Indian Financial System: A Young Entrepreneur’s Dilemmas

Prerequisite Conceptual Understanding


Synopsis of the Case Study

Indian financial system has come of age to feed the rapid growth of the economy with necessary funds. Especially after the 1991 economic reforms, the financial system has broadened and widened, cautious enough not to over stretch. The commercial banks became more proactive in both extending credit and risk management, the financial intermediaries became more participative and the capital markets grew to match their counterparts in developed countries. This case study helps in understanding the nitty-gritty of the Indian financial system and its constituents and achieving the following objectives.

Pedagogical Objectives

- To analyse the role of a financial system in the development of an economy
- To understand various constituents of a country’s financial system and debate on whether and how each of these constituents should work together to have the right influence on the economy
- To understand the rules and regulations that govern the Indian financial markets, along with the steps taken by regulators to ensure stability amidst global financial meltdown.

This teaching note was written by Saradhi Kumar Gonela (Team Leader), IBSCDC and D. Satish (Professor of Finance), IBS, Hyderabad. It is only an illustrative orchestration of the case study ‘Indian Financial System: A Young Entrepreneur’s Dilemmas’. It is never meant to limit the learning outcomes.

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Teaching Plan

Both Teaching note and structured assignment follow a specific teaching plan [Annexure (TN)-I]

Assignment Questions

I. What is a financial system and what are its constituents?
II. What is the importance of financial system in an economy?
III. What are the reasons for the transformation in the economy? Would those reasons aid me also in my business? If yes, how? If no, why not?
IV. What kind of financing difficulties would I find when I start my business now? What are the current trends in the Indian financial markets?
V. How long do I have to wait before the economy turns positive? Which are the institutions responsible for bringing back the economy on track and what are the regulations that govern them? What methods are these institutions taking up to ensure early recovery?
VI. What are the various regulations which my business has to comply with? Under what circumstances my business shall be subjected to each of the regulation?
VII. If I want to start an SME, what procedures would be necessary?
VIII. What is the purpose of having so many financial institutions? How different are they from one another?
IX. What are the different avenues available for raising capital and what would be the ideal way to raise money for my business from these markets?
X. Who are the major intermediaries in Indian capital markets and what are their distinct roles?

I. What is a financial system and what are its constituents?

One way of knowing the economic development of a nation is by examining the financial system of the country. The more matured the financial system, the more developed is the economy. Such is the importance of the financial system, as it acts as a bridge between the surplus owners of funds and the people who are in need of funds.

A financial system facilitates the movement of funds from the areas of surplus to the areas of deficit. A financial system is a composition of various financial institutions (such as banks), markets (such as stock markets), regulatory bodies (such as RBI) and depositors (majorly common public).

Financial Markets

Financial markets are the places where financial assets are created and/or transferred. Financial transactions involve creation of a financial asset, commonly known as financial instruments, and also transfer of the financial asset. Financial instrument is a claim to the payment of a sum of money in the future and/or periodic payment in the form of interest or dividend.

Money Market: The money market is where low-risk, highly liquid, short-term instruments are created and traded. Funds are available in these markets for a single day up to a year. Main participants of this market are mostly government, banks and large financial institutions.
Capital Market: The capital markets finance long-term investments. The instruments created here are high risk and high return instruments. The transactions taking place in this market will be for longer durations, typically more than 2 years.

Forex Market: The Forex market deals with exchange of currencies, at a price (called as exchange rate) determined by the demand and supply of a particular currency. Depending on exchange rate, the transfer of funds takes place in this market. This is one of the most developed and integrated markets across the globe.

Credit Market: In credit markets, all the participants of the financial system – banks, other financial institutions and non-banking financial companies – provide short, medium and long-term loans to corporate and individuals.

Financial Intermediation

Financial interpolation is a process through which exchange of money with financial instruments takes place. In other words, surplus funds reach the deficit parties, and the promise of the deficit party to repay the debt with interest or periodic dividend should reach the debt issuer. In general, the promise will be a legal document, and the possessor of the document would be eligible to claim the repayment on the end of stipulated period, as mentioned in the document. The legal document is called the financial asset. All the institutions that enable this process of exchange of money for financial assets are called financial intermediaries. These intermediaries are closely regulated by the government to ensure the safety of the deposits or the surplus parties. Financial intermediation and all the institutions in the process function under the strict surveillance of the RBI. As the financial system evolved, functions of the financial intermediaries also widened from the initial job of transferring funds.
II. What is the importance of financial system in an economy?

The importance of the financial system in development of an economy is well documented. Banks along with other financial institutions play a key role in resource allocation, by transferring surplus funds from one section of the economy to the other. The transfer of funds will fuel the growth of the economy and in turn economic growth will result in availability of more funds, resulting in complex credit allocation in all sectors – primary, manufacturing and services. To meet the complexities, banks and financial institutions diversify and expand to meet the demands placed on them. Therefore, as economies grow, the financial sector gets more sophisticated and will become broader and deeper, reducing reliance on banks as other financial institutions develop to fulfil specific needs.

