsidiary of the Andhra Pradesh Industrial Development Corporation Ltd. (APIDC). It functions as a specialised venture fund management company and is responsible for managing the APIDC Venture Capital Fund.

The fund has a capital base of ₹13.5 crore, contributed by APIDC, IDBI, Andhra Bank, Indian Overseas Bank (IOB), and a few other organisations.

AVCL invests in projects that introduce technological innovations aimed at improving product quality, reducing energy consumption, enhancing competitiveness, and increasing export potential.

b. Gujarat Venture Finance Ltd. (GVFL)

Gujarat Venture Finance Ltd. (GVFL) was promoted by the Gujarat Industries Investment Corporation Ltd. (GIIC) in association with the Gujarat Lease Finance Corporation Ltd., Gujarat Alkalies and Chemicals Ltd., and Gujarat State Fertiliser Corporation Ltd.

GIIC holds 40% of the equity capital of GVFL, while the remaining capital is contributed by the other participating organisations.

GVFL operates as a venture fund management company and serves as the trustee and manager of the Gujarat Venture Capital Fund (GVCF), which was established in 1990.

The company provides financial assistance for technological innovations that improve product quality, promote energy conservation, and support the introduction of new products based on imported technology.

III. Funds Promoted by Public Sector Banks like Canara Bank Venture Capital Fund (CVCF)

The Canara Bank Venture Capital Fund (CVCF) was established jointly by Canara Bank and its subsidiary, Canbank Financial Services Ltd. (CANFINA). It was set up as a trust in 1989 with a capital base of ₹24 crore.

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The fund provides financial assistance in the form of equity capital, conditional loans, conventional loans, or a combination of these forms. Its primary objective is to support the commercial exploitation of new technologies, encourage technological upgradation, improve product quality, and promote innovation across various industries.

IV. Private Agencies

Several venture capital funds have been established in the private sector to finance innovative business ventures. Some of the major private venture capital funds in India are:

1. Credit Capital Venture Fund (CCVF)
2. 20th Century Venture Capital Fund
3. India Investment Fund
4. Indus Venture Capital Fund (IVCF)
5. SBI Capital Venture Capital Fund

1. Credit Capital Venture Fund (CCVF)

The Credit Capital Venture Fund (India) was established in 1986 with a capital base of ₹10.8 crore. Its principal shareholders include Credit Capital Finance Corporation, Bank of India, Asian Development Bank (ADB), and the Commonwealth Development Corporation.

The fund finances high-risk ventures that have the potential to generate substantial returns. Financial assistance is generally limited to ₹50 lakh for each project.

In addition to providing finance, CCVF offers value-added advisory services and actively supports entrepreneurs in areas such as marketing, recruitment, and management. This comprehensive assistance enables entrepreneurs to maximize the success of their ventures.

The fund has also launched ten state-level venture capital funds, each with a corpus of ₹10 crore. It is presently known as Lazard Credit Capital Fund (India) Ltd. (LCCVF).

2. 20th Century Venture Capital Fund

The 20th Century Venture Capital Fund was promoted by 20th Century Finance Ltd. with a resource base of ₹20 crore.

Its primary objective is to revive sick industrial units and provide financial support to first-generation entrepreneurs who possess promising business ideas but require capital assistance.

3. India Investment Fund

The India Investment Fund is recognised as India's first private venture capital fund, with the majority of its investments coming from Non-Resident Indians (NRIs). It was established as an offshore company in 1987.

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The fund provides equity or equity-linked finance to new ventures as well as to young and established Indian companies that demonstrate strong potential for sustained growth. The maximum financial assistance provided to a single venture is ₹1 crore.

Its principal investment objective is to achieve long-term capital appreciation.

The Merchant Banking Division of Grindlays Bank serves as the investment adviser to the fund by evaluating and recommending suitable investment proposals. The fund generally follows a hands-off investment approach, allowing entrepreneurs to manage their businesses independently after receiving financial assistance.

4. Indus Venture Capital Fund (IVCF)

The Indus Venture Capital Fund (IVCF) was promoted by Shri T. Thomas, the former Director of Unilever.

The management of the fund is entrusted to Indus Venture Management Ltd. (IVML).

IVCF has a capital resource of ₹21 crore, contributed by IVML, IDBI, IFCI, Deutsche Bank, the International Finance Corporation (Washington), and several other national and international organisations. The fund aims to finance innovative business ventures with significant growth potential.

5. SBI Capital Venture Capital Fund

The SBI Capital Venture Capital Fund was established by SBI Capital Markets Ltd. to finance business ventures through its Bought-Out Deals Scheme.

The objective of this fund is to promote new capital issues by purchasing securities when the capital market is weak and selling them when market conditions improve. Through this strategy, the fund supports new companies while earning capital gains.

The fund has a capital base of ₹10 crore.

V. Overseas Venture Capital Funds

Overseas venture capital funds generally invest in sectors that offer high and assured returns, such as tourism, healthcare, air transport, information technology, and communication.

Foreign venture capitalists have also invested in industries including pharmaceuticals, consumer durables, food processing, machinery components, and textiles.

Some notable examples of overseas venture capital initiatives in India are:

1. American International Group (AIG) collaborated with Infrastructure Leasing & Financial Services (IL&FS) to establish a venture capital fund worth US$150 million.
2. IL&FS also planned to launch another venture capital fund of US$100 million in association with the Asian Development Bank (ADB).
3. George Soros established the Indocean Fund to invest in promising ventures.

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4. NIKKO Securities, in partnership with Walden and the San Francisco Company, proposed a venture capital fund with a minimum capital of US$50 million.

5.1.6 Leading Domestic & Foreign Venture Capital Firms Operating in India

- ◊ Peak XV Partners (formerly Sequoia Capital India): One of the largest VC investors in the region, backing major unicorns across technology, fintech, and consumer sectors.
- ◊ Accel India: Prominent early-stage backer with major investments in e-commerce, SaaS, and digital services.
- ◊ Blume Ventures: Leading domestic early-stage Indian fund focusing on deep-tech, fintech, and consumer internet.
- ◊ Kalaari Capital: Early-stage venture fund focused on technology-enabled ventures in India.
- ◊ Matrix Partners India: Stage-agnostic investor supporting tech-driven startups across financial services, healthcare, and enterprise software.

Recap

- ◊ Venture capital is financing provided to innovative start-ups and high-growth businesses with high risk and return potential.
- ◊ Venture capital is characterized by equity participation, high risk, long-term investment, and managerial support.
- ◊ Venture capital is classified into seed capital, start-up financing, early-stage financing, expansion financing, bridge financing, buyout financing, and turnaround financing.
- ◊ Venture capital financing progresses through seed, start-up, early, expansion, later-stage, and exit stages as the business grows.
- ◊ Venture capital firms in India finance and mentor promising businesses to promote entrepreneurship and innovation.

Objective Questions

1. Who provides venture capital financing?
2. Which type of business usually receives venture capital?

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3. What is the primary objective of venture capital investment?
4. Which stage of venture capital financing supports the development of a business idea?
5. What is bridge financing?
6. Why is venture capital considered a high-risk investment?
7. What is the usual exit route for venture capitalists after business growth?
8. Why do venture capitalists carefully evaluate business plans before investing?

Answers

1. Venture capital firms or venture capital funds.
2. Start-ups and innovative businesses with high growth potential.
3. To earn capital appreciation and high returns.
4. Seed stage.
5. Short-term finance provided before a company raises funds through a public issue.
6. Because it is invested in new and unproven businesses.
7. Selling their equity through an IPO or strategic sale.
8. To assess the feasibility and growth potential of the venture.

Self-Assessment Questions

1. Define venture capital.
2. Describe the various stages of venture capital financing.
3. Differentiate between seed financing and start-up financing.
4. List the major features of venture capital.
5. Write a note on venture capital firms in India
6. Briefly explain the types of venture capital
7. "Venture capital is limited to financing high-technology businesses" -Do you agree with this statement?

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Assignments

1. A technology-based start-up has developed an innovative product but requires funds to commercialize it. Identify the appropriate stage of venture capital financing and justify your answer.
2. Assess the contribution of venture capital to the growth of innovative enterprises in India.
3. Critically examine the advantages and limitations of venture capital financing for entrepreneurs.

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Unit 2
Securitisation of debt

Learning Outcomes

After completing this unit, the learner will be able to;

- ◊ comprehend the concept of Securitisation and the parties involved in the process
- ◊ explain the sequential steps involved in the Securitisation process.
- ◊ classify different types of securitisation based on the nature of the underlying assets.
- ◊ describe the advantages and disadvantages of Securitisation.

Prerequisite

Presume a housing finance company that has provided home loans to hundreds of customers. Every month, these customers repay their loans through instalments. Although the company will receive money regularly over several years, it may need a large amount of money immediately to provide new loans to other customers. The company therefore looks for a way to convert these future loan repayments into funds that can be raised today.

To achieve this, the company can pool together a number of similar loans and transfer the pool to another entity. The expected future cash flows from these loans can then be used to create financial securities, which are offered to investors. The money received from investors provides immediate funds to the lending institution, while investors receive returns from the cash flows generated by the underlying loans.

This situation provides the background for understanding Securitisation, including the different parties involved, the

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process through which loans are converted into securities, its various types, and the benefits and limitations associated with it.

Keywords

Securitisation, parties of Securitisation, Securitisation Steps.

Discussion

In financial markets, institutions often hold assets such as home loans, vehicle loans, or other receivables that generate regular future cash flows. However, these assets may not provide immediate liquidity to the institution. Securitisation provides a mechanism through which such financial assets can be pooled and transformed into marketable securities.

The process involves several participants, each performing a specific role in transferring the underlying assets and distributing the resulting securities to investors. Depending on the nature of the underlying assets and the structure adopted, securitisation can take different forms. It can provide financial institutions with liquidity, better utilisation of funds and access to alternative sources of finance, but it may also involve risks, complexity, costs and difficulties in managing the underlying assets.

5.2.1 Meaning of Securitisation

Securitisation is the process of converting illiquid and long-term financial assets, such as loans and receivables, into marketable securities. These securities can be bought and sold in the financial market, enabling financial institutions to convert future cash flows into immediate funds.

In this process, a financial institution pools together similar financial assets, creates securities backed by these assets, obtains a credit rating for the securities, and sells them to investors. As a result, long-term assets are removed from the institution's balance sheet and replaced with liquid cash. The funds received can then be used to create new assets, making Securitisation a continuous cycle of converting assets into securities, securities into cash, and cash into new assets.

Suppose a bank has granted 1,000 home loans that will be repaid over the next 20 years. Instead of waiting for the repayments, the bank bundles these loans and converts them into securities, which are sold to investors. The bank receives immediate cash, while the investors earn returns from the borrowers' monthly loan repayments. This process is known as Securitisation.

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5.2.2 Definition of Securitisation

The concept of Securitisation can be defined as follows:

"A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset-backed securities".

Yet another simple definition is as follows:

" Securitisation is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

According to Hendersen, J. and Scott, J.P., " Securitisation is the process which takes place when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead by investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse to the original lender".

5.2.3 Parties involved in Securitisation

For the operational mechanics of Securitisation, the following parties are required.

1. Originator

The originator is the financial institution or business that creates and owns financial assets, such as loans or receivables, during the normal course of its operations. In a Securitisation transaction, the originator pools these assets and transfers them to a Special Purpose Vehicle (SPV), thereby transferring the associated credit and other risks.

2. Issuer / Special Purpose Vehicle (SPV)

The issuer is a Special Purpose Vehicle (SPV), also known as a Special Purpose Entity (SPE) or Special Purpose Company (SPC). It is established specifically for the Securitisation transaction under a trust or similar legal arrangement. The SPV acquires the pooled assets from the originator, holds them on behalf of investors, and issues securities backed by these assets. Since it issues the securities, it is also referred to as the issuer.

3. Investors

Investors are the final buyers of the securities issued through the Securitisation process. They are generally banks, insurance companies, pension funds, and other institutional investors. They invest in these securities and receive returns from the cash flows generated by the underlying assets.

4. Underwriters / Placement Agents

Underwriters or placement agents are responsible for structuring the Securitisation transaction. They prepare the required legal and financial documents, such as offering

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documents, purchase agreements, trust agreements, and custodial agreements, and help market the securities to investors.

5. Custodian

The custodian is usually a bank that safely holds the securitized assets on behalf of the trustee. It acts as an agent responsible for safeguarding the receivables throughout the transaction.

6. Rating Agencies

Rating agencies evaluate the credit quality of the securitized assets and the securities issued against them. They assess factors such as the originator's financial strength, management quality, organizational structure, and administrative procedures before assigning a credit rating.

7. Servicer

The servicer manages the underlying assets on a day-to-day basis. Its responsibilities include collecting loan repayments or receivables from borrowers and transferring the collected funds to the accounts managed by the trustee. In most cases, the originator itself acts as the servicer.

8. Backup Servicer

A backup servicer takes over the servicing responsibilities if the primary servicer is unable to perform its duties. It ensures that collections and payments continue without interruption. In some transactions, the trustee appoints the backup servicer to monitor the servicing process on a regular basis.

9. Indenture Trustee

The indenture trustee is the trustee appointed under the trust or indenture agreement. It represents and protects the interests of investors, oversees compliance with the terms of the Securitisation agreement, and ensures that the rights of security holders are safeguarded throughout the transaction.

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5.2.4 Steps of Securitisation

Securitisation can be structured in several ways depending on the nature of the assets and the requirements of the transaction. Despite these variations, all Securitisation transactions follow a common basic framework. In its simplest form, Securitisation involves the transfer of a pool of receivables, created by an entity known as the originator during the normal course of business, to a Special Purpose Vehicle (SPV) that is legally structured to be bankruptcy-remote. The transfer is carried out as a true sale, ensuring that the assets are separated from the originator. The process involves several stages and requires the execution of various legal and financial documents, as explained below.

1. The process begins with the originator generating and pooling receivables in the ordinary course of business. These receivables are initially funded and recorded on the originator's balance sheet.

2. The underwriters or placement agents, along with the credit rating agencies, conduct a detailed due diligence of the originator, the asset pool, and the servicing procedures. Rating agencies may also visit the originator to assess the quality of management, organisational structure, and administrative systems.
3. After a sufficiently large portfolio of receivables has been created, the originator and the underwriter or placement agent jointly design the structure of the Securitisation transaction. Rating agencies often participate in this structuring process to ensure that the proposed transaction meets the desired credit standards.
4. Legal advisers representing the originator and the underwriters or placement agents prepare the draft transaction documents required for executing the Securitisation.
5. The originator and the SPV execute the necessary agreements, including underwriting or private placement agreements and agreements with the rating agencies.
6. The originator transfers the receivables to the SPV through a purchase agreement, thereby effecting the true sale of the assets.
7. Although ownership of the receivables is transferred to the SPV, the servicing and administration of these assets are generally outsourced back to the originator under a servicing arrangement.
8. The SPV finances the acquisition of the receivables by issuing marketable securities to investors. The repayment of these securities depends entirely on the cash flows generated by the underlying asset pool, and investors generally have no claim against the originator except in cases involving contractual breaches.
9. After entering into a custodian agreement, the originator delivers the receivables, on behalf of the SPV, to a custodian who holds them for the benefit of the indenture trustee.
10. The securities issued by the SPV are then evaluated, assigned a credit rating, and priced by the rating agency before being offered to investors.
11. The SPV sells these securities either to underwriters for distribution to investors or directly to investors through private placement arrangements managed by placement agents under Note and Certificate Purchase Agreements.
12. Investors subscribe to the securities because they expect timely payment of interest and repayment of principal from the cash flows generated by the receivables. The funds raised through the issue of securities are used by the SPV to pay the originator for the receivables transferred.
13. The servicer collects payments from the borrowers. After deducting approved servicing fees and related expenses, the remaining funds are deposited into a collection account managed by the indenture trustee and invested in eligible securities. Whenever payments to investors become due, the required funds are released from this collection account.
14. Any surplus generated during the funding process is paid by the SPV to the originator. Although ownership of the receivables has been transferred, the

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originator generally continues to maintain its relationship with borrowers, services the receivables, and benefits economically from managing the asset portfolio.

In a Collateralised Loan Obligation (CLO) transaction, the originator pools a portfolio of loans and transfers its rights, including the associated collateral, to a bankruptcy-remote SPV. The SPV subsequently raises funds by issuing securities to investors, with repayments supported by the cash flows generated from the underlying loan portfolio.

5.2.5 Types of Securitisation

Securitisation takes various forms depending on the type of assets involved and the objectives of the transaction. Each type has unique features, underlying assets, and methods of distributing risk and returns among investors.

1. Mortgage-Backed Securitisation (MBS)

Mortgage-Backed Securitisation (MBS) is a type of Securitisation in which a pool of residential or commercial mortgage loans is sold by a financial institution to a Special Purpose Vehicle (SPV). The SPV finances the purchase by issuing securities to investors. The monthly principal and interest payments made by borrowers on their mortgage loans are passed on to the investors as returns. MBS enables banks and housing finance companies to recover funds quickly and issue new housing loans without waiting for existing loans to mature.

For example, A housing finance company pools 10,000 home loans worth ₹1,000 crore and transfers them to an SPV. The SPV issues mortgage-backed securities to investors, who receive periodic returns from the monthly EMIs paid by the homeowners.

2. Asset-Backed Securitisation (ABS)

Asset-Backed Securitisation (ABS) involves the Securitisation of financial assets other than mortgage loans. The underlying assets may include auto loans, credit card receivables, education loans, consumer loans, lease receivables, or trade receivables. These assets generate regular cash flows, which are used to make interest and principal payments to investors. ABS helps financial institutions improve liquidity and transfer credit risk. For example, A non-banking financial company (NBFC) transfers its portfolio of vehicle loans to an SPV. The SPV issues asset-backed securities, and investors receive payments from the EMIs collected from vehicle loan borrowers.

3. Collateralised Debt Obligations (CDOs)

A Collateralised Debt Obligation (CDO) is a type of securation in which different types of debt assets, such as corporate loans, bonds, mortgages, and asset-backed securities, are pooled together and transferred to a Special Purpose Vehicle (SPV). The SPV finances the purchase of these assets by issuing securities to investors.

The securities are divided into different tranches (classes) based on the level of risk and expected return. The senior tranche has the lowest risk and receives

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payments first, so it offers lower returns. The mezzanine tranche carries moderate risk and return, while the equity (junior) tranche bears the highest risk but offers the highest potential return. Investors can choose the tranche that matches their risk appetite. The income generated from the repayments of the underlying loans and bonds is distributed among investors according to the priority of their tranche. If an investment bank pools corporate loans, commercial mortgages, and corporate bonds worth ₹2,000 crore and transfers them to an SPV. The SPV issues three tranches of CDOs:

- ◊ Senior Tranche: Receives payments first and has the lowest risk.
- ◊ Mezzanine Tranche: Receives payments after the senior tranche and has moderate risk.
- ◊ Equity (Junior) Tranche: Receives payments last and bears the highest risk but has the potential for higher returns.

If all borrowers repay on time, all investors receive their returns. However, if some borrowers default, the losses are first borne by the equity tranche, then the mezzanine tranche. In contrast, the senior tranche is affected only if the losses become very large.

, A CDO pools different types of debt assets and divides them into risk-based tranches, allowing investors to choose securities according to their desired level of risk and return.

4. Collateralised Loan Obligations (CLOs)

Collateralised Loan Obligations (CLOs) are a specialised form of CDOs that are backed mainly by corporate loans, particularly leveraged loans provided to companies. Professional managers actively manage the loan portfolio to maximise returns while controlling risk. CLOs provide companies with access to financing and offer investors diversified exposure to corporate debt.

Suppose ABC Bank has provided loans to five companies:

- ◊ XYZ Motors – ₹100 crore
- ◊ Bright Cement Ltd. – ₹80 crore
- ◊ Green Energy Ltd. – ₹120 crore
- ◊ Metro Infrastructure Ltd. – ₹90 crore
- ◊ Sunrise Textiles Ltd. – ₹110 crore
- ◊ The total corporate loan portfolio is ₹500 crore.

Instead of waiting several years for these companies to repay their loans, ABC Bank transfers the entire ₹500 crore loan portfolio to an SPV. The SPV purchases these loans and issues CLO securities to investors.

As the five companies make their regular interest and principal repayments, the SPV distributes these cash flows to the investors according to the priority of their tranche

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5. Collateralised Mortgage Obligations (CMOs)

Collateralised Mortgage Obligations (CMOs) are a type of mortgage-backed security in which the cash flows from mortgage loans are divided into different tranches. Each tranche has its own maturity period, payment schedule, and risk level. This structure allows investors to choose securities that best suit their investment objectives and risk preferences.

For instance, an SPV purchases a pool of residential mortgage loans and issues three tranches of CMOs. Investors seeking stable income invest in the senior tranche, while those seeking higher returns invest in the junior tranche.

6. Future Flow Securitisation

Future Flow Securitisation involves raising funds by securitising expected future receivables rather than existing assets. These receivables may arise from exports, toll collections, airline ticket sales, royalty income, or utility payments. This type of Securitisation is particularly useful for organisations with stable and predictable future cash flows.

Suppose an airport authority securitises its expected passenger service fee collections for the next ten years. Investors are repaid from the future fees collected from passengers it is future flow Securitisation.

7. Whole Business Securitisation

Whole Business Securitisation is a transaction in which the entire operating cash flow of a business is used as collateral for issuing securities. Instead of relying on a specific pool of receivables, the SPV receives cash generated from the business operations, such as franchise fees, royalties, or subscription income. It is commonly used by businesses with stable and predictable revenues.

For example, a restaurant chain may transfer its future franchise royalty income to an SPV, which issues securities to investors. The royalty income collected from franchisees is used to make payments to investorsit is ; it is a whole-of-business securitisation.

8. Synthetic Securitisation

Synthetic Securitisation is a type of Securitisation in which the originator (usually a bank) does not sell the underlying assets, such as loans, to a Special Purpose Vehicle (SPV). Instead, the bank retains ownership of the loans but transfers only the credit risk (the risk that borrowers may fail to repay) to investors using financial instruments such as credit default swaps (CDSs) or credit-linked notes (CLNs).

Since the loans remain on the bank's balance sheet, the bank continues to collect loan repayments and manage customer relationships. However, if some borrowers default, the investors who have agreed to take on the credit risk bear the agreed losses. This enables the bank to reduce its exposure to credit risk while continuing to earn income from the loans.

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For example, A bank has a portfolio of corporate loans worth ₹500 crore. Instead of selling these loans, the bank enters into a credit default swap agreement with investors. The bank continues to own the loans and collects interest and principal payments from the borrowing companies. If any company defaults on its loan, the investors compensate the bank for the agreed loss. Thus, the ownership of the loans remains with the bank, but the credit risk is transferred to the investors.

In short, traditional Securitisation transfers both the assets and the associated risks, whereas synthetic Securitisation transfers only the credit risk while the assets remain with the originator.

5.2.6 Advantages of Securitisation

Securitisation offers significant benefits to all parties involved in the transaction, including issuers, investors, and the financial system. By converting illiquid assets into marketable securities, it improves liquidity, enhances risk management, facilitates efficient capital allocation, and contributes to the overall development and stability of the financial markets.

A. To the Issuer (Originator)

1. Improves Capital Adequacy Ratio

Banks and financial institutions are required to maintain a minimum Capital to Risk-Weighted Assets Ratio (CRAR) under the Basel Committee guidelines. Loan portfolios generally carry a 100% risk weight. By securitising these loan assets, they are removed from the originator's balance sheet. The cash received can then be invested in assets with lower risk weights, thereby improving the institution's capital adequacy ratio.