Like every other sector, the financial sector also needs competition to drive down costs, increase efficiency and function to the best interests of the economy. As an efficient and competitive financial system lowers spread between deposit and lending rates, cost of capital reduces the prerequisite for higher investments. Competition will also lead to better risk assessment (as efficiencies call for lower NPAs) and with that resources will reach the deserving, thus improving capital productivity of the economy. In addition, on one hand, competition reduces borrowing costs and on the other hand, a broad financial system diversifies financial risk within the economy.

The central role played by the financial sector in the growth and stability of an economy calls for proper, effective and fool-proof regulation. Regulation of the banking system needs to be capitalised, so that the economy as a whole can avoid undue risk. All the other institutions also need to be tightly monitored to ensure that the chieftains of these sensitive institutions will not undertake high-risk bets that can potentially put the whole economy in jeopardy. For instance, the level of Non-Performing Loans (NPLs) needs to be carefully monitored as high proportions of NPLs signify inefficient allocation of resources – depriving resources for more productive economic activities – and poor risk management – endangering the stability of the economy. The system needs to be transparent, so that risks can be properly monitored.

A weak financial sector will seriously undermine the primary objectives of economic policy in two ways. It will generate financial instability which drains business from an economy and will also hamper economic growth by failing to keep pace with the changing needs of the economy by inefficient allocation of resources.

<table>
<thead>
<tr>
<th>Intermediary</th>
<th>Market</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Exchange</td>
<td>Capital Market</td>
<td>Secondary Market to securities</td>
</tr>
<tr>
<td>Investment Bankers securities</td>
<td>Capital Market, Credit Market</td>
<td>Corporate advisory services, Issue of securities</td>
</tr>
<tr>
<td>Underwriters</td>
<td>Capital Market, Money Market</td>
<td>Subscribe to unsubscribed portion of securities</td>
</tr>
<tr>
<td>Registrars, Depositories, Custodians</td>
<td>Capital Market</td>
<td>Issue securities to the investors on behalf of the company and handle share transfer activity</td>
</tr>
<tr>
<td>Primary Dealers/Satellite</td>
<td>Dealers</td>
<td>Money Market Market making in government securities</td>
</tr>
<tr>
<td>Forex Dealers</td>
<td>Forex Market</td>
<td>Ensure exchange ink currencies.</td>
</tr>
</tbody>
</table>
III. What are the reasons for the transformation in the economy? Would those reasons aid me also in my business? If yes, how? If no, why not?

A major liberalisation swept the economy during 1991. Almost overnight, the License Raj was replaced with free markets. Capital markets were liberated from price being determined by regulators to allow the firms to decide their own price. The gusto of the new brand entrepreneurs to operate in the new era coupled with capital market liberalisations let the private sector dictate the new trajectory of economic growth. The investment boom and increase in foreign investment, and the drive of the private sector unleashed the potential of Indian markets. Indian economy, which was notorious as an elephant economy for its sluggish growth, started posting annual growth rates beyond 7.5% or 8% consistently since then.

The dramatic growth was accompanied by growth in both employment and productivity. For the incumbent establishments, due to improvements in productivity, average capital-output ratio rose from below average 0.5 to a remarkable 0.7. Worker productivity rose by almost 30% and wages per worker rose almost as much. The resultant corporate savings and consumer disposable income, lubricated the virtuous cycle of investment, production, consumption and savings cycle, further accelerating economic growth. Profit margins increased significantly, inducing investments, multiplying production and speeding up growth.

The Major Changes in the Economy

1. The public sector’s role declined gradually. Public Sector Enterprise (PSE) was either disposed to private companies (like Modern Food being sold to HLL) or lost market share to private players (like BSNL, SAIL, GAIL, etc., to many private players in respective industry)

2. Small scale enterprises performed spectacularly in the new free arena. They account roughly to 50% of industrial output, 42% of India’s total exports, provide 50% percent of private sector employment, and were responsible for 30% to 40% of value-addition in manufacturing and constitute more than 80% of the total number of industrial enterprises in the country.

3. Growth of competition in all the sectors where foreign entrants or new establishments always pose threat to incumbents and provide choice for the Indian consumer. This not only has resulted in price reduction, but also had a profound positive effect over manufacturing processes and marketing strategies, forcing companies for relentless improvements.

4. Foreign investment has increased in leaps and bounds making India the second favoured destination for FDIs and FIIs. Automatic approval for investment up to 74% was permitted in all except four industries, and 100% subsidiaries were permitted by specific approval. This exposed Indian companies to global best practices. Though, Foreign Institutional Investors contribute for around 10% of total market capitalisation, they account for a disproportionate share of daily trading. Their buying preferences attracted penalty imposition on stock valuations of firms which have group cross-holdings and inadequate disclosures. This in turn fed interest in corporate governance, which otherwise might not have occurred.