2. Facilitates Better Asset-Liability Management

Securitisation improves the liquidity position of the originator by converting illiquid assets into cash. This enables banks and financial institutions to manage their asset mix more efficiently and reduces their dependence on costly traditional sources of borrowing. Since the cost of raising funds through Securitisation depends primarily on the quality of the underlying assets rather than the originator's credit rating, funds can often be raised at a lower cost, thereby improving the spread between interest income and interest expense.

3. Enhances Profitability

The originator can earn income by charging processing fees on loans and by receiving servicing fees from the Special Purpose Vehicle (SPV) for managing the securitised assets. In addition, profits from the sale of securitised assets are generally recognised upfront, leading to improved profitability and stronger financial performance.

4. Enables Risk Diversification

Securitisation allows the issuer to transfer credit risk associated with specific borrowers or sectors to investors. As a result, the originator can reduce its concentration of risk and achieve better diversification of its loan portfolio.

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5. Reduces Reserve Requirements

The cash generated through Securitisation is generally not subject to reserve requirements such as the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). This enables banks to utilise their funds more efficiently.

6. Supports Creation of New Loans

By selling illiquid loan assets, banks receive immediate cash without increasing their deposit liabilities. These funds can be used to issue new loans, allowing banks to expand lending while maintaining the same level of liabilities. Thus, Securitisation enhances the lending capacity of financial institutions.

B. Advantages to Investors

1. High Liquidity

Securitised securities are usually rated by recognised credit rating agencies, making them more acceptable in the secondary market. This provides investors, particularly institutional investors, with greater liquidity and flexibility.

2. Greater Safety

Asset-backed securities supported by credit enhancement mechanisms offer a high degree of safety. They are particularly attractive to conservative investors who prefer stable investments with relatively lower risk.

3. Higher Returns

Securitised instruments often provide higher yields than many conventional corporate debt securities. Consequently, investors may earn better returns while maintaining a reasonable level of risk.

4. Portfolio Diversification

Since Securitisation involves pooling assets from different borrowers, industries, and geographical regions, investing in securitised securities helps investors diversify their portfolios and reduce overall investment risk.

C. Advantages to the Financial System

1. Reduces the Overall Cost of Financing

Securitisation separates the lending and funding functions, allowing different institutions to specialise in various stages of the financing process. This specialisation improves efficiency, creates economies of scale, and ultimately reduces the overall cost of financing for the economy and its customers.

2. Improves the Flow of Funds

Securitisation channels funds from investors with surplus capital to sectors that require financing, such as housing, infrastructure, and other productive industries. This improves the availability of funds and supports economic growth.

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3. Enhances Financial Stability

Risks such as credit risk, liquidity risk, and interest rate risk can be separated and transferred to market participants that are better equipped to manage them. This efficient distribution of risk contributes to a stronger and more stable financial system.

4. Promotes Development of the Debt Market

The introduction of securitised instruments and the growth of an active secondary market increase the depth and liquidity of the debt market. As observed in many developed financial markets, Securitisation contributes to a more vibrant, efficient, and well-developed capital market.

5.2.7 Limitations of Securitisation

Although Securitisation provides several benefits, it also has certain limitations due to its complex structure, dependence on the quality of underlying assets, and exposure to market and regulatory risks.

1. Complex Process

Securitisation involves multiple parties, such as the originator, Special Purpose Vehicle (SPV), credit rating agencies, trustees, and investors. The involvement of several participants and legal formalities makes the process complex and time-consuming.

2. High Transaction Costs

The process requires legal services, credit ratings, underwriting, asset servicing, and administrative support. These costs make Securitisation economical mainly for large asset pools and less suitable for smaller transactions.

3. Dependence on Asset Quality

The success of Securitisation depends on the quality of the underlying assets. If borrowers fail to repay their loans or the assets perform poorly, the cash flows to investors decline, reducing the value of the securities.

4. Credit and Default Risk

Although credit enhancement techniques reduce risk, they cannot eliminate it completely. If a large number of borrowers default, investors may suffer financial losses.

5. Market Risk

The demand for securitised securities depends on market conditions. During periods of economic uncertainty or financial crises, investors may avoid such securities, making it difficult for issuers to raise funds.

6. Prepayment Risk

Borrowers may repay their loans before the scheduled maturity, particularly when

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interest rates fall. This reduces the expected interest income and creates uncertainty in cash flows for investors.

7. Regulatory and Legal Challenges

Securitisation transactions must comply with various legal, accounting, taxation, and regulatory requirements. Changes in regulations may increase compliance costs and delay transactions.

8. Systemic Risk

Improper use of Securitisation and weak lending standards can increase risks in the financial system. The 2008 global financial crisis highlighted how excessive Securitisation of poor-quality mortgage loans contributed to widespread financial instability.

Recap

- ◊ Securitisation is the process of converting illiquid financial assets into marketable securities to generate immediate funds.
- ◊ Securitisation enables financial institutions to transform loans and receivables into tradable securities backed by future cash flows.
- ◊ Securitisation involves key participants such as the originator, SPV, investors, underwriters, servicer, custodian, trustee, and credit rating agencies, each performing a specific role.
- ◊ The Securitisation process includes pooling assets, transferring them to an SPV, issuing securities, and distributing cash flows from the underlying assets to investors.
- ◊ Securitisation can be structured in different forms, such as MBS, ABS, CDOs, CLOs, CMOs, Future Flow, Whole Business, and Synthetic Securitisation, depending on the underlying assets and objectives.
- ◊ Securitisation improves liquidity, enhances risk management, lowers funding costs, and promotes efficient capital allocation for issuers, investors, and the financial system.
- ◊ Securitisation is affected by transaction complexity, high costs, asset quality, market conditions, and regulatory risks, requiring careful structuring and oversight.

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Objective Questions

1. Which type of assets are commonly securitized?
2. Who creates and transfers the financial assets in a Securitisation transaction?
3. What is the primary purpose of a Special Purpose Vehicle (SPV)?
4. Who are the final buyers of securitised securities?
5. What is the first step in the Securitisation process?
6. What is Mortgage-Backed Securitisation (MBS)?
7. What is Asset-Backed Securitisation (ABS)?
8. Which global financial event highlighted the risks of poorly managed Securitisation?
9. Why are credit ratings important in Securitisation?

Answers

1. Loans and receivables.
2. Originator
3. To acquire assets and issue securities backed by those assets.
4. Investors
5. Pooling of receivables by the originator.
6. Securitisation backed by residential or commercial mortgage loans.
7. Securitisation backed by non-mortgage financial assets such as vehicle loans and credit card receivables.
8. The 2008 Global Financial Crisis.
9. They help investors assess the credit risk of the securities.

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Self-Assessment Questions

1. Define Securitisation.
2. Explain the concept of Securitisation in your own words.
3. List the major parties involved in a Securitisation transaction.
4. Describe the role of the Special Purpose Vehicle (SPV) in Securitisation.
5. Outline the major steps involved in the Securitisation process.
6. Identify the different types of Securitisation.
7. Explain the difference between traditional Securitisation and synthetic Securitisation.
8. Summarise the major advantages of Securitisation.
9. State the major limitations of Securitisation.

Assignments

1. Explain the steps involved in the Securitisation process with the help of a suitable example.
2. A bank has a large portfolio of housing loans but requires immediate funds to issue new loans. Explain how Securitisation can help the bank achieve this objective.
3. Design a flowchart illustrating the complete Securitisation process and explain the role of each major participant.

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6 BLOCK

FinTech

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Unit 1
Introduction to FinTech

Learning Outcomes

- ◊ comprehend the concept of FinTech and its key characteristics
- ◊ trace the evolution of FinTech across different stages of financial development
- ◊ explain the relevance of FinTech in modern financial system
- ◊ aware of major innovations and transformations in FinTech

Prerequisite

Anita started a small homemade snacks business while studying in college. During the initial days, customers paid mostly in cash, and she maintained a notebook to record daily sales. When she wanted to save money or transfer payments to suppliers, she had to visit a bank branch, wait in queues, and complete paperwork. Keeping track of transactions and managing her finances often took a considerable amount of time.

As her business grew, she began using digital payment apps that allowed customers to pay by scanning a QR code. She started receiving instant payment notifications, checking her account balance through her phone, and transferring money to suppliers within seconds. Later, she explored an online investment app to save a portion of her earnings and used a digital platform to compare and purchase insurance for her business.

Within a short period, many of the financial activities that once required physical visits to banks became available through

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her smartphone. The same pattern can be seen in the lives of students, salaried employees, entrepreneurs, and even people in rural areas, where technology has made financial services quicker, simpler, and more accessible than before.

These changes raise an important question: How has technology transformed the financial sector so rapidly, and what role does it play in creating new financial services and opportunities? Understanding this transformation provides the foundation for studying the ideas and developments covered in this unit.

Keywords

Fintech, Block chain, Digital payments, Peer-peer lending

Discussion

The financial sector has undergone significant changes with the rapid growth of digital technologies. Earlier, most financial services depended on physical branches, paper-based processes, and manual transactions. With advancements in smartphones, the internet, cloud computing, artificial intelligence, and digital payment systems, financial services have become more efficient, secure, and customer-oriented.

This transformation has led to the emergence of Financial Technology (FinTech), which combines finance and technology to improve the delivery of financial services. FinTech has expanded beyond digital payments to include lending, investments, insurance, wealth management, blockchain-based services, and many other innovations. It has become an important driver of financial inclusion, business growth, and digital economic development. To understand this transformation, it is necessary to examine the concept of FinTech, its evolution, its relevance in the modern economy, and the innovations that continue to reshape the financial services industry.

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6.1.1 Concept of FinTech

Financial Technology, commonly known as FinTech, is formed from the combination of the words “Financial” and “Technology.” It refers broadly to the use of technology to introduce, improve, automate, and deliver financial products and services. FinTech brings together financial services and modern technologies to make financial activities faster, more convenient, accessible, efficient, and increasingly digital.

Unlike traditional financial systems that often rely on physical branches and manual processes, FinTech uses mobile applications, online platforms, cloud computing, artificial intelligence, and other digital technologies to deliver financial services. Today, people can transfer money, pay bills, invest, purchase insurance, and even apply for loans using their smartphones or computers.

The concept of FinTech is broader than simply providing financial services through mobile applications or websites. It includes technology-enabled financial innovation that can create new business models, products, services, applications, and processes and can influence financial institutions and financial markets. Thus, FinTech may involve both new technology-based businesses and established banks, insurance companies, investment firms, and other financial institutions adopting advanced technologies.

Examples of FinTech

FinTech covers a wide range of digital financial services, including:

- ◊ Mobile payment applications: PhonePe, Google Pay, Paytm, Amazon Pay, MobiKwik, BHIM UPI, Razorpay, and Freecharge.
- ◊ Digital banking: Internet banking and mobile banking services offered by banks.
- ◊ Cryptocurrencies: Digital currencies such as Bitcoin that operate using blockchain technology.
- ◊ Online lending platforms: Peer-to-peer (P2P) lending and digital loan providers.
- ◊ Robo-advisors: Automated investment and financial planning services.
- ◊ Blockchain technology: A secure digital ledger used for recording financial transactions.
- ◊ Digital wallets: Applications that store money electronically for cashless payments.
- ◊ Online investment platforms: Platforms that allow users to invest in stocks, mutual funds, and other financial products through digital channels.

These innovations have transformed the financial sector by making services more accessible, reducing transaction time, lowering costs, and improving the overall customer experience.

6.1.2 Major Areas of FinTech

FinTech is used in different areas of financial services. Some of the major areas are discussed below.

1. Digital Payments

FinTech has significantly changed the way people make payments. Mobile payment applications, digital wallets, contactless payments, and instant payment systems enable individuals and businesses to transfer money and make payments electronically. Examples include UPI-based payments, PhonePe, Google Pay, Paytm, BHIM, and other digital payment platforms.

2. Digital Banking

Banks increasingly use FinTech to provide banking services through internet and mobile platforms. Customers can check account balances, transfer funds, pay bills,

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open accounts, and access other services without visiting a bank branch. Some financial institutions also operate through digital-only banking models.

3. Digital Lending

Technology has simplified the process of applying for and obtaining loans. Online lending platforms can collect customer information digitally, automate parts of credit assessment, and process loan applications more quickly. Peer-to-peer (P2P) lending also provides a platform through which individuals or businesses can obtain funds from other individuals or investors, subject to the applicable regulatory framework.

4. Personal Finance and Financial Management

FinTech applications help individuals manage their personal finances. They may provide tools for tracking income and expenditure, setting budgets, monitoring spending patterns, and managing savings. Such tools can help users make more informed financial decisions.

5. Investment and Wealth Management

Technology has made investment services more accessible through online investment platforms. Individuals can invest in shares, mutual funds, bonds, and other financial products through digital platforms. **Robo-advisory** services use algorithms and data to provide automated or technology-assisted investment recommendations based on specified investor characteristics.

6. Algorithmic Trading

FinTech has also transformed securities trading. Algorithmic trading uses computer programs and predefined rules to execute trading decisions automatically. This can increase the speed and efficiency of transactions and is widely used in modern financial markets.

7. InsurTech

The application of technology in insurance is commonly known as InsurTech. Insurance companies use digital platforms, data analytics, artificial intelligence, and technologies such as telematics to improve areas such as customer service, underwriting, claims processing, and risk assessment. For example, vehicle telematics can provide information about driving behaviour for insurance-related purposes.

8. Blockchain and Digital Assets

Blockchain is a distributed digital ledger technology that can record transactions in a secure and transparent manner. It has applications in areas such as payment systems, settlement, digital identity, and digital assets. Cryptocurrencies such as Bitcoin are examples of digital assets that use blockchain technology, although cryptocurrencies represent only one area of blockchain application.

9. Alternative Finance

FinTech has created alternative methods of raising and providing finance. Crowdfunding allows individuals or organisations to raise funds from a large number

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of people through online platforms. Depending on the model, contributors may receive equity, rewards, or other forms of return. P2P lending provides an online mechanism for connecting borrowers and lenders.

10. RegTech

Regulatory Technology (RegTech) refers to the use of technology to help financial institutions comply with laws, regulations, reporting requirements, and other regulatory obligations. Automation, data analytics, artificial intelligence, and digital monitoring tools can make compliance processes more efficient.

6.1.3 Technologies Supporting FinTech

The growth of FinTech is supported by several emerging technologies. Important technologies include:

- ◊ **Artificial Intelligence (AI)** – used in fraud detection, customer service, credit assessment, and financial advice.
- ◊ **Machine Learning (ML)** – helps systems identify patterns and make predictions using financial data.
- ◊ **Big Data Analytics** – enables financial institutions to process and analyse large volumes of customer and transaction data.
- ◊ **Blockchain** – provides a distributed method of recording and verifying transactions.
- ◊ **Cloud Computing** – enables financial organisations to store data and operate applications through scalable digital infrastructure.
- ◊ **Application Programming Interfaces (APIs)** – allow different software systems and financial platforms to communicate and exchange information.
- ◊ **Biometric Technology** – uses characteristics such as fingerprints or facial recognition for authentication and security.
- ◊ **Internet of Things (IoT)** – connects physical devices and allows them to generate and transmit data that can be used in financial services.

6.1.4 Evolution of Fintech.

FinTech has not emerged suddenly with mobile applications, digital payments or cryptocurrencies. It is the result of a gradual transformation in the way financial services are created, delivered and used. Over time, technological developments have changed traditional banking from paper-based and branch-based operations to computerised, electronic, internet-based and mobile financial services.

The evolution of FinTech can therefore be viewed as a continuous journey in which technology and finance increasingly became integrated. The introduction of computers, ATMs and electronic payment systems created the early foundation, followed by internet banking and online payments. Later, smartphones, digital platforms, blockchain,

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artificial intelligence and other emerging technologies further expanded the scope of financial services. Thus, studying the evolution of FinTech helps us understand how financial services have changed from traditional systems to today's interconnected digital financial ecosystem.

i. Early Foundations of Financial Technology: Pre-1960s

The roots of FinTech can be traced to the gradual development of banking, payment and financial infrastructure. For centuries, financial transactions depended mainly on cash, coins, bills of exchange, cheques and physical banking institutions. With the growth of modern banking and financial markets, technological innovations were gradually introduced to make record-keeping, payment processing and communication more efficient.

During the first half of the twentieth century, banks began adopting mechanical and electronic technologies to process the increasing volume of financial transactions. For example, magnetic-ink technology helped automate cheque processing during the 1950s and 1960s. Telecommunications also enabled financial institutions to transfer payment information over long distances. These developments created the technological foundation for later digital financial services.

ii. The Beginning of Electronic Banking: 1960s–1980s

The 1960s and 1970s marked an important transition from manual banking operations to computer-based financial processing. Banks began using mainframe computers to maintain customer accounts, process transactions and manage large volumes of financial information. These systems were initially used mainly within financial institutions rather than directly by customers.

The introduction of ATMs during the late 1960s provided customers with a new way of accessing their bank accounts and withdrawing cash without depending entirely on bank tellers. Electronic payment systems also developed during this period. Automated Clearing House (ACH) systems were introduced in the 1970s, providing an electronic alternative to paper-based payments.

Credit-card networks also expanded during the 1960s and 1970s. BankAmericard, which later became Visa, and Interbank, which later became MasterCard, contributed to the development of electronic card-based payments. The use of computers in securities markets also gradually increased the speed and efficiency of financial transactions.

iii. The Rise of Digital Finance and the Internet: 1990s–2000s

The spread of personal computers and the Internet during the 1990s brought financial technology closer to ordinary consumers. Banks began introducing online banking services through which customers could check account balances, transfer funds and make payments without visiting a physical branch.

The Internet also encouraged the growth of online commerce and digital payment services. Companies such as PayPal, established in the late 1990s, helped make online payments more convenient for consumers and businesses. During this period, financial information, online brokerage and electronic payment services expanded rapidly.

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This period also witnessed the emergence of dedicated FinTech companies that used Internet-based technologies to provide financial services in new ways. The development of digital platforms created the foundation for the rapid growth of FinTech in the following decades.

iv. Mobile Finance and the Expansion of the FinTech Ecosystem: 2010s

The widespread adoption of smartphones and mobile Internet significantly transformed financial services during the 2010s. Banking and payment services increasingly moved from personal computers to mobile applications, enabling users to make payments, transfer money, manage accounts and access other financial services through smartphones.

FinTech expanded beyond payments into areas such as digital lending, personal finance, wealth management, insurance, crowdfunding and peer-to-peer lending. Companies such as Stripe, Square and Revolut became examples of technology-driven financial businesses, while P2P lending platforms provided new ways of connecting borrowers and lenders.

At the same time, mobile payment systems and digital wallets became increasingly important. In countries such as India, the development of digital payment infrastructure and mobile-based payment systems further accelerated the movement towards cashless and instant transactions.

v. Blockchain, Cryptocurrency and Decentralized Finance: Mid-2010s Onwards

Another major development in FinTech was the emergence of blockchain technology and cryptocurrency. Bitcoin was introduced in 2008 under the name Satoshi Nakamoto and demonstrated the possibility of transferring digital value through a decentralized network.

Blockchain, or distributed ledger technology, attracted attention beyond cryptocurrencies because it provided a new method of recording and verifying transactions. During the mid-2010s, Initial Coin Offerings (ICOs) became a method through which some blockchain projects attempted to raise funds by issuing digital tokens.

The development of smart contracts subsequently supported the growth of decentralized finance. Decentralized finance applications seek to provide services such as lending, borrowing and trading through blockchain-based systems and smart contracts, reducing reliance on some traditional intermediaries.

However, blockchain and cryptocurrency represent one part of the broader FinTech ecosystem rather than the entire development of FinTech.

vi. FinTech in the 2020s: Integrated Digital Financial Services

During the 2020s, FinTech has increasingly moved towards integrated and interconnected digital financial services. Digital-only banks and neobanks provide banking services primarily through mobile and online platforms, while embedded

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finance enables financial services such as payments, credit and insurance to be incorporated into non-financial digital platforms.

Buy Now, Pay Later (BNPL) services have also expanded as an alternative method of consumer financing. At the same time, instant payment systems, digital wallets, open banking and API-based financial services have strengthened the integration of different financial platforms.

The FinTech ecosystem is therefore no longer limited to individual applications or payment services. It increasingly connects banking, payments, lending, investment, insurance and financial management through digital platforms.

vii. Artificial Intelligence and the Future of FinTech

Artificial Intelligence (AI) and Machine Learning (ML) are becoming important technologies in the next phase of FinTech development. Financial institutions and FinTech companies use these technologies for activities such as fraud detection, credit assessment, customer service, risk management and personalised financial services. BIS research identifies AI as increasingly relevant to financial intermediation, insurance, asset management and payments.

Other technologies such as cloud computing, application programming interfaces (APIs), distributed ledger technology, digital identity and tokenisation are also shaping the future of financial services. The Basel Committee on Banking Supervision identifies these technologies as important components of the ongoing digitalisation of finance.

Thus, the evolution of FinTech can be viewed as a gradual movement from manual financial processes → computerised banking → electronic payments → Internet banking → mobile finance → blockchain-based services → AI-driven and integrated digital finance. The process is continuing as new technologies and financial business models emerge.

Table 6.1.1 Evolution of Fintech

Period	Major development
Pre-1960s	Foundations of financial technology
1960s–1980s	Computerisation and electronic banking
1990s–2000s	Internet and digital finance
2010s	Mobile banking and FinTech ecosystem
Mid-2010s onwards	Blockchain, cryptocurrency and DeFi
2020s	Integrated digital finance and embedded finance
Present & future	AI, ML, cloud, APIs and tokenization

6.1.5 Relevance of Fintech

FinTech has become an important part of the modern financial system because it uses technology to make financial services more accessible, convenient, efficient, and secure. It has changed the way individuals and businesses save, borrow, invest, transfer money, and manage their finances.

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i. Increased Accessibility and Financial Inclusion

FinTech helps people access financial services without depending entirely on physical bank branches. Mobile banking, digital wallets, and mobile money services enable people in remote and underserved areas to make payments, transfer money, save, and access credit through digital devices. Thus, FinTech can bring more people into the formal financial system.

ii. Enhanced Convenience and Speed

FinTech enables customers to access financial services at any time and from almost anywhere through mobile applications and online platforms. Activities such as fund transfers, bill payments, account management, and loan processing can be completed much faster than through traditional methods.

iii. Improved Efficiency and Lower Costs

Technology and automation reduce the time and effort required to perform routine financial activities. Automated processing, digital documentation, and electronic transactions can reduce the operating costs of financial institutions and may result in lower charges and more competitive services for customers.

iv. Greater Choice and Personalised Services

FinTech has introduced a wide range of financial products and services designed to meet different customer requirements. For example, budgeting applications, robo-advisory services, digital lending platforms, and peer-to-peer lending provide customers with additional choices and more personalised financial solutions.

v. Advanced Security

FinTech uses technologies such as artificial intelligence, machine learning, biometric authentication, encryption, and blockchain to strengthen the security of financial transactions. Real-time monitoring can help identify unusual transactions and detect potential fraud more quickly.

vi. Data-Driven Insights

FinTech platforms can use big data analytics and artificial intelligence to process large amounts of financial information. This helps financial institutions and customers obtain useful insights about spending patterns, investment decisions, creditworthiness, and financial risks, supporting better-informed decisions.

FinTech is relevant because it makes financial services more accessible, convenient, efficient, secure, personalised, and data-driven. It is transforming the way individuals and businesses manage money and is contributing to the wider development of the digital financial system.

6.1.6 Innovation and Transformation in FinTech

FinTech is not limited to using technology to perform existing financial activities. It also involves developing new financial products, services, processes, and business models. Continuous technological innovation has transformed traditional banking and

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financial services by making them more digital, connected, automated, and customer-oriented.

6.1.6.1 Innovation in FinTech

Innovation in FinTech refers to the introduction of new or improved technologies, products, services, and methods in the financial sector. FinTech companies combine financial knowledge with technologies such as artificial intelligence, cloud computing, blockchain, big data, and mobile technology to provide new solutions to financial needs.