5. Not just Indian companies, but Indian consumers are also exposed to foreigners. As imports flooded several industries, particularly electronics and cosmetics, foreign products have become increasingly common.

6. Exports have become major revenue earners for a growing number of Indian firms, and account for the major share of sales in software, pharmaceuticals, apparels and leather products.

7. Another major change in the economy is the emergence of new sectors like the IT and ITES. The IT industry has in no time became the single largest industry by stock market valuations, accounting for over a fourth of total stock market capitalisation.
8. While new sectors emerged, some old sectors regenerated themselves in the free market era. Automobile, pharmaceuticals, insurance, telecommunications, finance and banking, among many others have witnessed a phenomenal growth.

9. Restructuring of several industry sectors was almost enforced. Earlier, licensing led to fragmented capacity in many industries with legions of small players. The market place was too crowded for any company to attain economies of scale. That changed with the easing of regulations and entry of foreign players. The cement industry has consolidated beyond recognition, with the entry of two major foreign groups (Lafarge and Blue Circle), and the acquisition of small players by Indian firms to increase market share and to escape the threat of acquisitions. Same can be said about apparel, chemical, plastics and many such industries.

IV. What kind of financing difficulties would I find when I start my business now? What are the current trends in the Indian financial markets?

Though Indian economy is posting robust growth rates, global recession will certainly have some effects on the Indian economy. Like in any other economy, and any crisis time, business confidence is at dismal levels. This is severely affecting credit availability and money movement. This can be seen from the fact that, while repo rate and bank rate are at lower levels, PLR of many banks is much higher, and PLR of private banks is still higher.

Under these conditions credit availability for new ventures could be quite difficult, if not impossible. Even if some banks or any other lending institutions come forward to provide credit, cost of capital will be too high for a novice entrepreneur. May not be prohibitive, though. Indian retail markets provide ample evidence for credit crunch. Many of the big retail companies have either abandoned their expansion plans or have postponed. Same is the case with many other sectors like cement, banking, consumer electronics, etc.

The possibility of raising capital from an IPO is almost nonexistent. In the times when many established companies have rolled back their plans of going for IPO, finding takers for a rookie is out of question. This leaves with the option of private placement or venture capital – neither of which are matured enough in India.

V. How long do I have to wait before the economy turns positive? Which are the institutions responsible for bringing back the economy on track and what are the regulations that govern them? What methods are these institutions taking up to ensure early recovery?

In the current economic scenario nothing seems to have more takers than speculation, for every economist, observer, analyst and everyone else is coming up with a prediction as to when the economy would turn positive. Most of them, however, feel that the recession would last a year and half or two. The Indian Government, through RBI is leaving no stone unturned to evade recessionary impact on the economy. RBI is vigilant over the economic developments and has been adjusting (read decreasing) interest rates continually for about 6 months now. In a bid to provide relief from credit crunch, the RBI brought REPO rates down to 3.25% from a high of 7.5% during second quarter of 2008–2009 fiscal. While in the United States, Federal Reserve, Treasury Department and the Federal Deposit Insurance Corporation (FDIC), together with the key decisions from the President, in India, RBI is the whole and sole executor that works under the directives of Ministry of Finance.

The RBI, exercising its prerogative of liquidity management in a credit starved economy, has been reducing interest rates continuously. This has eased the credit pressure to a great extent, especially to the working class population that contributes to most of the consumer demand. Reduction in repo rates enabled the SBI,
largest commercial bank in India, to reduce its interest rates on consumer loans. Soon all the other banks followed suit. For instance, interest rates on home loans reduced to 8% by February 2009, from a high of 14% in October 2008. The reduction in interest rates provided the much needed impetus to consumer demand by improving disposable income of the working class. This in turn helped many sectors to stay afloat under difficult conditions.

On the policy front, the RBI has used its authority to provide breather for businesses. It has amended FDI rules and got almost all sectors in the automatic clearance arena from earlier tight regulations, enabling domestic business to raise capital in foreign lands. The RBI also altered accounting rules for banks, especially rules related to accounting NPAs. This reduced the risk exposure of banks, easing their monetary and liquidity positions to provide more loans to consumers and businesses. In this regard, the definition of NPA was also slightly altered. Likewise, to save the reeling reality sector, RBI gave it a special preferential status, that allowed banks to restructure loans to realty companies and also extend additional loans.

In a bid to curb the free fall of rupee in the Forex markets, RBI intervened by selling dollars. Selling dollars for rupees improved the demand of rupee in the Forex markets and value of rupee improved. With the collapse of stock markets across the globe, FII pulled out their investments from Indian stock markets to the tune of tens of billions of dollars in a span of few months, thus, exerting tremendous pressure on the rupee. For sometime, rupee was on free fall and reached historical lows against dollar. The immediate effect was on the Indian corporate houses, which faced sever losses due to currency fluctuations. RBI intervention helped the corporate sector to come back on track.