Some important areas of FinTech innovation are:

i. Digital Payments:

FinTech has introduced convenient methods of making payments through mobile applications, digital wallets, QR codes, contactless payments, and UPI. These innovations have reduced dependence on cash and traditional payment methods.

ii. Digital Lending:

Technology has changed the way loans are provided. Online lending platforms can collect information digitally, assess creditworthiness, and process loan applications with less paperwork and faster processing.

iii. Robo-Advisory and Digital Investment:

Technology has made investment services accessible through online investment platforms and robo-advisors. These platforms can provide automated investment suggestions based on information about the investor's financial requirements and preferences.

iv. Blockchain and Digital Assets:

Blockchain technology provides a decentralized method of recording and verifying transactions. It has introduced new possibilities in areas such as digital assets, smart contracts, cross-border transactions, and financial record management.

v. Artificial Intelligence and Machine Learning:

AI and machine learning are increasingly used for fraud detection, customer support, credit assessment, risk management, and personalised financial services. These technologies enable financial institutions to process large volumes of data and identify patterns quickly.

vi. InsurTech:

Technology has also transformed insurance services. Digital platforms can support online policy purchase, automated claims processing, customer service, risk assessment, and fraud detection.

6.1.6 2. Transformation in FinTech

Transformation in FinTech refers to the significant changes brought about by technology in the way financial services are created, delivered, accessed, and managed.

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It is not simply about replacing paper with digital documents or using computers instead of manual work. It involves changing traditional financial processes, business models, customer experiences, and methods of decision-making through the use of modern technologies.

In the traditional financial system, customers generally depended on physical branches, face-to-face interactions, paperwork, cash transactions, and manual processing. For example, a person who wanted to open an account, apply for a loan, transfer money, or purchase an insurance policy often had to visit a financial institution and complete several physical procedures. FinTech has gradually changed these practices by bringing many financial services directly to computers and smartphones. FinTech is transforming financial services through

1. Transformation from Physical to Digital Services:

Financial services are increasingly moving from physical locations to digital platforms. Customers can open accounts, transfer money, make payments, invest, obtain loans, and purchase insurance through websites and mobile applications. This reduces the need for physical visits and makes financial services available beyond traditional banking hours.

2. Transformation from Manual to Automated Processes:

Many activities that were previously performed manually are now automated. For example, data entry, transaction processing, credit assessment, fraud monitoring, and claims processing can be supported by automated systems. This reduces processing time and human intervention while improving operational efficiency.

3. Transformation in Customer Experience:

FinTech has changed the way customers interact with financial institutions. Instead of depending only on bank employees, customers can use mobile applications, chatbots, virtual assistants, and self-service platforms. This provides faster access to information and allows customers to perform financial activities according to their own convenience.

4. Transformation in Payments:

Payment systems have undergone major changes through mobile banking, digital wallets, QR-code payments, contactless payments, and UPI. Money can be transferred electronically within a short period, reducing dependence on cash and traditional payment instruments.

5. Transformation in Lending

Traditional lending generally involves physical applications, extensive documentation, and lengthy processing. FinTech platforms can collect and process financial information digitally and use data-based methods to support credit assessment. This has made loan applications and processing more digital and streamlined.

6. Transformation in Investment Services

Investment activities that traditionally required physical interaction with brokers or financial advisers can now be carried out through online platforms. Investors can access

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market information, purchase securities, monitor portfolios, and receive automated investment suggestions through digital platforms.

7. Transformation through Data:

Data has become an important resource in modern financial services. FinTech firms use big data and artificial intelligence to identify patterns in customer behaviour, assess risks, detect unusual transactions, and develop personalised services. Thus, financial decisions are increasingly supported by real-time and data-based information.

8. Transformation of Business Models

FinTech has also changed how financial services are provided. Financial services are no longer offered only by traditional banks and financial institutions. FinTech companies, payment platforms, digital lenders, investment platforms, and other technology-based firms have entered the financial services ecosystem and introduced new ways of delivering financial products.

Table 6.1.2 Transformation through Fintech

Traditional Financial Services	FinTech Transformation
Physical bank branches	Mobile and digital banking
Cash and paper-based payments	Digital payments and UPI
Manual loan processing	Automated digital lending
Paper-based records	Digital records and cloud systems
Face-to-face customer service	Chatbots and virtual assistants
Traditional investment advice	Robo-advisory and online investment platforms
Periodic fraud checks	Real-time fraud monitoring
Standardized services	Data-driven personalised services

6.1.6.3 Major Drivers of FinTech Transformation

The transformation of financial services is driven by the rapid development of digital technologies, changing customer needs, and increasing competition in the financial sector. These factors encourage banks, FinTech companies, and other financial institutions to adopt new technologies and develop faster, more convenient, and customer-oriented services.

1. Smartphones and Mobile Technology:

The widespread use of smartphones has made financial services easily accessible through mobile applications. Customers can make payments, transfer money, check account balances, invest, and access other financial services anytime and anywhere.

2. Internet Connectivity

Improved internet connectivity enables customers and financial institutions to access and exchange financial information quickly. It has supported the growth of online ba nking, digital payments, online investment platforms, and other digital financial services.

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3. Cloud Computing:

Cloud computing provides flexible and scalable digital infrastructure for storing data and running financial applications. It helps financial institutions process large volumes of information and introduce new digital services more efficiently.

4. Big Data Analytics:

Financial institutions generate large amounts of customer and transaction data. Big data analytics helps process this information to identify patterns, understand customer behaviour, assess risks, and develop more suitable financial products and services.

5. Artificial Intelligence and Machine Learning:

AI and ML enable financial institutions to automate various activities and make data-based decisions. They are used in areas such as fraud detection, credit assessment, customer support, risk management, and personalised financial services.

6. Blockchain Technology:

Blockchain provides a distributed method of recording and verifying transactions. Its applications in areas such as digital assets, payment systems, settlement, and smart contracts have created new possibilities for financial services.

7. Biometrics

Biometric technologies such as fingerprint and facial recognition provide convenient methods of customer authentication. They can strengthen security and reduce dependence on traditional passwords and identification methods.

8. Application Programming Interfaces (APIs)

APIs allow different software systems and financial platforms to communicate and exchange information. They support the integration of banking, payment, investment, and other financial services across different digital platforms.

9. Changing Customer Expectations

Customers increasingly expect financial services to be quick, convenient, accessible, and available digitally. This growing demand encourages financial institutions to improve their services and adopt technologies that provide better customer experiences.

10. Increasing Competition and Innovation:

The entry of FinTech companies and digital platforms has increased competition in the financial sector. Traditional financial institutions are therefore adopting new technologies and developing innovative products and services to meet changing market requirements.Thus, technological development, changing customer expectations, and increasing competition together act as major drivers of FinTech transformation, moving financial services towards a more digital, automated, connected, and customer-oriented system.

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6.1.6.4 Impact of Innovation and Transformation

FinTech innovation and transformation have changed the relationship between financial institutions and customers. Financial services can now be accessed through digital platforms, transactions can be completed in real time, and financial products can be designed using customer data. At the same time, these developments create new concerns relating to cybersecurity, data privacy, digital fraud, technological dependence, and regulatory compliance.

Thus, innovation provides new ideas, technologies, products, and methods, while transformation changes the overall way financial services are delivered and experienced. Together, they are reshaping the financial sector from a largely traditional and branch-based system into a more digital, connected, automated, and customer-oriented financial ecosystem.

Recap

- ◊ FinTech (Financial Technology) is the use of technology to improve, automate, and deliver financial services more efficiently.
- ◊ It covers major areas such as digital payments, digital banking, digital lending, investment and wealth management, InsurTech, blockchain, and RegTech.
- ◊ The growth of FinTech is supported by technologies such as Artificial Intelligence, Machine Learning, Big Data, Blockchain, Cloud Computing, APIs, Biometrics, and the Internet of Things.
- ◊ FinTech has evolved from manual banking to computerised banking, electronic payments, internet banking, mobile finance, blockchain-based services, and AI-driven digital finance.
- ◊ FinTech is relevant because it improves financial inclusion, increases convenience, reduces costs, enhances security, and supports data-driven financial decisions.
- ◊ Innovation in FinTech has introduced digital payments, digital lending, robo-advisors, blockchain-based services, AI-powered solutions, and InsurTech.
- ◊ FinTech has transformed financial services by replacing physical branches and paper-based processes with digital, automated, and customer-oriented platforms.
- ◊ The major drivers of FinTech transformation include smartphones, internet connectivity, cloud computing, AI, blockchain, and changing customer expectations.

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Objective Questions

1. What does FinTech stand for?
2. Which technology enables transactions to be recorded and verified through a distributed digital ledger?
3. Which FinTech innovation enables customers to make payments using QR codes and mobile applications?
4. Which period witnessed the rapid growth of mobile finance and the FinTech ecosystem?
5. What is one major benefit of FinTech in relation to financial inclusion?
6. Which development enabled customers to access banking services without visiting a bank branch during the early evolution of electronic banking?
7. Which FinTech service allows individuals or businesses to obtain funds through an online platform from lenders or investors?
8. What is RegTech?

Answers

1. Financial Technology.
2. Blockchain.
3. Digital payments.
4. The 2010s.
5. It improves access to financial services, particularly for underserved populations.
6. Automated Teller Machines (ATMs).
7. Peer-to-peer (P2P) lending.
8. The use of technology to support regulatory compliance.

Self-Assessment Questions

1. What is Fintech?
2. Explain any five major areas in which FinTech is used.

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3. Describe the important technologies supporting the growth of FinTech.
4. Trace the major stages in the evolution of FinTech from traditional banking to AI-driven digital finance.
5. Explain the relevance of FinTech in improving financial inclusion, convenience, efficiency, and security.
6. What is meant by innovation in FinTech? Explain the major areas of FinTech innovation.
7. Explain how FinTech has transformed traditional financial services from physical and manual processes to digital and automated services.
8. Explain the major drivers responsible for the transformation of financial services through FinTech.

Assignments

1. Distinguish between innovation and transformation in FinTech, with suitable examples.
2. A financial institution wants to provide personalised services based on customers' spending patterns and financial behaviour. Identify the technologies that could support this objective and explain how they can be used
3. A small business receives payments through UPI and uses mobile banking to transfer money to suppliers. Identify the FinTech services involved and explain their benefits to the business.

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Unit 2
FinTech Trends

Learning Outcomes

- ◊ comprehend the concept of peer-peer (P2P) lending
- ◊ explain the features and applications of robo-advising
- ◊ describe the role of payment-tech in digital financial transactions
- ◊ aware of the significance of insurTech in transforming insurance services
- ◊ explain the concept, types and applications of crowd funding

Prerequisite

Ananya has a small boutique and wants to expand her business before the festive season. Instead of visiting several banks for a loan, she discovers an online platform where individuals are willing to lend money directly to borrowers. At the same time, her friend Rahul, who has just started earning, uses a mobile application that suggests where he should invest based on his income and future goals. When Ananya pays her suppliers, she completes the transaction instantly through a digital payment app. She also renews her business insurance online without visiting an insurance office. Meanwhile, her cousin launches an eco-friendly product and raises the initial funds by collecting small contributions from hundreds of people through an online platform.

These experiences show how technology has created new ways of borrowing, investing, making payments, buying insurance, and raising funds. Instead of depending only on traditional financial institutions, digital platforms now connect people with financial services in faster, simpler, and

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more convenient ways. This unit explores these emerging FinTech trends and explains how Peer-to-Peer Lending, Robo-Advising, Payment Technology (Payment-Tech), InsurTech, and Crowdfunding are transforming the way financial services are delivered in the modern economy.

Keywords

Peer to Peer lending, Payment -tech, crowd funding, InsurTech

Discussion

The growth of FinTech has led to the emergence of specialised digital financial services that address different customer needs. Some platforms connect borrowers directly with lenders, while others use artificial intelligence to provide investment guidance. Digital payment technologies enable secure and instant transactions, reducing the need for cash. Insurance services are becoming more accessible through technology-driven platforms, and crowdfunding allows entrepreneurs, creators, and social organisations to collect funds from a large number of contributors through the internet.

These innovations have made financial services more convenient, accessible, and efficient for both individuals and businesses. Understanding how these FinTech trends work helps learners recognise their role in shaping the future of banking, investments, insurance, and digital finance.

6.2.1 Peer to Peer Lending

Peer-to-Peer (P2P) lending is a technology-enabled form of lending that directly connects people or businesses who need money with individuals or institutions willing to lend money. The connection is made through an online P2P lending platform, which acts as an intermediary between borrowers and lenders.

In traditional lending, a person who needs money generally approaches a bank or other financial institution. The institution assesses the borrower, provides the loan from its available funds, and collects the repayment with interest. In P2P lending, the process is different. The money is provided by one or more lenders through a digital platform, rather than the platform itself functioning as a conventional bank.

For example, consider a small business owner who needs ₹2 lakh to purchase equipment. Instead of obtaining the entire amount from a bank, the business owner can submit a loan request on a P2P platform. The platform may make the request available to several lenders. Five lenders, for instance, may each contribute ₹40,000. The borrower then repays the loan, generally with interest, according to the agreed terms, and the lenders receive their corresponding repayments.

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The P2P platform mainly provides the digital infrastructure for bringing borrowers and lenders together. It may facilitate activities such as registration, collection of information, credit assessment, loan listing, matching borrowers with lenders, documentation, repayment collection and related services. Thus, technology plays an important role in making the lending process more accessible and convenient.

The term "peer-to-peer" highlights the idea of connecting participants directly through a digital platform. However, "direct" does not mean that borrowers and lenders interact without an intermediary; rather, the platform facilitates the relationship between them.

Therefore, P2P lending can be understood as a digital marketplace for borrowing and lending, where technology connects fund-seeking borrowers with potential lenders and facilitates the lending process.

6.2.1.1 How P2P Lending Works

P2P lending involves a systematic process through which borrowers seeking funds are connected with lenders willing to provide funds through an online platform. The platform facilitates various stages of the lending process, from borrower registration and credit assessment to funding, loan disbursement and repayment servicing**.** The process involves **-**

- ◊ The prospective borrower registers on the P2P lending platform by providing the required credentials and submitting a loan application.
- ◊ The platform processes the borrower's information, conducts a preliminary credit assessment, and prepares a summary report for the prospective lender to review.
- ◊ Based on the platform's credit assessment and, if required, additional evaluation, the lender decides whether to provide the funds.
- ◊ The borrower pays a loan origination fee to the platform, while the lender pays a fee for loan sourcing and processing services, as applicable.
- ◊ The loan agreement or instrument is executed, after which the disbursement and servicing of the loan are generally facilitated through the platform.

6.2.1.2 Models of P2P Lending

P2P lending platforms can operate in different ways depending on how borrowers and lenders are connected, who provides the funds, how the loan is structured, and who bears the credit risk. The models can broadly be discussed under two classifications. The first classification focuses on the operational and financial structure of the platform, while the second focuses on the method through which borrowers and fund providers are connected. Some models may overlap because they describe different aspects of the same lending arrangement.

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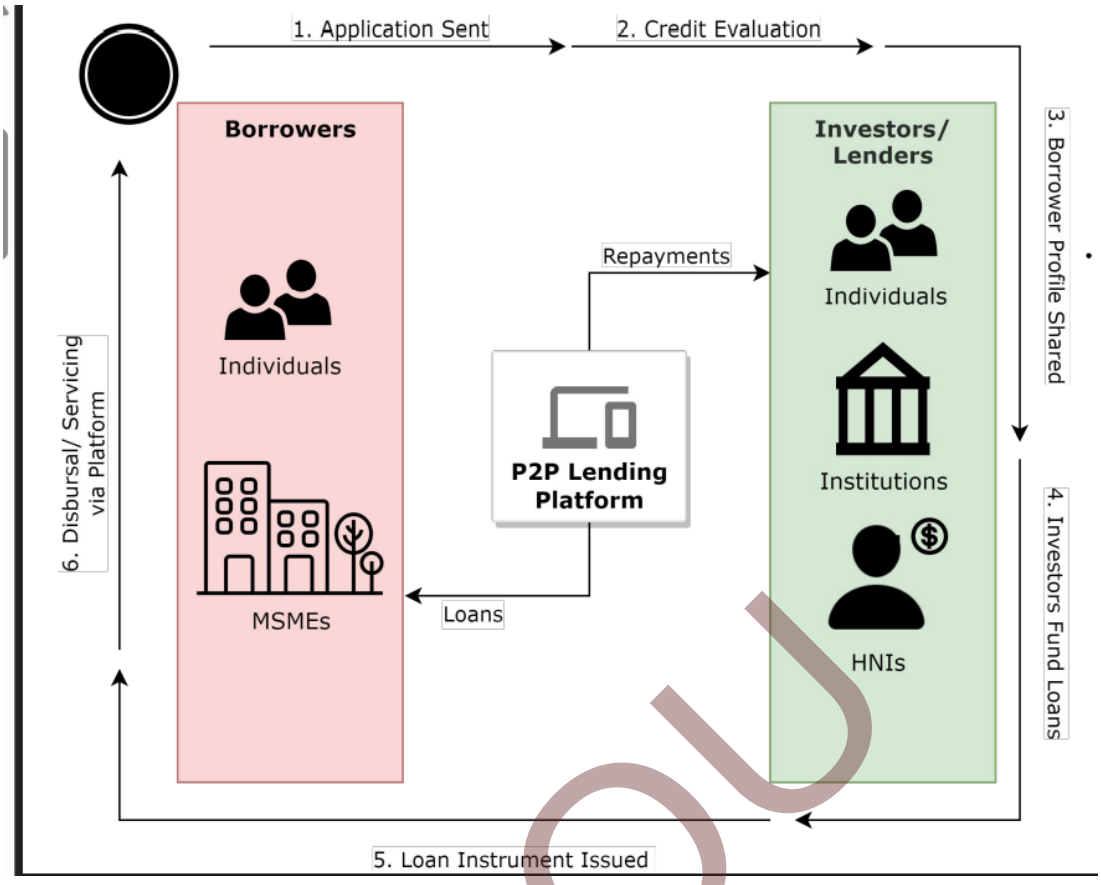


Figure 6.2.1 -How P2P Lending Works

I. P2P Lending Models Based on Platform Structure

1. Client-Segregated (Traditional) Model

The Client-Segregated or Traditional Model is the conventional form of P2P lending in which the platform mainly acts as an intermediary between borrowers and lenders. The money belonging to lenders and borrowers is maintained separately from the platform's own funds. The platform facilitates activities such as registration, credit assessment, matching, documentation, disbursement and repayment servicing, while the actual lending relationship exists between the borrower and lender.

For example, if Anu needs ₹1 lakh to expand her small business, she can submit a loan application through a P2P platform. After assessing her credit profile, the platform makes her loan requirement available to potential lenders. Five lenders may each contribute ₹20,000 to fund the loan. The platform facilitates the transaction and repayment, while the funds are provided by the lenders.

2. Notary Model

Under the Notary Model, the loan is generally originated by a bank or other authorised financial institution, while the P2P platform performs the role of connecting the borrower with investors and facilitating the investment. The platform may also assist with loan administration and servicing, but the formal loan arrangement is established through the originating institution.

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For instance, suppose a small business requires ₹5 lakh. A bank originates the loan after assessing the business, while the P2P platform connects investors who are willing to finance the loan. The platform facilitates the investment and subsequent servicing, while the bank remains involved in the formal origination of the loan.

3. Guaranteed Return Model

In the Guaranteed Return Model, the platform operator provides a guarantee relating to the lender's principal and/or interest, subject to the conditions of the arrangement. Unlike the traditional model, where the lender generally bears the borrower's default risk, the platform assumes a greater role in relation to the specified repayment risk.

For example, if Ravi invests ₹50,000 through a platform that provides a specified repayment guarantee, the platform may undertake to cover the guaranteed principal and/or interest if the borrower fails to make the required payment, subject to the terms and conditions of the guarantee.

4. Balance Sheet Model

In the Balance Sheet Model, the platform or lending company itself originates the loan and records it on its own balance sheet. Thus, the platform moves beyond simply connecting borrowers and lenders and assumes the position of a lender. It uses its own funds or funding sources to provide the loan and bears the associated credit risk.

For example, if a digital lending company provides a ₹3 lakh loan to a small business using its own funds, the company records the loan as an asset on its balance sheet. The borrower makes repayments to the company, and the company bears the risk if the borrower defaults.

II. Related Platform-Based Lending Models

1. Direct Lending Model

The Direct Lending Model connects borrowers directly with individuals or institutions willing to provide funds through the digital platform. The platform facilitates the matching process and may also provide services relating to documentation, disbursement and repayment.

For example, if a borrower requires ₹2 lakh, four lenders may each contribute ₹50,000 through the platform. The platform brings the borrower and lenders together and facilitates the lending and repayment process.

2. Marketplace Model

In the Marketplace Model, the platform functions as an online marketplace where several borrowers and lenders participate. Borrowers can present their funding requirements, while lenders can select loans according to factors such as the borrower's credit profile, loan period, expected return and risk.

For example, a platform may display several loan applications from individuals and small businesses. An investor can review the available loan information and choose the

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loans that match the investor's preferred risk and return characteristics. The platform facilitates the transaction between the selected borrower and lender.

3. Auction-Based Model

In the Auction-Based Model, borrowers place their loan requirements on the platform and potential lenders compete by offering the interest rate or other lending terms at which they are willing to provide funds. The platform uses its specified auction mechanism to facilitate the selection of suitable offers.

For example, suppose Meera requires ₹1 lakh for her business. Several lenders may offer to finance the loan at different interest rates. The platform facilitates the bidding process and, according to its rules, determines the appropriate funding arrangement.

4. Institutional Lending Model

The Institutional Lending Model involves institutional investors rather than, or in addition to, individual lenders. Financial institutions, investment companies and other large investors can provide funds to borrowers through the digital lending platform. This allows platforms to facilitate lending on a larger scale.

For example, an investment institution may decide to finance a portfolio of loans given to small businesses through a digital lending platform. Instead of one individual funding each loan, the institutional investor provides a substantial amount of funding across several borrowers.

5. Invoice Trading Model

The Invoice Trading Model provides financing against a business's outstanding invoices or receivables. It is particularly useful for businesses that have made sales but must wait for their customers to make payment. The platform connects the business holding the invoices with investors or financiers willing to provide funds against those receivables.

For example, suppose a small business has supplied goods to a customer and has an invoice of ₹5 lakh payable after 60 days. Instead of waiting two months for payment, the business can obtain finance against the invoice through an online platform. The financier provides funds based on the invoice, while repayment is linked to the underlying receivable.

Thus, P2P and related digital lending models differ according to the role of the platform, the source of funds, the method of connecting borrowers with lenders, and the allocation of credit risk. The Client-Segregated, Notary, Guaranteed Return and Balance Sheet Models primarily describe the structural and financial role of the platform, whereas the Direct Lending, Marketplace, Auction-Based, Institutional Lending and Invoice Trading Models describe different mechanisms through which platform-based financing can be organised. Together, these models illustrate how FinTech platforms have created different ways of facilitating access to credit beyond the traditional bank-based lending process.

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6.2.2 Robo advising

Robo-advising refers to the use of digital platforms, computer algorithms and automated processes to provide investment advice and manage investment portfolios with limited human intervention. Instead of depending entirely on a traditional financial advisor, an investor can enter details such as their financial goals, investment amount, risk tolerance, income and investment period through an online platform. The Robo-advisor processes this information using algorithms and suggests a suitable investment strategy or portfolio.

For example, consider an Indian investor who wants to invest ₹5 lakh for a long-term financial goal but has limited knowledge about selecting and managing investments. Through a digital wealth-management platform such as Scripbox, the investor can provide information about the investment objective, investment period and risk preference. The technology-based system can then assist in identifying a suitable investment strategy and help the investor monitor and manage the portfolio digitally. Platforms such as INDmoney similarly provide technology-enabled investment and wealth-management services through digital platforms.