However, the most important step from RBI in the times of crisis was in the direction of averting the US-like mortgage crisis in India. RBI set tighter regulations for mortgage houses and related financial institutions in terms of securitisation of home mortgages. This interventions of RBI in interest rates, accounting rules, lending policies, Forex manipulations and mortgage regulations proves that the central bank has control over the whole gamut of financial system in the country.

VI. What are the various regulations which my business has to comply with? Under what circumstances my business shall be subjected to each of the regulation?

1. Private/Public/Limited Liability/Unlimited Liability

The Companies Act of 1956 regulates both public and private companies in India. A company, public or private, can have limited or unlimited liability. In a limited liability company, the personal liability of the floating members is limited to the amount equivalent to their shares in business or to the extent of predetermined amount, also called guarantee. All the public limited companies come under this category. In an unlimited liability company, as the name suggests, the liability of its members is unlimited. Sole proprietorship companies and in some cases, partnership companies fall into this category.

All the companies have to register with the Registrar of Companies (RoC), the Department of Company Affairs and the Company Law Board (CLB).

Private and Public Companies

The Department of Company Affairs, with the assistance from both the RoC and the CLB, ensures compliance of each company with the Companies Act.

1. Private Companies

Private companies are defined under the Act as those companies for which the number of shareholders or members is limited to between two and 50; the right to transfer shares – among members and also with outsiders – is restricted; and the shares and debentures are not offered to the public.
While the private companies are restricted, they also are entitled to many benefits and privileges under the Act, such as:

- No compulsion on holding statutory meetings and sending reports to shareholders and the ROC
- No obligatory appointment of directors, also no limitations on compensation offered to management personnel
- No restrictions on offering loans to other companies and management personnel
- No restrictions on investments in other companies and
- No obligation on declaring results from operations.

In certain circumstances, however, a private company may be deemed to be a public company:

- When 25% or more of the company’s capital is held by one or more public companies
- When a private company owns 25% or more share capital of a public company
- When a private company accepts deposits from the public
- When a private company’s average annual turnover exceeds INR 10 crore (INR 100 million) during three consecutive financial years.

2. Public Companies

Public companies are those companies that have a minimum of seven members or shareholders and whose shares are listed on any of the Indian stock exchanges. Unlike private companies, public companies are restricted by the Act as they have public deposits in exchange of share in the company. Of numerous provisions that the public companies have to comply with, the following are some major and important ones:

- The company is restricted from giving financial assistance to subscribe its own shares
- The amount of compensation offered to management personnel is limited to 11% of the net profit of the company during the financial year
- Though the board of directors is the ultimate decision making body of a public company, their authority is severely restricted by company law
- The company shall not advance any loans to the directors without prior approval from the authorities concerned at SEBI and other regulators
- The company cannot act independent in the future issue of share capital, it has to comply with SEBI regulations
- The usage of share capital and share premium is highly restricted and
- Declaring results regularly is coercive on public companies.

3. Joint Ventures

Joint ventures are generally used by foreign companies for investing in India. However, though less in number, even Indian companies follow this method of starting a company. A foreign company interested in establishing a joint venture must comply with the following:

- Achieve in principal approval for the investment, either through the Foreign Investment Promotion Board (FIPB) or the Reserve Bank of India (RBI)
- Register with the ROC
• Register a joint venture agreement and
• Get a formal approval from the RBI for acquiring equity contribution.

After this the company can open a bank account for the foreign equity. This foreign equity shall be converted into share capital after final formalities.

Joint ventures may take three forms: green field projects, takeovers and strategic alliances.

**Green Field Projects**

When a joint venture company is formed by 51% foreign equity for establishing new manufacturing facilities with new machinery, it is called a green field project. Remaining 49% may be held by an Indian company, a financial institution, or issued to public through Indian stock exchanges. In high-priority sectors, the Indian government is encouraging more foreign investment. For example, in the power sector, 100% foreign ownership is allowed. The list of high-priority industries allowing not only greater amounts of foreign investment but also repatriation of capital invested and income accruing in India can be found in Annexure III to the Industrial Policy Act of 1991.

**Takeovers and Strategic Alliances**

These forms of joint ventures occur with existing Indian companies in a niche market. For example, in the technology sector, many joint ventures have been formed in order to take advantage of India’s well-educated and expanding labour base and abundant raw materials.

**Process of Incorporating a Company in India**

In order to incorporate a company in India, the first step is to register with the RoC. This registration process consists of two-part important aspects: (1) name approval from RoC; and (2) documentation and fees to the RoC.