Robo-advisors can perform several functions beyond simply giving investment suggestions. They may construct diversified portfolios, monitor investments, rebalance portfolios, when necessary, track performance and support goal-based investment planning. Since these services are delivered through digital platforms, they can reduce dependence on face-to-face advisory services and provide investment assistance in a convenient, accessible and relatively low-cost manner.

Thus, Robo-advising represents the application of FinTech to wealth management, where algorithms and digital platforms perform many of the investment advisory and portfolio-management functions traditionally carried out by human financial advisors.

6.2.2.1 How do Robo -advisors work

Robo-advisors work through a systematic, technology-driven process in which information provided by the investor is processed by algorithms to develop and manage an appropriate investment portfolio. The major steps involved are as follows:

1. Collection of Investor Information:

The process begins when the investor provides information through an online questionnaire. The robo-advisor collects details about the investment objective, investment amount, income, financial situation, investment horizon and future financial needs. For example, the investor may indicate whether the objective is retirement planning, saving for a major expenditure, creating an emergency fund or generating regular income.

2. Assessment of Risk Profile

The Robo-advisor determines the investor's risk tolerance and risk capacity. Objective factors such as income, financial position, age and years until retirement are considered

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along with subjective responses, such as how the investor would react to a significant fall in the market or how comfortable the investor is with fluctuations in investment value.

3. Determination of Investment Strategy

Based on the investor's goals, time horizon and risk profile, the algorithm determines an appropriate investment strategy. A long-term investor with a higher risk tolerance, for instance, may be assigned a portfolio with a relatively higher proportion of equity, whereas an investor seeking regular income or having lower risk tolerance may receive a portfolio with a greater proportion of relatively less risky assets.

4. Portfolio Construction and Asset Allocation:

The robo-advisor then determines how the investment should be distributed among different asset classes such as **equity, bonds and other investment instruments**. Many robo-advisors use principles of **Modern Portfolio Theory (MPT)**, which seeks to achieve an appropriate balance between expected return and risk through diversification.

5. Investment Recommendation:

After determining the asset allocation, the system recommends a suitable portfolio to the investor. Depending on the platform and service, the investor may then invest through the platform, with the system facilitating or managing the selected investments.

6. Continuous Portfolio Monitoring:

Robo-advising does not necessarily end after the initial portfolio is created. The system can continuously monitor the portfolio and compare its actual composition with the target allocation and desired risk level.

7. Automatic Rebalancing:

When market movements cause the portfolio to move significantly away from its intended allocation, the robo-advisor can automatically rebalance it. For example, if equity investments increase substantially in value and their proportion becomes higher than the target level, some equity may be sold and the funds shifted towards bonds or other assets to restore the desired allocation.

8. Adjustment According to Changing Needs:

The portfolio can also be modified when the investor's financial goals, risk tolerance or investment horizon changes. For example, as an investor approaches retirement, the robo-advisor may gradually reduce exposure to higher-risk investments and increase the proportion of relatively stable investments.

Thus, the working mechanism of a Robo-advisor combines investor-specific information, algorithmic decision-making, portfolio diversification, continuous monitoring and automatic rebalancing to provide a technology-driven approach to investment management.

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6.2.3 Payment-Tech

PaymenTech, or Payment Technology, refers to the use of digital technologies and innovative payment systems to make financial transactions faster, safer and more convenient. It is a major area of FinTech that enables individuals and businesses to send, receive and process payments electronically without relying solely on cash or traditional banking methods.

PaymentTech uses technologies such as mobile applications, digital wallets, QR codes, UPI, contactless cards, Near Field Communication (NFC), biometric authentication and payment gateways to facilitate secure transactions. These technologies reduce transaction time, improve security through encryption and authentication, and provide users with easy access to payment services through smartphones and other digital devices.

For example, in India, a customer can scan a QR code at a grocery store using PhonePe, Google Pay or BHIM UPI to make an instant payment directly from a bank account. Similarly, businesses use payment gateways such as Razorpay to accept online payments from customers.

6.2.3.1 Technologies used in PaymentTech

PaymentTech uses a combination of technologies to support the initiation, authentication, processing and security of digital payments. Although many technologies are involved, the following are some of the most important ones.

1. Mobile Technology

Mobile technology is one of the most important foundations of modern digital payments. Smartphones provide a common platform through which users can access banking applications, digital wallets and payment applications. A customer can use a mobile device to transfer money, pay bills, make online purchases, scan QR codes and check transaction records without visiting a bank or using cash. Mobile technology also allows other payment technologies, such as UPI, QR codes, NFC and biometric authentication, to be integrated into a single device.

2. UPI Technology

Unified Payments Interface (UPI) enables users to transfer money directly between bank accounts through a digital payment application. It allows payments to be initiated using a UPI ID, mobile number or QR code, without requiring the customer to enter detailed bank-account information for every transaction. UPI has become an important technology for person-to-person as well as merchant payments because transactions can be initiated instantly through smartphones.

Example: A customer purchasing groceries can scan the merchant's UPI QR code, enter the amount and authenticate the transaction through the payment application. The amount is transferred electronically from the customer's bank account to the merchant's account.

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3. QR Code Technology

QR code technology provides a simple mechanism for initiating digital payments. A QR code can contain payment-related information about a merchant or recipient. When a customer scans the code using a smartphone, the payment application retrieves the relevant information and allows the customer to complete the transaction after authentication. QR codes are particularly useful for small retailers, shops and service providers, as merchants can accept digital payments without requiring expensive payment infrastructure.

4. Near Field Communication (NFC)

NFC is a short-range wireless communication technology that enables two compatible devices to exchange information when they are brought close together. It is widely used for contactless payments through cards, smartphones and smartwatches.

For example, instead of inserting a card into a payment terminal, a customer can simply tap a contactless card or smartphone on the terminal. The transaction information is communicated electronically, making the payment quick and convenient.

5. Digital Wallet Technology

Digital wallets are applications that allow users to store payment information and make electronic transactions through digital devices. They can store information required for payments and allow users to make purchases, pay bills and transfer money without repeatedly entering payment details.

Digital wallets also contribute to convenience because customers can access their payment facilities through a smartphone. They may incorporate additional security features such as PINs, passwords, biometric authentication and tokenisation to protect payment information.

6. Artificial Intelligence and Machine Learning

Artificial Intelligence (AI) and Machine Learning (ML) are increasingly used to make payment systems more intelligent and secure. These technologies can analyse large volumes of transaction data and identify patterns that may indicate fraudulent or unusual activity.

For example, if a transaction differs significantly from a customer's normal transaction behaviour, an AI-based system can flag it for further verification. AI is also used in fraud detection, risk assessment, transaction monitoring and automated customer support. Machine learning systems can improve their ability to identify suspicious patterns as they process more transaction data.

7. Biometric Technology

Biometric technology uses a person's unique physical characteristics, such as fingerprints or facial features, to verify identity. In PaymentTech, biometrics can be used to authenticate a payment or authorise access to a payment application. For example,

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a customer may use fingerprint or facial recognition on a smartphone to confirm a payment instead of entering a password. This provides an additional layer of security while making authentication more convenient.

8. Blockchain Technology

Blockchain is a distributed digital ledger that records transactions in a structured and tamper-resistant manner. Instead of maintaining transaction records in a single central database, blockchain allows records to be maintained across a network.

In payment systems, blockchain can support secure transaction recording, verification and settlement, particularly where several parties need to share and verify transaction information. Its use is particularly relevant to certain digital-asset and cross-border payment applications.

9. Encryption and Tokenisation

Encryption and tokenisation are important technologies for protecting payment information. Encryption converts sensitive information into an encoded form so that unauthorised persons cannot easily access or interpret it.

Tokenisation, on the other hand, replaces sensitive payment details, such as card information, with a unique substitute called a token. The actual payment information is therefore not repeatedly exposed during transactions. Together, these technologies help reduce the risk of payment-data theft and strengthen the security of digital transactions.

10. Application Programming Interfaces (APIs)

APIs enable different software systems to communicate and exchange information with each other. In PaymentTech, APIs help connect banks, payment applications, merchants and payment service providers.

For example, when a customer makes an online payment, APIs can enable the merchant's platform to communicate with the payment service and banking system to initiate, authenticate and confirm the transaction. This connectivity allows different financial systems to work together smoothly.

In short, the important technologies underlying PaymentTech are mobile technology, UPI, QR codes, NFC, digital wallets, AI and ML, biometrics, blockchain, encryption and tokenisation, and APIs. Together, they enable digital payments to be convenient, fast, interconnected and secure, while reducing dependence on traditional cash-based payment methods.

6.2.4 InsurTech

InsurTech, short for Insurance Technology, refers to the use of digital technologies and innovative tools to improve, automate and modernise insurance services. It combines insurance with technologies such as big data, artificial intelligence, mobile applications, smart devices, Internet of Things (IoT), wearable devices and digital platforms.

InsurTech enables insurance companies to collect and analyse real-time customer data, assess risks more accurately and offer personalised insurance products and pricing.

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For example, data from a fitness tracker or smart device can provide information about a customer's lifestyle or usage patterns, which may support more customised insurance services.

It also makes insurance processes more convenient and efficient. Customers can purchase and manage policies through mobile apps and online platforms, while insurers can use technology to improve underwriting, claims processing, fraud detection and settlement of claims. Automated systems and digital records can make the claims and payment process faster and more transparent.

Thus, InsurTech refers to the application of technology to the insurance industry to make insurance products and processes more personalised, efficient, accessible and secure.

6.2.4.1 Components of InsurTech

InsurTech can be broadly classified into two main components: Technology and Solutions. The technology component provides the digital tools that collect, process and analyse insurance-related information, while the solutions component applies these technologies to improve insurance products, services and business operations.

1. Technology

Technology is the foundation of InsurTech, as it enables insurance companies to gather real-time data, assess risks more accurately and automate various insurance processes. It includes technologies such as Artificial Intelligence (AI), Machine Learning (ML), the Internet of Things (IoT), mobile applications, wearable devices, GPS trackers and drones. AI and ML help analyse large volumes of data for risk assessment, fraud detection and customer support through chatbots. IoT devices, wearable fitness trackers and GPS-enabled devices continuously collect information about a customer's health, driving behaviour or insured assets, allowing insurers to develop more personalised insurance products. Mobile apps make insurance services accessible anytime, while drones help inspect property damage quickly by capturing and transmitting images to insurance companies.

2. Solutions

Solutions represent the practical use of these technologies to improve different insurance functions and enhance customer experience. They include data management systems, digital payment services, claims processing, underwriting, policy administration and quote generation. Data management solutions integrate information from different sources and make it easily available for decision-making. Digital payment solutions enable customers to pay premiums and receive claim payments securely through online platforms. Claims management solutions simplify the process of filing, verifying and settling claims, reducing delays and paperwork. Technology-driven underwriting solutions help insurers evaluate risks and approve policies more efficiently, while digital policy management allows customers to purchase, renew and monitor their policies online. Quote generation solutions also speed up the process of preparing insurance quotations by automatically processing customer information through a centralised system.

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Together, these two components enable InsurTech to deliver faster, more accurate, personalised and customer-friendly insurance services while improving the operational efficiency of insurance companies.

6.2.5 Crowd Funding

Crowdfunding is a method of raising funds by collecting small amounts of money from a large number of individuals, usually through an online crowdfunding platform or social networking site. The funds may be raised for a business venture, creative project, social or charitable cause, community initiative, or other specific purpose. Instead of obtaining the entire amount from a single investor or financial institution, crowdfunding enables the project owner to obtain contributions from a large "crowd" of people.

The process generally involves a fund seeker presenting a project or proposal on an online platform, while individuals contribute funds according to their interest and the nature of the crowdfunding arrangement. Social media and other digital channels may also be used to promote the campaign and reach potential contributors.

6.2.5.1 Types of Crowd Funding

Crowdfunding is mainly classified into donation crowdfunding, reward crowdfunding, peer-to-peer lending crowdfunding, and equity crowdfunding. The major difference among these types is the purpose of funding and what the contributor receives in return for the contribution.

1. Donation Crowdfunding

Donation crowdfunding is a form of crowdfunding in which individuals contribute money without expecting any financial return or ownership interest. It is mainly used to support social, charitable, humanitarian, medical, educational, environmental, and community-related causes.

The fund seeker presents the cause and the required amount through an online platform, and a large number of people may contribute small amounts according to their willingness and capacity. The contributor participates mainly because of social concern, personal interest, or a desire to support a particular cause.

Example: A community organisation may raise ₹10 lakh through an online campaign to provide relief to families affected by a natural disaster. Hundreds of individuals may contribute small amounts, but they do not expect repayment or ownership in the organisation.

2. Reward Crowdfunding

Reward crowdfunding is a form of crowdfunding in which individuals contribute money to support the development of a product, creative project, event, or business idea and receive a non-financial reward in return. The reward may be the product itself, early access to the product, a service, special recognition, or another benefit connected with the project.

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It is particularly useful for creative projects and new product development, as the fund seeker can obtain finance while also creating awareness about the product among potential customers. The contributors are not normally given ownership of the business and do not receive interest on their contribution.

Example: A start-up planning to develop an innovative educational device may raise funds from potential customers through an online platform. Those contributing ₹2,000 may receive the device after its development, while higher contributors may receive additional features **or early access.**

3. Peer-to-Peer Lending Crowdfunding

Peer-to-peer (P2P) lending crowdfunding is a form of crowdfunding in which individuals or businesses seeking finance are connected with lenders through an online platform. Instead of obtaining the entire loan from a bank or other traditional financial institution, the required amount may be provided by several lenders.

The contributors act as lenders and generally expect repayment of the principal along with interest. The online platform facilitates the matching of borrowers and lenders and may also support activities such as loan processing, repayment collection, and information sharing.

Example: A small business requires ₹5 lakh for expansion. Instead of obtaining the entire amount from one lender, the business may receive ₹5,000 each from 100 lenders through a P2P platform. The business repays the borrowed amount along with interest according to the agreed terms.

4. Equity Crowdfunding

Equity crowdfunding is a form of crowdfunding in which individuals invest money in a business or start-up in exchange for an ownership interest or equity. The business raises capital from a large number of investors rather than depending entirely on traditional sources such as banks, venture capitalists, or individual investors.

The investors become shareholders or obtain another form of ownership interest, depending on the legal structure of the arrangement. Unlike reward crowdfunding, investors do not receive merely a product or service; their return is linked to the performance and future value of the business. They may benefit through dividends, capital appreciation, or other rights associated with their investment, subject to the applicable legal framework.

Example: A technology start-up requires ₹50 lakh to expand its operations. It may raise the amount from a large number of investors through an equity crowdfunding arrangement by offering them an ownership interest in the business. If the business grows in value, investors may benefit from their investment.

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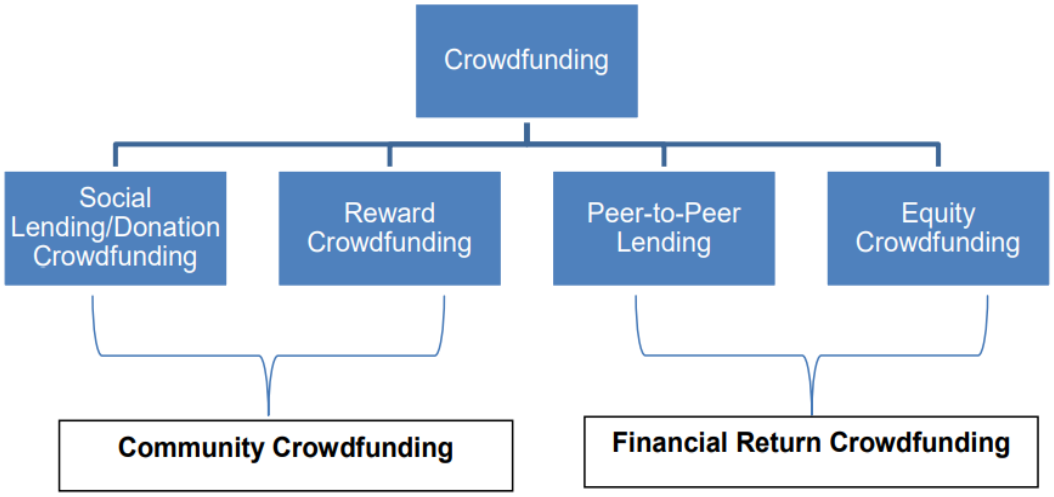


Figure 6.2.2 Types of Crowd Funding (Source: IOSCO Staff Working Paper,2014)

Recap

- ◊ P2P Lending connects borrowers with individuals or institutions willing to lend money through digital platforms, providing an alternative to traditional bank lending.
- ◊ P2P lending operates through different models, including Client-Segregated, Notary, Guaranteed Return, Balance Sheet, Direct Lending, Marketplace, and Auction-Based models.
- ◊ Robo-Advising uses algorithms and digital platforms to provide automated investment advice and portfolio-management services based on an investor's goals, financial situation, and risk profile.
- ◊ The Robo-advising process involves investor profiling, risk assessment, investment strategy, portfolio construction, monitoring, and rebalancing.
- ◊ Payment-Tech uses digital technologies to enable fast, convenient, secure, and cashless financial transactions through technologies such as UPI, QR codes, NFC, digital wallets, AI/ML, biometrics, encryption, tokenization, and APIs.
- ◊ InsurTech applies technology to modernize insurance services, including risk assessment, underwriting, policy management, claims processing, fraud detection, and customer service.
- ◊ The major components of InsurTech are Technology and Solutions, supported by technologies such as AI, ML, IoT, mobile applications, wearable devices, GPS trackers, and drones.

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- ◊ Crowdfunding raises small amounts of funds from a large number of people through online platforms for business, creative, social, charitable, or community purposes.
- ◊ The four major types of crowdfunding are Donation, Reward, P2P Lending, and Equity Crowdfunding, differing mainly in the return or benefit received by contributors.
- ◊ Overall, P2P Lending, Robo-Advising, Payment-Tech, InsurTech, and Crowdfunding demonstrate how FinTech is transforming borrowing, investment, payments, insurance, and fundraising through digital technology.

Objective Questions

1. What does P2P stand for in FinTech?
2. Which P2P lending model records loans on the platform's own balance sheet?
3. Name one Indian digital wealth-management platform mentioned as a robo-advisory example.
4. Expand UPI.
5. Which Payment-Tech feature allows users to make payments by tapping a card or smartphone?
6. What does InsurTech mean?
7. Which type of crowdfunding provides contributors with ownership in a business?
8. Name the two major components of InsurTech.
9. What is the primary role of a P2P lending platform?

Answers

1. Peer-to-Peer.
2. Balance Sheet Model.
3. Scripbox.
4. Unified Payments Interface.

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5. Near Field Communication (NFC).
6. The application of digital technology to improve insurance services.
7. Equity Crowdfunding.
8. Technology and Solutions.
9. It connects borrowers with lenders through a digital platform

Self-Assessment Questions

1. Explain the meaning and working process of Peer-to-Peer lending.
2. Explain the concept of Payment-Tech and its significance in digital finance
3. Explain the two major components of InsurTech with suitable examples.
4. Describe the types of crowd funding?
5. Explain the working mechanism of Robo advising?
6. Explain the models of P2P lending?
7. Describe any four important technologies used in Payment-Tech with suitable examples.
8. What is PaymentTech?

Assignments

1. Select any one Robo-advisory platform (such as Scripbox or INDmoney). Examine how it collects investor information and prepares investment recommendations.
2. Observe three different digital payment methods (UPI, QR Code, and NFC/contactless payment). Explain how each method works and identify one advantage of each.
3. Interview five people about their preferred digital payment method. Present the findings in a table and briefly explain the most preferred option.
4. "Digital technology has transformed financial services beyond traditional banking". Discuss this statement.

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MODEL QUESTION PAPER SETS

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SREENARAYANAGURU OPEN UNIVERSITY

QP CODE: ……

Reg. No : .....

Name : …….....

Model Question Paper- Set-I

FOURTH SEMESTER BACHELOR OF COMMERCE (Honours) EXAMINATION

Major Discipline Specific Elective Courses (ME)–

SGB24CM504ME-Financial Service And Markets

(CBCS - UG)

2024-25 - Admission Onwards

Time: 3 Hours Max Marks: 70

SECTION A

I Answer any 8 questions. Each question carries 1 mark

1. What is FinTech?
2. What are Index Funds?
3. What is NEAT?
4. What is Venture Capital?
5. What is Dematerialisation?
6. What do you mean by commercial paper?
7. What is insider trading?
8. What is forfaiting?
9. What are blue chip shares?
10. What do you mean by Arbitrage? **(8 X 1=8 marks)**

SECTION B

II Answer any 6 questions. Each question carries 2 marks

11. What is stop loss order?
12. Explain custodial services.
13. What do you mean by cornering?
14. What do you mean by Peer to Peer Lending?
15. Explain the term “Wash Sales”
16. What is Tripartite Lease?
17. What do you mean by Depository?
18. What is FPO? **(6X2=12 marks)**

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SECTION C

III Answer any 6 questions. Each question carries 5 marks

19. Explain the functions of Primary Market.
20. Write a short note on CDSL.
21. Differentiate between factoring and bills discounting.
22. Explain the procedure for trading in a Stock Exchange
23. Differentiate between primary market and secondary market.
24. Elucidate the different types of Securitization.
25. Elaborate on the different types of Speculators.
26. Explain the functions of merchant banking. **(6X5=30 marks)**

SECTION D

IV Answer any 2 questions. Each question carries 10 marks

27. Elucidate the features and types of Venture Capital.
28. Explain the different primary market and secondary market intermediaries.
29. Give a detailed note on the different types of Leasing.
30. Discuss the different types of Financial Services. **(2X10=20 marks)**

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SREENARAYANAGURU OPEN UNIVERSITY

QP CODE: ……

Reg. No : .....

Name : …….....

Model Question Paper- Set-II
FOURTH SEMESTER BACHELOR OF COMMERCE (Honours)
EXAMINATION
Major Discipline Specific Elective Courses (ME)–
SGB24CM504ME-Financial Service And Markets
(CBCS - UG)
2024-25 - Admission Onwards

Time: 3 Hours Max Marks: 70

SECTION A

I Answer any 8 questions. Each question carries 1 mark

1. What is Robo advising?
2. What is margin trading?
3. What do you mean by forfaiting?
4. What do you mean by Buyouts?
5. What is Nifty 50?
6. Define Factoring
7. What is Rematerialisation?
8. What do you mean by Loan Syndication?
9. What are Certificate of Deposits?
10. What is NSDL? **(8 X 1=8 marks)**

SECTION B

II Answer any 6 questions. Each question carries 2 marks

11. List any two advantages of securitisation of debt.
12. What do you mean by rigging the market?
13. List any two fee based financial services
14. What is With Recourse Factoring and Without Recourse Factoring?
15. What is call money market?
16. State any two differences between factoring and forfaiting.
17. What do you mean by the term cornering?
18. Mention any two differences between leasing and hire purchase ?

(6X2=12 marks)

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SECTION C

III Answer any 6 questions. Each question carries 5 marks

19. Explain the relevance of Fintech
20. Discuss the disadvantages of leasing.
21. Briefly explain the recent developments in the Indian Financial System
22. Discuss the functions of financial institutions
23. Explain the advantages of Securitization.
24. Explain the functions of a factor.
25. Differentiate between money market and capital market.
26. Briefly explain the components of depository system. **(6X5=30 marks)**

SECTION D

IV Answer any 2 questions. Each question carries 10 marks

27. Explain the different stages of Venture Capital Financing.
28. Elucidate the different types of Factoring.
29. Briefly explain the components of the Indian Financial System.
30. Give a detailed account of the Major Stock Market Indices.

(2X10=20 marks)

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