**Name Approval**

The company should receive the name approval from the regional wing of the RoC, under which the company intends to establish its registered office. Name of the company has to meet certain criteria to get approved, like it should not have been already registered, should not be a noun of national importance (names of national leaders, monuments, etc), should not be against the beliefs of a group of people and should not be derogatory in general, among many other restrictions. In addition, a private limited company’s name must end with ‘Private Ltd.’ and a public limited company’s name must end with ‘Limited’.

Documents necessary for a company to be incorporates include, but not limited to, the following:

• Memorandum of association, which sets forth the objects and parameters of the company’s mission and activity. In India, it is relatively difficult to amend the objects clause of the memorandum; any proposed amendments have to be approved by the Company Law Board. Therefore, one will find that the memorandum usually has myriad objects, many of which are never pursued or implemented, in order that the company will never be found to be acting against them.

• Articles of association, which contain the rules and regulations for managing the company and achieving its goals and objectives. These include any restrictions on transferring a company’s share capital. A private company must file its articles, although this is optional for a public company. If a public company does not file its own articles, a model set incorporated in the Act is applied to the company

• Registration fee, which is scaled according to the share capital of the company, as stated in the memorandum of association.

Once the RoC certifies incorporation, upon ratification of all the documents, a private company can begin conducting business once it receives its certification of incorporation. A public company, however, needs to file its prospectus with the RoC if it wishes an IPO for raising share capital. If the public company decides to
obtain its capital through private equity, the company may file a ‘statement in lieu of prospectus’ with the RoC. On the fulfilment of these preliminary obligations, RoC will issue the certificate of commencement of business.

VII. If I want to start an SME, what procedures would be necessary?

The Indian government insists the following approvals before a company starts operations:

<table>
<thead>
<tr>
<th>Approvals/Clearances Required</th>
<th>Department to be Approached and Consulted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incorporation of Company</td>
<td>Registrar of Companies</td>
</tr>
<tr>
<td>Registration/IEM/Industrial License</td>
<td>DIC for SSI/SIA for Large and Medium Industries</td>
</tr>
<tr>
<td>Allotment of Land</td>
<td>State DI/SIDC/Infrastructure Corporation/SSIDC</td>
</tr>
<tr>
<td>Permission for Land Use (in case industry is located outside an industrial area)</td>
<td>a. State DI</td>
</tr>
<tr>
<td></td>
<td>b. Dept. of Town and Country Planning</td>
</tr>
<tr>
<td></td>
<td>c. Local Authority/Distt. Collector</td>
</tr>
<tr>
<td>NOC and Consent under Water and Air Pollution</td>
<td>State Pollution Control Board</td>
</tr>
<tr>
<td>Control Acts</td>
<td></td>
</tr>
<tr>
<td>Approval of Construction Activity and Building Plan</td>
<td>a. Town and country planning</td>
</tr>
<tr>
<td></td>
<td>b. Municipal and local authorities</td>
</tr>
<tr>
<td></td>
<td>c. Chief Inspector of Factories</td>
</tr>
<tr>
<td></td>
<td>d. Pollution Control Board</td>
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<tr>
<td></td>
<td>Electricity Board</td>
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<tr>
<td>Sanction of Power</td>
<td>State Electricity Board</td>
</tr>
<tr>
<td>Use and Storage of Explosives</td>
<td>Chief Controller of Explosives</td>
</tr>
<tr>
<td>Use and Storage of explosives</td>
<td>Chief Controller of Explosives</td>
</tr>
<tr>
<td>Boiler Inspection Certificate Finance</td>
<td>Chief Inspector of Boilers</td>
</tr>
<tr>
<td></td>
<td>a. SFC/SIDC for term loans</td>
</tr>
<tr>
<td></td>
<td>b. For loans higher than INR 15 Million, all India Financial institutions like IDBI, ICICI, IFCI, etc.</td>
</tr>
<tr>
<td>Registration under States</td>
<td>a. Sales Tax Department</td>
</tr>
<tr>
<td></td>
<td>b. Central and State Excise Departments.</td>
</tr>
<tr>
<td>Sales Tax Act, and Central and State Excise Act</td>
<td></td>
</tr>
<tr>
<td>Extraction of Minerals</td>
<td>State Director of Mines and Geology</td>
</tr>
<tr>
<td>ISI Certificate</td>
<td>Regional Office of the Bureau of Indian Standards (BIS)</td>
</tr>
<tr>
<td>Quality Marking Certificate</td>
<td>Quality Marking Centre of the State Government</td>
</tr>
<tr>
<td>Weights and Measures</td>
<td>Inspector of Weights and Measures</td>
</tr>
<tr>
<td>Code Number for Export and Import</td>
<td>Regional Office of Director General of Foreign Trade.</td>
</tr>
</tbody>
</table>
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SIDC : State Industrial Development Corporation
SSI : Small Scale Industries
SIA : Secretariat of Industrial Assistance
SSIDC : Small Scale Industrial Development Corporation
SFC : State Financial Corporation
DIC : District Industry Centre
GOI : Government of India
IDBI : Industrial Development Bank of India
ICICI : Industrial Credit and Investment Corporation of India
IFCI : Industrial Finance Corporation of India

**Business Registration Procedures**

1. Company Formation
2. Start
3. Obtaining approval for the proposed name of the Company from the ROC
4. Drawing up the Memorandum of Association
5. Drawing up the Articles of Association
6. Getting the appropriate persons to subscribe to the Memorandum (a minimum of 7 for a public company and 2 for a private company)
7. Payment of Registration Fee to the ROC
8. Receipt of Certificate of Incorporation
9. Obtain a certificate of commencement of business from the ROC in case of a public company

VIII. What is the purpose of having so many financial institutions? How different are they from one another?

<table>
<thead>
<tr>
<th>Institution</th>
<th>Examples</th>
<th>Roles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>SBI, HDFC, ICICI, etc.</td>
<td>Receiving Deposits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>i. Current Account or Demand Deposits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ii. Saving Account</td>
</tr>
<tr>
<td></td>
<td></td>
<td>iii. Fixed Deposit</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Advancing Loans</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td>i. Extending Loans</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ii. Bank Overdraft</td>
</tr>
</tbody>
</table>

Contd...
### Specialised Institutions

<table>
<thead>
<tr>
<th>Institution(s)</th>
<th>Functions</th>
</tr>
</thead>
</table>
| NHB, EXIM, NABARD, ECGC | iii. Cash Credit  
iv. Discounting of Bills. |

### Credit Functions

<table>
<thead>
<tr>
<th>No.</th>
<th>Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>Framing policy and guidelines for financial institutions</td>
</tr>
<tr>
<td>II.</td>
<td>Providing credit facilities to issuing organisations</td>
</tr>
<tr>
<td>III.</td>
<td>Preparation of potential-linked credit plans annually for all districts for identification of credit potential</td>
</tr>
<tr>
<td>IV.</td>
<td>Monitoring the flow of ground level rural credit.</td>
</tr>
</tbody>
</table>

### Developmental and Promotional Functions

<table>
<thead>
<tr>
<th>No.</th>
<th>Function</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>Help cooperative banks and Regional Rural Banks to prepare development action plans for themselves</td>
</tr>
<tr>
<td>II.</td>
<td>Enter into MoU with state governments and cooperative banks specifying their respective obligations to improve the affairs of the banks in a stipulated timeframe</td>
</tr>
<tr>
<td>III.</td>
<td>Help Regional Rural Banks and the sponsor banks to enter into MoUs specifying their respective obligations to improve the affairs of the Regional Rural Banks in a stipulated timeframe</td>
</tr>
<tr>
<td>IV.</td>
<td>Monitor implementation of development action plans of banks and fulfilment of obligations under MoUs.</td>
</tr>
</tbody>
</table>

### Development Financial Institutions

<table>
<thead>
<tr>
<th>Institution(s)</th>
<th>Functions</th>
</tr>
</thead>
</table>
| All India - IFCLIIBI  
State level: SIDBI, SFC | I. Administration of SIDF and NEF for development and equity support to small and tiny industry  
II. Providing working capital through single window scheme  
III. Providing refinance support to banks/development finance institutions  
IV. Undertaking direct financing of SSI units  
V. Coordination of functions of various institutions engaged in finance to SSI and tiny units  
VI. Direct financial support (by way of rupee term loans as well as foreign currency loans) to industrial units for undertaking new projects, expansion, modernisation, diversification, etc.  
VII. Subscription and underwriting of public issues of shares and debentures  
VIII. Guaranteeing of foreign currency loans and also deferred payment guarantees  
IX. Merchant banking, leasing and equipment finance |

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IX. What are the different avenues available for raising capital and what would be the ideal way to raise money for my business from these markets?

Any company has two broad avenues for raising capital (apart from normal bank loans): money markets and capital markets.

- **Money Market**: The money market is a wholesale debt market for low-risk, highly-liquid, short-term instruments. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

- **Capital Market**: The capital market is aimed at financing the long-term investments. The transactions taking place in this market will be for periods over a year. Capital market is dominated by the stock markets.

Indian stock markets are regulated by Securities and Exchange Board of India (SEBI). Established in 1989, SEBI is governed by the representatives of Ministries of Finance and Law, the RBI, who are appointees by the central government. This body forms the ultimate governing body of Indian stock markets, which in turn act in accordance with The Securities and Exchange Board of India Act, 1992 (the SEBI Act, 1992) and further amendments to the Act in 1995, 1999 and 2002. The Act established the Board functions to protect the interests of investors in securities, works towards promoting, developing and regulating the securities market and involves in all matters connected to securities. The mission of SEBI is to make India as one of the best securities market of the world and SEBI as one of the most respected regulators in the world. SEBI also endeavours to achieve the standards of IOSCO/FSAP.

The Indian stock markets provide two prime means of raising capital: through issue of shares, called as share capital and through issue of debentures, called debenture capital.

**Share Capital**

Two kinds of share capital were permitted by the 1992 Act: preference share capital (preferred stock) or equity share capital (common stock). A third type of stock was recognised by the Companies (Amendment) Act of 1999, called sweat equity shares. These are issued by a company at a discount or without any monetary payment, in recognition to the contribution of a person or entity, in any form, for the respective company.

The percentages of shares held by a person (or entity) are of a greater significance, as they decide the voting rights and thereby the participation of the holder in the activities of the company. For example, only (and only) those holding higher than 50% of shares of a company are eligible to pass an ordinary resolution concerning the adoption of annual accounts, capital structure of the company, the appointment of auditors and the appointment of directors. Put simply the holders of 51% shares can technically act as the owners of the company. Only those persons holding greater than 75% of shares of company can pass a special resolution, such as a resolution changing the memorandum and articles of association of the company, i.e., holders of 76% can change the basic structure of the company.

**Debentures**

Under SEBI’s guidelines, a company can issue debentures to raise long term capital. The basic difference between the shares and debentures is, as names suggest, that the shareholders own a part of the company (equal to the percent of shares owned), while debenture holders are mere debtors to the company and not owners. The most common types of debentures are Fully Convertible Debentures (FCD), NonConvertible Debentures (NCD), and Partly Convertible Debentures (PCD). Convertibility here means the provision of converting debentures into shares after a stipulated period of time, as is mentioned at the time of announcement of debentures.
Apart from share and debentures, alternate ways to raise funds are:

**Corporate Bond:** Corporate Bonds are issued normally up to 15 years although some companies have also issued perpetual bonds. In India, an investor can invest in corporate bonds from a minimum of INR 10 lakh (face value, INR 1 million) only. Compared to government bonds, corporate bonds possess a higher risk of default, due to highly volatile company, market, industry and economic conditions. Thus, to compensate the high risk, corporate bond receive higher yield compared to government bonds. Corporate bonds also offer higher returns than government securities, fixed deposits and commercial papers (CP’s). Risk of the corporate bonds is assessed by rating agencies (for example, CARE, ICRA, CRISIL, FITCH) and give an appropriate rating for the bonds. Some corporate bonds have an embedded call option that allows the issuer to redeem the debt before its maturity date. Other bonds, known as convertible bonds, allow investors to convert the bond into equity.

**Commercial Papers**

Commercial Papers (CPs) are promissory notes with fixed maturity, issued by companies to accumulate short-term finance as an alternative to the bank loans. Companies prefer CPs when interest rate on working capital, charged by banks, is higher compared to cost on CPs. The maturity period of CPs ranges from 7 days to 1 year and are normally issued in denomination of INR 5 lakh (face value, INR 0.5 million) or multiples thereof.

**Bills of Exchange**

These are generally used to facilitate funding trade transactions and therefore are short-term (between 1 to 6 months) with low face value. Depending on the repayment period and the documents attached, these bills of exchange are classified into different types.

**Inter Corporate Investments/Deposits (ICDs)**

Another usual funding method for short-term capital requirement is the Inter Corporate Deposit (ICD) markets. They carry higher interest rates than the alternative short-term sources as they carry higher risk.

**X. Who are the major intermediaries in Indian capital markets and what are their distinct roles?**

The role of intermediaries enables smooth functioning of the capital and money markets; they are service providers and thus an integral part of the markets. Intermediaries are professional experts to carry out all the required legalities necessary for financial transactions between lenders and borrowers. Additionally, they also undertake promotional role in organising a perfect match between the supply and demand for capital in the market. Thus, a hoard of financial institutions – a commercial bank, an insurance company, a mutual fund, stock exchange or depository are as much intermediaries, as a broker, a merchant banker, a Registrar, etc.

All the intermediaries in the primary and secondary markets are controlled by SEBI. SEBI’s regulations have defined the role of each of the intermediary, the eligibility criteria for granting registration, their functions and responsibilities and the code of conduct. SEBI is also entitled to inspect the functioning of these intermediaries and impose penalties.

**Primary Market Intermediaries**

**Merchant Bankers**

According to SEBI: ‘Merchant Banker’ means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management.
Merchant bankers play an important role in issue management process as they need to provide appropriate data for the investors to make a well informed decision. To meet this end, they have to ensure compliance with SEBI’s rules and regulations and ‘Guidelines for Disclosures and Investor Protection’. As a proof of this compliance, they have to submit due diligence certificate to SEBI, confirming that the disclosures made in the draft prospectus or letter of offer are true and fair. SEBI issued various operational guidelines regularly to merchant bankers compelling their due diligence functions.

Registrars to an Issue and Share Transfer Agents

Registrars to an Issue (RTI) and Share Transfer Agents (STA) are regulated under SEBI (Registrar to an Issue and Share Transfer Agent) Rules and Regulations, 1993. Under these regulations, registration is granted under two categories: Category I enables registration for both as registrar and share transfer agent to an issue and Category II for registration either as registrar to an issue or share transfer agent. By SEBI orders, all RTIs and/or STAs have to appoint compliance officers to ensure compliance with all rules, regulations, guidelines and directions issues by SEBI, the government and other regulatory authorities.

Bankers to an Issue

SEBI regulates the bankers to an issue, which by default, in India are scheduled banks. These scheduled banks have to be registered with SEBI under SEBI (Bankers to an Issue) Rules and Regulations, 1994. The bankers to an issue are required to comply with all the regulations and guidelines issued by SEBI and present quarterly reports of their activities.

Debenture Trustees

Debenture trustees are registered with SEBI under SEBI (Debenture Trustees) Rules and Regulations, 1993. Debenture trustees are required to submit their details regarding compliance with the debenture trust deed, creation of security, payment of interest, redemption of debentures and redressal of complaints of debenture holders regarding non-receipt of interest/redemption proceeds on due dates.

Underwriters

SEBI governs all the underwriters under SEBI (Underwriters) Rules and Regulations, 1993. In addition to underwriters registered with SEBI in terms of these regulations, all registered merchant bankers in categories I, II and III and stockbrokers and mutual funds registered with SEBI can function as underwriters.

Portfolio managers

Like all the intermediaries, even portfolio managers are required to register with SEBI. In addition to them, the Category I and II merchant bankers are also authorised to undertake the activities of portfolio managers, however, the registered portfolio managers are not authorised to carry any other activity.

Secondary Market Intermediaries

Stock Brokers and Sub Brokers

All the brokers dealing in securities are to register with SEBI under the SEBI (Stock Brokers and Sub Brokers) Regulation Act 1992. In many cases, individual investors transact in securities through sub brokers.

Big Picture

No matter how intelligent one is or how deep is one’s product knowledge, success either as a finance manager of a company or portfolio/fund manager depends to a great extent on the macro-environment in which the company is operating or would be operating. Either ignorance or under reading of the macro-environment would only jeopardise any brilliant financial analysis that is carried out.

Final Thoughts

Having explained the nuances of the financial system and the importance of it in the growth of the economy, the platform is now set to get into the details of various issues of financial management. The class is better placed to appreciate the working of various financial instruments and the purpose of each of the institution.
<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Analysis Section</th>
<th>Expected Learning Objectives</th>
<th>Forward Linkage</th>
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</table>
| 1      | Role of a Financial System and the Macro Environment | • Promising economic stability in the economy  
• Providing enough financial infrastructure and confidence to the existing as well as prospective investors  
• Enable savings and investments  
• A mechanism to mobilise funds from surplus pockets of the economy to deficit pockets  
• Capital and money markets. | Constituents of financial system | 20 |
| 2      | Constituents of Financial System | • Banks  
• Stock exchanges  
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• Financial intermediaries. | Rules and regulations that govern the Indian financial markets | 20 |
| 3      | Rules and Regulations that Govern the Indian Financial Markets | • SEBI Act  
• RBI Act  
• Banking Regulation Act  
• Companies Act  
• MRTP Act  
• FEMA Act  
• Market Intermediaries. | | 40 |
### Pedagogical Objectives

**To analyse the role of a financial system in the development of an economy**

**Classroom Deliverables**

Using the slides provided in the case study, the faculty will link up the constituents of the financial system and their respective roles to make the class delve into:

- Setting up the macroeconomic environment for the financial markets, including providing an historical perspective on the evolution of Indian financial markets
- The ease and reach (in terms of the depth of and width of financial instruments) of raising funds in an economy
- The overall regulatory architecture governing the functioning of the Indian financial system
- The mechanism through which savings are converted into investments.

**To understand various constituents of a country’s financial system and debate on whether and how each of these constituents should work together to have the right influence on the economy**

**Classroom Deliverables**

After having established the role of a financial system for the overall economic development of a country, the faculty using the questions raised by Mr. Subodh (and in the backdrop of the relevant slides) should focus on:

- Various constituents of a financial system
- What is the distinct role of each of the constituent and should establish the intermittent/connecting points between these constituents

**To understand the rules and regulations that govern the Indian financial markets, along with the steps taken by regulators to ensure stability amidst global financial meltdown.**

**Classroom Deliverables**

When the whole world was crumbling under the current economic melt down, few spots were shining bright with promising growth. India is one of them. And why? The regulators have taken enough precautions in framing the rules and regulations that govern the financial system. Not just the rules, even they have acted precisely at the needy hour to avert ruthless recession that bulldozed many a developing economy. This section deals with the rules that govern the financial system and the measures taken by the central bank to avert the impact of financial crisis.

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